

# How AIG's Collapse Began a Global Run on the Banks

By Porter Stansberry

October 4, 2008

Something very strange is happening in the financial markets. And I can show you what it is and what it means...

If September didn't give you enough to worry about, consider what will happen to real estate prices as unemployment grows steadily over the next several months. As bad as things are now, they'll get much worse.

They'll get worse for the obvious reason: because more people will default on their mortgages. But they'll also remain depressed for far longer than anyone expects, for a reason most people will never understand.

**What follows is one of the real secrets to September's stock market collapse. Once you understand what really happened last month, the events to come will be much clearer to you...**

Every great bull market has similar characteristics. The speculation must – at the beginning – start with a reasonably good idea. Using long-term mortgages to pay for homes is a good idea, with a few important caveats.

Some of these limitations are obvious to any intelligent observer... like the need for a substantial down payment, the verification of income, an independent appraisal, etc. But human nature dictates that, given enough time and the right incentives, any endeavor will be corrupted. This is one of the two critical elements of a bubble. What was once a good idea becomes a farce. You already know all the stories of how this happened in the housing market, where loans were eventually given without fixed rates, without income verification, without down payments, and without legitimate appraisals.

As bad as these practices were, they would not have created a global financial panic without the second, more critical element. For things to get really out of control, the farce must evolve further... into fraud.

And this is where AIG comes into the story.

Around the world, banks must comply with what are known as Basel II regulations. These regulations determine how much capital a bank must maintain in reserve. The rules are based on the quality of the bank's loan book. The riskier the loans a bank owns, the more capital it must keep in reserve. Bank managers naturally seek to employ as much leverage as they can, especially when interest rates are low, to maximize profits. AIG appeared to offer banks a way to get around the Basel rules, via unregulated insurance contracts, known as credit default swaps.

Here's how it worked: Say you're a major European bank... You have a surplus of deposits, because in Europe people actually still bother to save money. You're looking for something to maximize the spread between what you must pay for deposits and what you're able to earn lending. You want it to be safe and reliable, but also pay the highest possible annual interest. You know you could buy a

portfolio of high-yielding subprime mortgages. But doing so will limit the amount of leverage you can employ, which will limit returns.

So rather than rule out having any high-yielding securities in your portfolio, you simply call up the friendly AIG broker you met at a conference in London last year.

"What would it cost me to insure this subprime security?" you inquire. The broker, who is selling a five-year policy (but who will be paid a bonus annually), says, "Not too much." After all, the historical loss rates on American mortgages is close to zilch.

Using incredibly sophisticated computer models, he agrees to guarantee the subprime security you're buying against default for five years for say, 2% of face value.

Although AIG's credit default swaps were really insurance contracts, they weren't regulated. That meant AIG didn't have to put up any capital as collateral on its swaps, as long as it maintained a triple-A credit rating. There was no real capital cost to selling these swaps; there was no limit. And thanks to what's called "mark-to-market" accounting, AIG could book the profit from a five-year credit default swap as soon as the contract was sold, based on the *expected* default rate.

Whatever the computer said AIG was likely to make on the deal, the accountants would write down as actual profit. The broker who sold the swap would be paid a bonus at the end of the first year – long before the actual profit on the contract was made.

With this structure in place, the European bank was able to assure its regulators it was holding only triple-A credits, instead of a bunch of subprime "toxic waste." The bank could leverage itself to the full extent allowable under Basel II. AIG could book hundreds of millions in "profit" each year, without having to pony up billions in collateral.

It was a fraud. AIG never any capital to back up the insurance it sold. And the profits it booked never materialized. The default rate on mortgage securities underwritten in 2005, 2006, and 2007 turned out to be *multiples* higher than expected. And they continue to increase. In some cases, the securities the banks claimed were triple A have ended up being worth less than \$0.15 on the dollar.

Even so, it all worked for years. Banks leveraged deposits to the hilt. Wall Street packaged and sold dumb mortgages as securities. And AIG sold credit default swaps without bothering to collateralize the risk. An enormous amount of capital was created out of thin air and tossed into global real estate markets.

On September 15, all of the major credit-rating agencies downgraded AIG – the world's largest insurance company. At issue were the soaring losses in its credit default swaps. The first big writeoff came in the fourth quarter of 2007, when AIG reported an \$11 billion charge. It was able to raise capital once, to repair the damage. But the losses kept growing. The moment the downgrade came, AIG was forced to come up with tens of billions of additional collateral, immediately. This was on top of the billions it owed to its trading partners. It didn't have the money. The world's largest insurance company was bankrupt.

The dominoes fell over immediately. Lehman Brothers failed on the same day. Merrill was sold to Bank of America. The Fed stepped in and agreed to lend AIG \$85 billion to facilitate an orderly sell off of its assets in exchange for essentially all the company's equity.

Most people never understood how AIG was the linchpin to the entire system. And there's one more secret yet to come out...

AIG's largest trading partner wasn't a nameless European bank. It was Goldman Sachs.

I'd wondered for years how Goldman avoided the kind of huge mortgage-related writedowns that plagued all the other investment banks. And now we know: Goldman hedged its exposure via credit default swaps with AIG. Sources inside Goldman say the company's exposure to AIG exceeded \$20 billion, meaning the moment AIG was downgraded, Goldman had to begin marking down the value of its assets. And the moment AIG went bankrupt, Goldman lost \$20 billion. Goldman immediately sought out Warren Buffett to raise \$5 billion of additional capital, which also helped it raise another \$5 billion via a public offering.

The collapse of the credit default swap market also meant the investment banks – all of them – had no way to borrow money, because no one would insure their obligations.

To fund their daily operations, they've become totally reliant on the Federal Reserve, which has allowed them to formally become commercial banks. To date, banks, insurance firms, and investment banks have borrowed \$348 billion from the Federal Reserve – nearly all of this lending took place following AIG's failure. Things are so bad at the investment banks, the Fed had to change the rules to allow Merrill, Morgan Stanley, and Goldman the ability to use equities as collateral for these loans, an unprecedented step.

The mainstream press hasn't reported this either: A provision in the \$700 billion bailout bill permits the Fed to pay interest on the collateral it's holding, which is simply a way to funnel taxpayer dollars directly into the investment banks.

Why do you need to know all of these details? First, you must understand that without the government's actions, the collapse of AIG could have caused every major bank in the world to fail.

Second, without the credit default swap market, there's no way banks can report the true state of their assets – they'd all be in default of Basel II. That's why the government will push through a measure that requires the suspension of mark-to-market accounting. Essentially, banks will be allowed to pretend they have far higher-quality loans than they actually do. AIG can't cover for them anymore.

And third, and most importantly, without the huge fraud perpetrated by AIG, the mortgage bubble could have never grown as large as it did. Yes, other factors contributed, like the role of Fannie and Freddie in particular. But the key to enabling the huge global growth in credit during the last decade can be tied directly to AIG's sale of credit default swaps without collateral. That was the barn door. And it was left open for nearly a decade.

There's no way to replace this massive credit-building machine, which makes me very skeptical of the government's bailout plan. Quite simply, we can't replace the credit that existed in the world before September 15 because it didn't deserve to be there in the first place. While the government can, and certainly will, paper over the gaping holes left by this enormous credit collapse, it can't actually replace the trust and credit that existed... *because it was a fraud.*

And that leads me to believe the coming economic contraction will be longer and deeper than most people understand.

**You might find this strange... but this is great news for those who understand what's going on.** Knowing why the economy is shrinking and knowing it's not going to rebound quickly gives you a huge advantage over most investors, who don't understand what's happening and can't plan to take advantage of it.

How can you take advantage? First, make sure you have at least 10% of your net worth in precious metals. I prefer gold bullion. World governments' gigantic liabilities will vastly decrease the value of paper currencies.

Second, I can tell you we're either at or approaching a moment of maximum pessimism in the markets. These kinds of panics give you the chance to buy world-class businesses incredibly cheaply. A few worth mentioning are ExxonMobil, Intel, and Microsoft. I have several stocks like these in the portfolio of my *Investment Advisory*.

Third, if you're comfortable short selling stocks (betting they'll fall in price), now is the time to be doing it... simply as a hedge against further declines.

Keep the fraud of AIG in mind when you form your investment plan for the coming years. By following these three strategies, you'll survive and prosper while most investors sit back and wonder what the hell is going on.

Good investing,

Porter Stansberry