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Stocks Plunge as Crisis Intensifies

AIG at Risk; $700 Billion In Shareholder Value Vanishes

By Glenn Kessler and David S. Hilzenrath
Washington Post Staff Writers
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The Federal Reserve and Treasury Department struggled yesterday to contain the fallout from an upheaval among the country's largest investment banks as they moved on to their next challenge -- engineering a $75 billion private rescue of the nation's largest insurance company.

The insurer, American International Group, faces a cash crunch that grew more severe last night when the major credit-rating agencies warned investors that the company could have greater difficulty in meeting its obligations. It was unclear whether the downgrades by the agencies would force AIG to post additional collateral at a time when it is having difficulty raising money.

Investors sent the Dow Jones industrial average plunging more than 500 points, or 4.4 percent, for the biggest point loss since the Sept. 11 terrorist attacks seven years ago. About $700 billion in shareholder value disappeared in a single day of trading.

The wrenching reshaping of Wall Street -- which over the weekend included the demise of one big firm and the sale of another -- also pushed the value of the dollar lower. It sent the price of crude oil below $100 a barrel for the first time since Feb. 15 as traders bet a global downturn would reduce the demand for energy.

Wall Street's biggest shakeout since the Great Depression stems from a collapse in housing prices, which spread losses among firms that bet on securities linked to mortgages. Twice in the past year, regulators intervened to save financial firms and prevent further erosion in the housing markets. But over the weekend, officials drew the line at rescuing the storied investment bank Lehman Brothers, which yesterday filed for bankruptcy protection.

"We had a very, very tough day on the market," said Art Hogan, chief market analyst at Jefferies & Co. "Investors are anxious about the spillover effect of Lehman and what is the next shoe to drop."

As investors digested the news, some economists worried whether Wall Street's troubles were spilling over into other parts of the economy, renewing pressure on the Federal Reserve to cut interest rates when it meets today.

Fed leaders, however, believe it is too early to tell what the impact might be, and they are unlikely to cut rates for now.

In the meantime, Treasury Secretary Henry M. Paulson Jr. signaled yesterday that taxpayer funds could still be used broadly to "maintain the stability and orderliness of our financial system" but that he was pressing healthier Wall Street firms and commercial banks to join together to assist in rescuing individual firms -- much like the purchase of Merrill Lynch on Sunday by Bank of America.

Goldman Sachs, for instance, was asked by the Federal Reserve Bank of New York to help AIG, a $1 trillion-asset insurance company that serves 74 million consumers in 130 countries. AIG had been heavily involved in the business of issuing complex insurance contracts to investors in securities backed by mortgages, and the collapse of subprime and other home loans threatened to hobble the company and trigger a chain reaction in the financial system.

J.P. Morgan Chase, which is serving as AIG's financial adviser, was seeking support for a credit line of $70 billion to $75 billion that would involve multiple lenders, spreading the risk, according to two sources familiar with the discussions. They spoke on condition of anonymity because the talks were private.

New York's governor, meanwhile, said his state would allow AIG to use $20 billion from its own insurance subsidiaries to ease a financial crunch. By posting the assets as collateral, AIG can borrow money to run its day-to-day operations, Gov. David A. Paterson (D) said. The move required special dispensation from state insurance superintendent Eric R. Dinallo, who is responsible for protecting the stability of AIG insurance companies in New York and their policyholders.

"It's no secret that the company has been talking to the Feds and talking to us," Paterson said. "They asked us what assistance we could provide, and this is our idea."

A deal to rescue AIG may have to come quickly now that Standard & Poor's and Moody's Investors Service have lowered their credit ratings for the firm, should the decision force AIG to boost its collateral to meet its obligations.

The Fed has maintained that it will not offer AIG a bridge loan or other direct injection from the government, according to sources familiar with the conversations. AIG executives huddled at their Manhattan headquarters over the weekend with potential private investors including J.C. Flowers, Kohlberg Kravis Roberts, and TPG as well as Paterson's representatives, including Dinallo; AIG was also talking to Warren E. Buffett's Berkshire Hathaway.

"I don't think anybody is going to lend that amount of money at terms that are anywhere near economically feasible without a backstop, without some form of guarantee, say by the Fed or another party," said Donn Vickrey of Gradient Analytics, who has been warning of trouble at AIG for months.

Vickrey said it appeared the Fed was playing a game of chicken with Wall Street, trying to pressure firms with a big stake in AIG's continued viability to step up to the plate.

AIG's stock fell 61 percent, to close at $4.76, yesterday.

At the same time, the Fed over the weekend made it easier for investment banking firms to borrow money by agreeing to accept a wider range of assets as collateral, including mortgage-backed securities that banks may not be able to sell. The increased availability of cash could be crucial to the investment banks, the rough equivalent of a home-equity line for a house-rich, cash-poor family.

"The actions of the Federal Reserve, it was the most overlooked but the most important thing that happened this weekend," said Steve Bartlett, president of the Financial Services Roundtable, which represents the largest financial companies.

The Fed's willingness to take those assets off banks' balance sheets could also help the institutions avoid further write-downs if those assets continue to lose value.

The Fed, for its part, is betting that the assets could eventually be sold for more than the market is willing to pay right now. If not, taxpayers could lose money.

Patricia McCoy, who served on the Fed's Consumer Advisory Council from 2002 to 2004, cautioned that "it's a big, big risk . . . Right now it's really hard to value that collateral. And in the meantime, even though the Fed financing is temporary, it sends a huge message to the investment banking industry to continue to arrange your balance sheets to be dependent on short-term financing, because when you get into a liquidity crunch, you can turn to us and we'll help you out."

Stocks' plunge yesterday showed that investors remained nervous. Shares opened lower but generally traded in the same range until the last hour of trading -- when a 300-point drop in the Dow became a 504.48-point rout, bringing it to 10,917.51, moving below the 11,000 mark for the first time since mid-July. The technology-heavy Nasdaq was down more than 3.5 percent, and the Standard & Poor's 500-stock index was down 4.7 percent.

The financial sector was among the hardest hit. Bank of America closed down 21 percent, while Wachovia fell 25 percent. Goldman Sachs and Morgan Stanley, the two remaining survivors of what were once Wall Street's Big Five, report quarterly earnings this week -- and closed down 12 and 14 percent respectively.

Although it was a horrible day for the market, it was no worse than Treasury and Fed officials had expected when they declined to intervene to save Lehman. Indeed, officials said they were pleased that the credit markets seemed to generally to function alright.

Another bit of good news for consumers: Oil prices fell about $5 a barrel, to close at $95.71, the first time prices have closed below $100 in months. Hurricane Ike did not do as much damage as some had feared and overall demand for fuel continues to decline, analysts said.

"One of the reasons that oil is weak is that [there is an acknowledgment that] the slowdown in the economy could affect everything, and that includes demand for oil," said Phil Flynn, oil analyst at Alaron Trading in Chicago.

Risk-adverse investors are likely to move away from U.S. assets, dragging down the value of the dollar compared with a range of foreign currencies, said Joseph Brusuelas, chief U.S. economist at California-based Merk Investments. Already, Treasury bond prices surged yesterday, meaning that yields fell. "There is a concern about the basic stability of the market going forward," he said.

Global stocks also plunged on the weekend news, and central bankers tried to calm the situation during deepening uncertainty about the resilience of the global financial system and the strength of the world economy. China's central bank announced it was cutting a key interest rate to uphold growth, and U.S. industrial production fell faster than expected in August.

Meanwhile, the sidewalk outside Lehman's headquarters in midtown Manhattan took on a carnivalesque atmosphere yesterday, as dozens of reporters clamored outside the doors, a half-dozen television trucks parked on the street, tourists grouped on the sidewalk taking photos, a few political partisans preached their platforms -- and occasionally an employee came out dragging a suitcase on wheels.

One man waved a red flag, calling for a workers' revolution and yelling, "The capitalist order is in freefall collapse!"

Staff writers Binyamin Appelbaum, David Cho, Zachary A. Goldfarb, Neil Irwin, Heather Landy, Renae Merle, and Robin Shulman contributed to this report.