Billions for AIG to Protect the Speculative Profits of Goldman Sachs/Morgan Stanley

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In November of 2008 with the nation's economy unraveling, Morgan Stanley and Goldman Sachs (one of the top five U.S. municipal bond underwriters) were infuriating politicians and public finance officials by recommending the purchase of credit-default swaps (CDS) thereby betting against debts of eleven states, including New Jersey, California, Wisconsin, Florida, and Ohio among others. Many of these were municipal bonds that they had originally underwritten. Thereby, through an act of blatant opportunism they were adding to the destabilization of the financial markets already at the edge.

CDS are in effect insurance policies. Insurance policies are normally taken out to cover loss against the occurrence of an event such as fire, or flood, or accident, and so on. But CDS, rather than being called "insurance," became, in the parlance of the Street, "derivatives," making them much more elegant to deal with and for the rest of us much more difficult to understand. They were, in this case, simply insurance bets on the bankruptcy or inability of municipalities throughout the country to meet their debt obligations. A bit like taking out insurance against fire on the house next door and having a lottery on the proceeds should it burn down.

Now to buy "insurance" one would naturally go to an insurance company to cover the risk. And the insurance company would sell you an insurance policy and would set an amount on their balance sheet that would represent a reserve against the potential loss/payout. An insurance company likely to write a policy covering this would be AIG. After all, AIG had become the king of CDS. In all likelihood this was the case for the likes of Goldman and Morgan-Stanley.

Except it gets worse. You see, in the mumbo-jumbo of the term "credit-default swaps," the word "insurance" is not mentioned. And according to the good souls at AIG, if you don't use the word insurance, you don't have to set aside any reserves in case of loss. And if you don't set aside any reserves, you can issue all the CDS the market can bear (understood to be in the range of $400 billion at AIG), cash in the policy premiums as a humongous supplement to your usual insurance business, allowing for zillions in paychecks and bonuses. And of course, if it all comes crashing down you can put up the "systemic risk" flag and your Wall Street friends in Washington will charge to the rescue with taxpayer dollars. (What did Goldman CEO Lloyd Blankfein say to Treasury Secretary and ex-Goldman CEO Hank Paulson when he was party to the discussions on the first AIG bailout, or as Bloomberg reported yesterday, is this also part of the government's refusal "to disclose names of the borrowers and the loans"?.

During his testimony this week, Fed Chairman Bernanke felt compelled to say, and I quote:

"AIG exploited a huge gap in the regulatory system; there was no oversight of the financial products division. This was a hedge fund basically that was attached to a large and stable insurance company, made huge numbers of irresponsible bets, took huge losses" One knows the folks at Goldman are no fools. Were they going to put good money down for CDS that their counterparty (AIG) might not be able to honor because it made no reserve provisions? Or was the temptation of another big pay day just too tempting not to risk Other People's Money to play the game?

To date we have poured $160 billion into AIG — this while others see the value of their homes cut in half, the better part of their 401(k)s wiped out, their government services significantly reduced, and other lending institutions diligently try to work out past due credits, taking significant mark-downs and extending due dates to keep industries and corporations alive.

This, as Goldman Sachs and Morgan Stanley are being covered 100 cents on the dollar on their speculative positions of intrinsically flawed CDS derivatives on which they gorged themselves to the bursting point. It is past time that a distinction be made between that part of AIG's business that was a "large and stable insurance company," and that part that was a "hedge fund," or better put, a casino. So the big question becomes, why should AIG's CDS be paid down 100 cents on the dollar when the rest of the country is taking at or near 50% haircut on the value of its assets?

But then again the rest of the country doesn't have those well-oiled K Street lobbyists pursuing their special interests in Washington. They just vote and pay.

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