Fear and greed are the stuff that Wall Street is made of. But inside the great banking houses, those high temples of capitalism, fear came to the fore this weekend.

As Lehman Brothers, one of oldest names on Wall Street, filed for bankruptcy protection, anxiety over the bank’s fate — and over what might happen next — gripped the nation’s financial industry. By Sunday night, Merrill Lynch, under mounting pressure, had reached a deal to sell itself to Bank of America for $29 a share or about $50 billion, according to people with knowledge of the deal.

Dinner parties were canceled. Weekend getaways were postponed. All of Wall Street, it seemed, was on high alert.

In skyscrapers across Manhattan, banking executives were holed up inside their headquarters, within cocoons of soft rugs and wood-paneled walls, desperately trying to assess their company’s exposure to the stricken Lehman. It was, by all accounts, a day unlike anything Wall Street had ever seen.

In the financial district, bond traders, anxious about how the markets would react on Monday, sought refuge in ultrasafe Treasury bills. Greenwich, Conn., that leafy realm of hedge fund millionaires and corporate chieftains, felt like a ghost town. Greenwich Avenue, which usually bustles on Sundays, was eerily quiet.

A year into the financial crisis, few dreamed that the situation would spiral down so far, so fast. Only a week ago, the Bush administration took control of Fannie Mae and Freddie Mac, the nation’s two largest mortgage finance companies. Then, before anyone could sigh a breath of relief after that crisis, Lehman was on the brink.

As details of Lehman’s plight began to trickle out on Sunday, the worries deepened that big financial companies might topple like dominoes. Bank of America began discussions to buy Merrill Lynch, the nation’s largest brokerage.

“I spent last weekend watching Fannie and Freddie die. This weekend it was Lehman,” said one longtime Wall Street executive.

By late Sunday, a consortium of banks, working with government officials, announced a $70 billion pool of funds to lend to troubled financial companies.

The rat-a-tat-tat of bad news has frayed nerves up and down Wall Street. “People are just weary,” said another executive. And even more ill tidings loom. Thousands of employees at Lehman are likely to be laid off, casting them into one of the worst Wall Street job markets in years. Other banks are cutting back, too.
Even employees who manage to hold on are likely to make a lot less money this year. Bonuses are not only going to decrease; for many, they will evaporate completely.

While people were stunned by the near collapse of Bear Stearns in March, they were flabbergasted that Lehman, a respected firm with a 158-year history, could be brought to its knees. Many were equally shocked by the downfall of Richard S. Fuld Jr., Lehman’s chairman and chief executive.

“Everyone thought Bear Stearns was a bunch of cowboys; it made sense what happened,” said another executive. “But this is the great Dick Fuld. This is not supposed to happen to Lehman Brothers.”

Many Wall Street executives struggled to draw parallels to the current crisis. The collapse of the junk bond powerhouse Drexel Burnham Lambert in 1991 seems small by comparison, as does the 1998 failure of the big hedge fund Long Term Capital Management.

On Sunday, as the heads of major Wall Street banks huddled for a third day of emergency meetings at the Federal Reserve Bank of New York, many rank-and-file employees were at work in their offices.

“It’s all hands on deck,” said one senior banker.

At hedge funds, analysts worried that investors would rush to withdraw their money.

As a precaution, Wall Street banks have taken the extraordinary step of hiring advisers to assess the impact of the possible bankruptcies of other big financial institutions.

The mood could darken even further this week as several big Wall Street banks report what are expected to be grim quarterly results.

The problems the industry faces are myriad. Mortgage assets that both commercial and investment banks hold on their balance sheets continue to decline in value as potential buyers wait for prices to fall even further and sellers balk at prices being offered. At the same time, revenues from bread and butter Wall Street businesses like debt and equity underwriting and proprietary trading are sliding in a softening economy at home and abroad.

“I have not seen a quarter like this since 2001,” said Meredith Whitney, analyst at Oppenheimer. “And the expense bases at the banks are still built for 2006-style revenues. So the clash of these two things is going to produce the kind of quarter we have not seen in some time.”

Some thought that Merrill Lynch’s sale of $30.6 billion worth of mortgage-related securities in July to the private equity group Lone Star for $6.7 billion (75 percent of which was provided as a loan by Merrill) would unleash a torrent of similar sales. That has not happened.

Big investment groups like Pacific Investment Management Company have put together “vulture” funds worth at least $70 billion to buy distressed assets. So far, not many sales have happened amid a buyer’s strike.

Part of the fear gripping Wall Street is the “who’s next” game. After the collapse of Bear Stearns it was Lehman. After Lehman, many worry about who might be next.
Those who bet on a rebound in financials are getting clobbered. In March, O'Shaughnessy Asset Management, a $9 billion quantitative money management group, started investing in financials and the group continues to add to its portfolio. “We’re patient and we keep buying,” said Jim O'Shaughnessy, chairman and chief executive of the firm.

Mr. O'Shaughnessy created a proxy index of financials to test the performance of previous financial stock routs and recoveries dating back to 1964. The average return for the 20 worst 12 month periods was -34.96 percent. In the last year, through June 30, his proxy index was down 31 percent.

But Mr. O'Shaughnessy is betting on the rally.

In the subsequent one- and three-year periods after those drastic declines, his index rose an average 30.5 percent and an annualized 19.7 percent. “Financials falling out of bed has happened in the past,” he said. “I’m interested in what happens after they crash and burn.”

That strategy has not yet panned out this year. The O'Shaughnessy Dividend fund, which heavily invests in financials, is down 17.2 percent through July 30 compared with a 15.2 percent drop in the Russell 1000 value index. The three-year compounded return through July 30 is 6.5 percent, compared with 2.4 percent for the Russell 1000.

By contrast, hedge funds that continue to short financials (betting their prices will fall) are still performing well. Goshen Investments, a $200 million fund seeded by Tiger Management, is up 35 percent through the end of August, according to one investor. The fund has large short positions in American brokerage firms, European banks and American exchanges. Christopher Burn, founder of the fund, declined to comment.