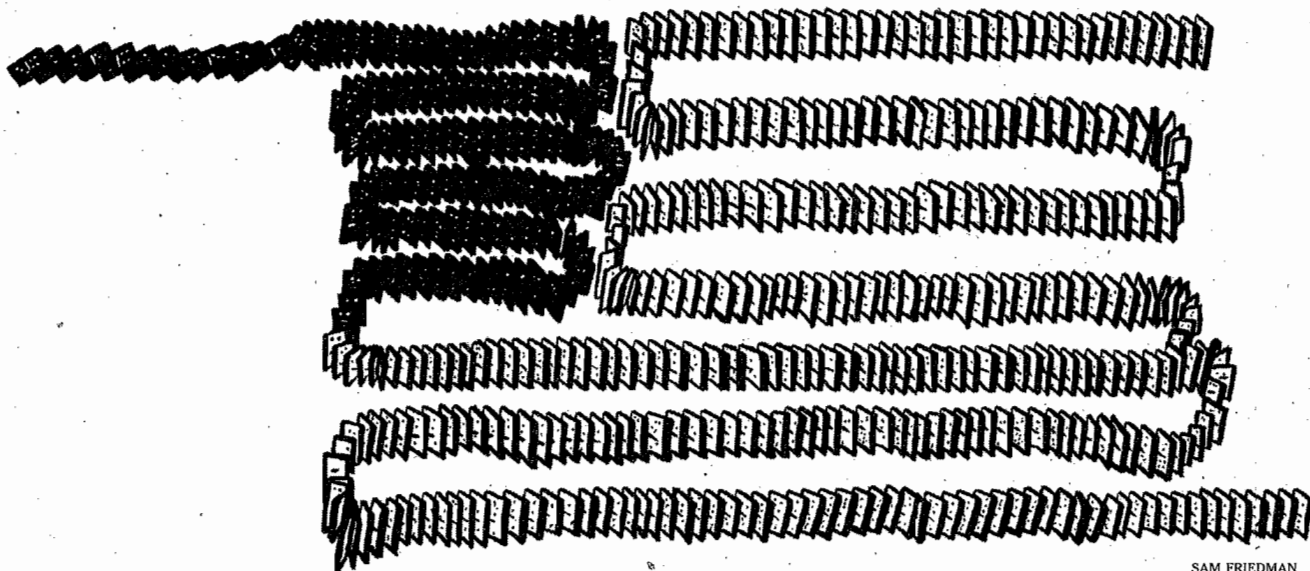


Wall Street's Next Big Problem



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By Michael Lewitt

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WHEN I drove to the Beverly Hills offices of Drexel Burnham Lambert on Feb. 13, 1990, the last thing I expected to hear was that the investment bank where I worked was going under. Yet early that morning, we were told that the company was filing for bankruptcy. I was, to put it mildly, blown away. At the time, Drexel had \$3.5 billion in assets and was the biggest underwriter of junk bonds.

It all seemed like a very big deal at the time. But what's happening this week makes me pine for the good old days.

When Lehman Brothers filed for bankruptcy on Monday, it became the latest but surely not the last victim of the subprime mortgage collapse. Lehman owned more than \$600 billion in assets. Financial institutions around the world have already reported more than half a trillion dollars of mortgage-related losses and that figure will most likely double or triple before the crisis exhausts itself.

But there is a bigger potential failure lurking: the American International Group, the insurance giant. It poses a much larger threat to the financial system than Lehman Brothers ever did because it plays an integral role in several key markets: credit derivatives, mortgages, corporate loans and hedge funds.

The immediate concern is that A.I.G. will be downgraded by the major credit rating agencies (which inexplicably still retain an enormous amount of power in the marketplace despite having gutted their credibility with unreliable ratings

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for mortgage-backed securities during the housing boom). A credit downgrade would require A.I.G. to post billions of dollars of additional collateral for its mortgage derivative contracts.

Fat chance. That's collateral A.I.G. does not have. There is therefore a substantial possibility that A.I.G. will be unable to meet its obligations and be forced into liquidation. A side effect: Its collapse would be as close to an extinction-level event as the financial markets have seen since the Great Depression.

A.I.G. does business with virtually every financial institution in the world. Most important, it is a central player in the unregulated, Brobdingnagian credit

best described as an insurance market where many of the individual trades are undercapitalized. But even worse, many of the insurers are grossly undercapitalized. In one case in the New York courts, the Swiss banking giant UBS is suing a hedge fund that said it would insure nearly \$1.5 billion in bonds but was unable to do so. No wonder — the hedge fund had only \$200 million in assets.

If A.I.G. collapsed, its hundreds of billions of dollars of mortgage-related assets would be added to those being sold by other financial institutions. This would just depress values further. The counterparties around the world to A.I.G.'s credit default swaps may be unable to collect on their trades. As a large hedge-fund investor, A.I.G. would suddenly become a large redeemer from hedge funds, forcing fund managers to sell positions and probably driving down prices in the world's financial markets. More failures, particularly of hedge funds, could follow.

Regulators knew that if Lehman went down, the world wouldn't end. But Wall Street isn't remotely prepared for the inestimable damage the financial system would suffer if A.I.G. collapsed.

While Gov. David A. Paterson of New York on Monday allowed A.I.G. to borrow \$20 billion from its subsidiaries, that move will only postpone the day of reckoning. The Federal Reserve was also trying to arrange at least \$70 billion in loans from investment banks, but it's hard to see how Wall Street could come up with that much money.

More promisingly, A.I.G. asked the Federal Reserve for a bridge loan. True, there is no precedent for the central bank to extend assistance to an insurance company. But these are unprecedented times, and the Federal Reserve should provide A.I.G. with some form of financial support while the company liquidates its mortgage-related assets in an orderly manner.

The Fed cannot afford to stand on principle. The myth of free markets ended with the takeover of Fannie Mae and Freddie Mac. Actually, it ended with their creation. □

Why the Fed can't let A.I.G. go under.

default swap market that is reported to be at least \$60 trillion in size.

Nobody knows this market's real size, or who owes what to whom, because there is no central clearinghouse or regulator for it. Credit default swaps are a type of credit insurance contract in which one party pays another party to protect it from the risk of default on a particular debt instrument. If that debt instrument (a bond, a bank loan, a mortgage) defaults, the insurer compensates the insured for his loss. The insurer (which could be a bank, an investment bank or a hedge fund) is required to post collateral to support its payment obligation, but in the insane credit environment that preceded the credit crisis, this collateral deposit was generally too small.

As a result, the credit default market is