This greed was beyond irresponsible

By John Gapper

Published: September 17 2008 19:09 | Last updated: September 17 2008 19:09

I have a fine seat in the FT's New York office looking down the canyon of Sixth Avenue towards the banks of Midtown. From my perch, I have watched the flabbergasting events of the past week.

My initial reaction was excitement – what a time to be observing Wall Street for a living! This steadily gave way to bafflement, fear and finally, after the US government's $85bn (£48bn, €60bn) bail-out of **AIG** , anger.

I was pleased that Hank Paulson, the Treasury secretary, heeded my advice (OK, that of others too) and refused to rescue **Lehman Brothers**. Guess what? The world did not end on Monday, even if the stock market dropped, and on Tuesday, the Federal Reserve was also defiant.

Its unanimous decision not to bow to market fears and cut interest rates was greeted with boos on the New York Stock Exchange floor. But the stock market took the medicine and went on to rally again.

Then came Mr Paulson's retreat, executed with gritted teeth, as the government and the Fed reluctantly decided that the risks of letting AIG founder in the same way as Lehman were too great.

That frightened me.

There would be no justification for rescuing AIG under other circumstances. The chances of the average homeowner not getting an insurance claim paid if AIG's holding company had been allowed to go under were slim, since its local property and casualty operations are sturdy and well-run.

Propping it up also creates moral hazard. Although its shareholders will lose most of their money, it encourages the idea that institutions can run amok in markets and will be bailed out. Indeed, the bigger they are and the worse they have behaved, the more likely it is to happen.

But forget all of that. It can be considered at leisure later on. The thing that frightened me was that Mr Paulson put up US government money when he so obviously did not want to. Having examined the heart of darkness – AIG's $60bn book of derivatives written on other derivatives based on bad residential mortgages – his resolve crumbled.

Lord knows where this leaves us, since only He knows what a credit default swap (CDS) on a collateralised debt obligation (CDO) is worth.

Warren Buffett warned in 2003 that derivatives were "financial weapons of mass destruction" and that, while the Federal Reserve system was created in part to prevent financial contagion, "there is no central bank assigned to the job of preventing the dominoes toppling in insurance or derivatives".

Incidentally, I recommend re-reading the entire passage, in the report for 2002 to Berkshire Hathaway shareholders, because it is amazingly prescient about the "time bomb" that has now detonated.

For want of an alternative, the Fed has now become that central bank. This alone is a mess. At least when the Fed rescued Bear Stearns in March, it could turn itself into the de facto regulator of investment banks. But insurance groups are supervised – absurdly – by a network of state regulators. What happens now?

Mr Paulson is not only picking up the bill for the states. He is also doing a favour for European governments, whose banks would have been hit. Many of AIG's toxic insurance contracts linked to subprime CDOs were sold to European banks to allow them to treat the securities they held as double A rated.

Given that AIG was helping them to dodge Basel I capital requirements by taking out flawed insurance contracts, it is not surprising that confidence and interbank liquidity have collapsed. A spike in Libor and the need for **Lloyds TSB** to take over **HBOS** are two consequences.

My final reaction is anger.

We are now, unquestionably, in the worst financial crisis since 1929. We do not know how many more banks and institutions will fail – **Washington Mutual**, the US counterpart of HBOS, is under severe pressure – but Bear Stearns, Fannie Mae and Freddie Mac, Lehman and AIG are plenty.

There are lots of people and institutions to blame for that, from regulators to mortgage brokers to, let us admit it, all of us who decided to speculate on house prices.

But AIG takes the biscuit. Here was a huge multinational insurance group with a reputation for solid underwriting and risk management that decided to diversify from insuring risks it knew well – car crashes and fires – to covering derivatives it did not understand.

Of course, it thought it understood them. In presentations to investors this year, it emphasised how thoroughly its AIG Financial Products arm assessed the risks of insuring CDOs. It ran all the data and decided that, in the worst case, it risked losing $2.4bn on the portfolio.

Well, $24bn of write-downs later – a mere 10 times its maximum estimate – the company has burned through its equity, spread financial chaos to all corners of the earth and humiliated the US Treasury. The job of insurance companies is to guard others against catastrophes, not cause them.

The word "irresponsible" does not begin to describe AIG's behaviour. Like Bear, Lehman and others, it saw a way to get in on the growing action in mortgage-backed derivatives. Its bankers were soon earning huge fees for themselves and AIG by piling up unimaginable risks.

Call me a spoilsport, but I do not believe that AIG or any other capital markets institution should be allowed to play like that with my money (I am a US taxpayer) in future.

If this means going back to basics, and redesigning the global regulatory system so that a renegade insurance company is denied the chance to blow up the world's banks again, so be it. Regulation cannot solve everything but enough is enough.

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