Downgrades And Downfall

How could a single unit of AIG cause the giant company's near-ruin and become a fulcrum of the global financial crisis? By straying from its own rules for managing risk and then failing to anticipate the consequences.

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The contracts were flying out of AIG Financial Products. Hardly anyone outside Wall Street had ever heard of credit-default swaps, but by early 2005, investment banks were snapping them up to insure all kinds of deals in case of default, fueling one of the great financial booms in U.S. history.

During twice-monthly conference calls that originated from the company's headquarters in Wilton, Conn., president Joseph Cassano would listen as marketing executive Alan Frost listed the latest swap transactions for associates in the firm's offices in London, Paris and Tokyo.

Once a small part of the firm's business, the increasingly popular contracts had helped boost the company's profits to record levels. The company's computer models continued to show only a minute chance that the firm would ever pay out a dime on the contracts, and it turned down deals that didn't meet its standards. After their reviews, Cassano and his team would consult with AIG executives, sometimes including chairman and chief executive Maurice "Hank" Greenberg. "We rode pretty tight rein on them," Greenberg recalls.

But the swaps also exposed Financial Products and its parent AIG, the global insurance titan, to billions of dollars in possible losses. By spring 2005, some Financial Products executives were questioning the surge in volume. Among them was Cassano, an early advocate for the swaps business who ran the firm from its London office.

"How could we possibly be doing so many deals?" one executive recalls Cassano asking Frost, the firm's liaison with Wall Street dealers, during one conference call.

"Dealers know we can close and close quickly," Frost said. "That's why we're the go-to."

Efficiency wasn't the only reason. Frost didn't have to say aloud what everyone at the firm already appreciated. Financial Products had become the "go-to" for credit-default swaps in part because of its knowledge and reliability, but also because it had AIG's backing. The parent company's top-drawer, Triple A credit rating and its deep pockets assured customers that they could rest easy.

Their comfort turned out to be illusory. The credit-default swaps became a primary force in the disintegration of AIG as a private enterprise and a massive government rescue aimed at preventing catastrophic damage to the world's financial system. Never in U.S. history has the government invested so much money trying to save a private company.

Even as Frost spoke, trouble was brewing for AIG. On March 14, 2005, Greenberg stepped down amid allegations about his involvement in a questionable deal and accounting practices at AIG. The next day, the Fitch Ratings service downgraded AIG's credit rating to AA. The two other major rating services, Moody's and Standard & Poor's, soon followed suit.

The initial fallout came swiftly, as AIG's annual report to federal regulators disclosed. The downgrades had triggered provisions in Financial Products' existing transaction, the report said, requiring its parent company to post $1.16 billion in collateral for the deals.

The company also warned that the downgrades could erode confidence in Financial Products, a crucial element in the unit's phenomenal success. "Historically, AIG's triple-A ratings provided AIGFP a competitive advantage. The downgrades will reduce this advantage and [some] counterparties may be unwilling to transact business with AIGFP except on a secured basis," AIG reported to the Securities and Exchange Commission in May 2005.

The swaps business had bound Financial Products to hundreds of counterparties in New York and Europe. Wall Street firms such as Goldman Sachs and Merrill Lynch favored the credit-default swaps as an extra layer of protection for mortgage-backed securities, one of the many investment by-products helping to fuel the overheated housing boom. European banks liked them because they could treat the swaps as a form of collateral, which freed up cash that the banks would ordinarily have to set aside as protection against losses.

The interlocking, complex nature of these contracts would speed their downfall. When the housing market began to unravel in 2007, it set off a chain of events that would prove disastrous: downgrades in the ratings of securities that Financial Products had insured; demands by Financial Products' counterparties for billions of dollars in collateral; AIG's desperate search for cash to meet the collateral calls; a panicky weekend of negotiations in New York and Washington; and, finally, Treasury Secretary Henry M. Paulson's conclusion that AIG could not be allowed to collapse.

The taxpayer rescue of AIG stands at $152 billion, including $60 billion in loans, a $40 billion investment in AIG preferred stock and a $52 billion purchase of troubled AIG assets that the government hopes to sell off to recoup its investment.

Meanwhile, federal investigators are examining statements made last year by the company and its executives to determine whether shareholders received misleading information. Several investors have filed civil lawsuits, alleging that executives at AIG and Financial Products hid the extent of their credit-default swap troubles.

Whether that turns out to be the case, there's no doubt that Cassano's concern in spring 2005 did not slow the firm's mounting involvement in the credit-default swap business for several months. The deals mounted and the risks grew.

Even after Financial Products stopped writing the credit-default swaps at the end of 2005, it maintained a public veneer of confidence that the contracts it had on its books were fine and that their computer models were sound. As Cassano told investors in a December 2007 webcast, "Our fundamental analysis says this is a money-good asset. We would not be doing the shareholders any benefit by exiting this right now and taking that loss."

2: Playing Catch-Up

By 2005, the world of debt had changed dramatically since Financial Products wrote its first credit-default swap in 1998. Back then, the swaps involved corporate debt, essentially the bonds that corporations use to finance their operations. There was a wealth of historical data about corporate debt, which gave Financial Products' executives a high degree of confidence in consultant Gary Gorton's computer models.

Gorton, a Yale business professor with a PhD in economics, had written scores of intricate papers about corporate finance, banking and the history of financial panics. Cassano saw Gorton as a valuable asset. "Gary has helped us tremendously in helping us organize our procedures, organize our modeling effort, developing the intuition," Cassano said during the December 2007 webcast for investors.

By then, Gorton had worked as a consultant for Financial Products for nearly a decade. At that same investor conference, Gorton explained how he saw the analysis that he and his colleagues had been doing. "These models are guided by a few very basic principles, which are designed to make them very robust and to introduce as little model risk as possible," he said. "No transaction is approved by Joe if it's not based on a model that we built."

Financial Products had built itself on data, analysis and a culture of healthy skepticism. Even as the firm grew to about 400 in 2005 from 13 employees in 1987, it sought to maintain its discipline. At Financial Products, God had always been in the details, and the details were always rooted in the math.

Over the years, the firm had stayed ahead of competitors by finding innovative ways to manage and minimize the risks it took on for clients. Financial Products executives made fortunes, some taking home tens of millions of dollars a year, as the firm created markets in untapped areas -- such as buying synthetic coal equipment to capitalize on energy tax breaks.

On credit-default swaps, the firm adapted as the market evolved. By 2004, Wall Street investment banks were discovering how to turn consumer debt into a moneymaker, churning out bond-like securities backed by mortgages and other assets. Credit-default swaps helped attract institutional investors to these mind-bendingly complex deals, known in Wall Street jargon as collateralized debt obligations, or CDOs.

CDOs defined a revolution in corporate finance called "securitization." Wall Street saw any income stream as a candidate for securitizing: mortgages, credit card payments, car loans, even student loans. The investment banks would bundle these loans, and the monthly payments that came with them, into a new security for investors looking for steady but higher yields than Treasurys or corporate bonds.

CDOs had been around for years, but the real estate boom suddenly made mortgages one of the hottest investments on Wall Street. The mortgage industry turned into the equivalent of a giant assembly line, lubricated by fees from one end to the other. New lenders sprung up by the month, offering loans to first-time buyers as well as existing homeowners who wanted to move up to more square footage. For people with shaky credit, the industry provided subprime loans, with higher rates that some homebuyers now cannot repay.

Banks packaged and resold the mortgages in pools, which became the basis for mortgage-backed securities. Wall Street scooped them up. The CDO market took off, ballooning to $551 billion issued in 2006 from $157 billion in 2004.

The CDO structure depended on the concept of layered risk. The securities in the "super senior" top tier were considered low risk and attracted the highest ratings. In return for their safety, these bonds paid the lowest interest rate. The reverse was true at the other end: The lower tiers absorbed the first losses in the case of loan defaults. For accepting extra risk, investors in these tiers earned a higher interest rate.

Financial Products made its money by selling credit-default swaps only on the super-senior tier. It seemed a safe bet: Cassano once defined super senior as the portion of the deal that was safe even "under worst-case stresses and worst-case stress" assumptions.

The mortgage-backed CDOs were also thought to be safe because of the geographic diversity of the underlying loans. Surely, investment bankers reasoned, people in different parts of the country would not default on their home loans at the same time. The real estate market was strong and showed no sign of faltering.

Financial Products executives said the swaps contracts were like catastrophe insurance for events that would never happen.

Hedging, the firm's hallmark, seemed largely unnecessary. "Given the conservatism in that we've built these portfolios, we haven't had to do a huge amount of hedging over the years," Andy Forster, the firm's global head of credit trading, said at a May 2007 presentation to investors in New York.

Cassano also emphasized that both Financial Products and AIG had a review role. "Each and every one of our transactions," he told investors listening to the December 2007 webcast, "passes through the same careful process. We don't have any short-cuts. . . . So there's always two eyes, two teams reviewing our business. There is not one dollar of this business that's been done that hasn't gone through that double-review check."

But there were provisions in the swap contracts that the computer simulations hadn't adequately addressed, as later events showed. There were also tremors in the mortgage industry that would convince one Financial Products executive that the company should get out of the credit-default swap business -- fast.

3: The Subprime Threat

In fall 2005, Eugene Park was asked to take over Alan Frost's responsibilities at Financial Products. Frost had done exceedingly well in marketing the credit-default swaps to Wall Street, and was getting a promotion. He would now report to Cassano directly on other strategic projects.

Park had been at the firm for six years and ran the North American corporate credit derivative portfolio. Taking on that swaps business would boost his already handsome compensation.

But he wanted no part of it. He was worried about the subprime component of the CDO market. He had examined the annual report of a company involved in the subprime business. He was stunned, he told his colleagues at the time.

The subprime loans underlying many CDOs formed too large a part of the packaged debt, increasing the risk to unacceptable levels. Those loans could default at any time, anywhere across the country because the underwriting processes had been so shoddy. The diversification was a myth -- if the housing market went bust, the subprimes would collapse, like a house of cards.

Park spelled out his reasoning in meetings and conversations with colleagues over the next several weeks. It was as if he had scratched the needle across an old record album at full volume.

Cassano agreed the firm should dig deeper. Over the next few weeks, Financial Products executives worked with researchers from investment banks to examine the subprime threat.

They discovered that the subprime exposure had been growing since early 2004, when the composition of the CDOs were increasingly dominated by mortgages rather than other kinds of consumer debt.

Cassano decided it was time to stop. Gorton explained the decision to investors during the December 2007 webcast: "We stopped writing this business in late 2005 based on fundamental analysis and based on concerns that the model was not going to be able to handle declining underwriting standards."

By then, the firm had $80 billion worth of existing CDOs that included subprime mortgages as underlying assets. About half had been issued before Greenberg's ouster, Nicholas J. Ashooh, an AIG spokesman, said this week. Greenberg said in a recent interview that his research shows only $7 billion in swaps were issued on CDOs with subprime assets during his tenure.

Either way, the exposure would prove significant. If additional downgrades occurred, either in AIG's credit rating or in the CDO ratings, Financial Products would have to come up with tens of billions of dollars in collateral it did not have.

4: 'Not a Lot Of Risk'

In May 2007, Cassano stepped before a crowd of entrepreneurs in Manhattan.

Financial Products was itself an entrepreneurial success story, with the numbers to prove it: an investment portfolio in excess of $50 billion; a trading operation that dealt in dozens of currencies, 18 commodities and a host of credit and equity services; a reputation for finding innovative ways to assess and manage the risks in interest rates, equities and other deals for its clients.

"And who are our clients?" Cassano asked. "It's a broad global swath of mostly high-grade institutions, mostly high-grade entities around the world and it includes banks and investment banks, pension funds, endowments, foundations, insurance companies, hedge funds, money managers, high-net-worth individuals, municipalities and sovereigns and supranationals."

Cassano went on. "My colleagues and myself have $500 million invested in the company," he said. "And so we've become very, very good caretakers of the value of the company."

As a company with billions of dollars riding on arcane financial transactions such as derivatives, Financial Products certainly faced challenges, Cassano said. He then alluded to the debate within the firm over credit-default swaps.

"Credit risk is the biggest risk our group has. It's the single biggest risk that we manage," he said. "But with a AA plus/AA credit portfolio, there's not a lot of risk sitting in there. And so while it is the largest risk, it's not by any stretch a risky business."

Three months later, in a conference call with investors, AIG chief executive Martin Sullivan struck a different note, acknowledging the growing unrest over defaults in the U.S. mortgage market.

The 52-year-old Sullivan had taken the reins at AIG after Greenberg's ouster in March 2005. He was an AIG veteran, with more than 35 years at the company, primarily on the insurance side. His rise to the top was an exclamation point on a career that began at 17, when he joined AIG's London office as a clerk.

Cassano joined Sullivan on the call. Asked by a Goldman Sachs analyst about the stability of Financial Products' huge portfolio of credit derivatives, Cassano responded with calm and confidence.

"It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing $1 in any of those transactions," Cassano said.

Sullivan added: "That's why I am sleeping a little bit easier at night."
5: Collateral Calls

After Sullivan's comment to investors, a wave of collateral calls would begin, swamping AIG.

The first came from Goldman Sachs, the venerable Wall Street investment bank and one of Financial Products' biggest counterparties. Citing the plummeting value of some subprime assets underlying securities that Financial Products had insured, Goldman demanded $1.5 billion to help cover its exposure.

The 2005 downgrade of AIG to a AA company now came into play. Under the swaps contracts, AIG had to post more collateral than in its Triple A days.

AIG disputed the amount but had no choice but to negotiate. It agreed to post $450 million.

As if AIG didn't have enough problems, the rapidly crumbling real estate market was causing the ratings services to downgrade the securities in CDOs, including the top layers that investors had been led to believe were safe. Those downgrades also made AIG more vulnerable under the swaps contracts.

In October, Goldman came calling again, demanding $3 billion. AIG balked once more, but agreed to provide another $1.5 billion.

These and other events sent AIG's stock price tumbling. In six weeks, between early October and mid-November, it fell more than 25 percent, contributing to the perception that AIG was in trouble.

The collateral calls also set off alarms at PricewaterhouseCoopers, AIG's outside auditing firm. The auditors told Sullivan on Nov. 29 that they had found serious oversight problems and "that AIG could have a material weakness" relating to risk management. More ominously, they said, no one knew whether the value that Financial Products placed on its portfolio of derivatives was accurate. That meant the losses in market value could be much worse.

About the same time, the SEC required companies like AIG to adopt an accounting standard known as "mark-to-market," designed to give investors a better sense of the current values of a company's assets. As the housing market declined, and the rate of defaults increased, the swaps looked at greater risk. That allowed counterparties to ask for more collateral.

Greenberg questioned the merits of the rule. "Mark-to-market accounting, I would argue, probably caused a great deal of the trauma that the financial industry is in today," he said.

On paper, the value of the credit-default swaps was sliding. In November, the company reported the portfolio had lost $352 million. At the December 2007 webcast for investors, Cassano reported a higher number, $1.1 billion.

Sullivan, Cassano and others at the company remained bullish on their ability to weather the calls, and in the long run, even recover the collateral they had posted. "But because this business is carefully underwritten," Sullivan said, "we believe the probability that it will sustain an economic loss is close to zero."

AIG's chief risk management officer, Robert E. Lewis, reminded investors of the company's culture. "If you look at AIG's history," Lewis said, "I think you can realize that AIG in its culture does not have an appetite for undue concentrations of risk."

Cassano made the case that Financial Products would survive the storm because it had one of the world's best companies behind it.

"Clearly this is a time where it's a huge benefit to be part of the AIG family," he told the investors. "It's these crises and these points in time that give us the wherewithal right now to stand here with you and say on the back of giants, on the back of everybody at AIG who has built the capital that AIG has, the AIGFP unit is able to withstand this aberrant period."

Federal investigators are examining the December 2007 webcast as part of their effort to determine whether Cassano, Sullivan and others at the company misled investors about how dire the situation had become.

Two months later, on Feb. 11, AIG disclosed that its auditors had found the company "had a material weakness in its internal control over financial reporting and oversight relating to the fair value valuation of the AIGFP super-senior credit-default swap portfolio." On Feb. 28, AIG announced that its estimate of paper losses had spiraled to $11.5 billion. The company also acknowledged that its collateral postings had reached $5.3 billion.

The next day, Sullivan announced that the Cassano era was over. The Financial Products president had resigned, effective March 31. Sullivan did not reveal that Cassano would get $1 million a month as a consultant. That fact came out months later during congressional hearings on AIG's near-collapse. AIG had also provided a record of Cassano's compensation history to the committee, showing that he received $43.6 million in salary and bonuses in 2006, and $24.2 million in 2007.

"Joe has been a very valuable member of the AIGFP senior management team for over 20 years," Sullivan said in making the announcement. "He has had a great career with us, and we wish him the very best in the future."

The worst was still to come.

6: A Deep Hole

The urgent phone call that alerted Eric Dinallo to the extent of the financial meltdown came Friday, Sept. 12, as he drove to his family's weekend home in the Hudson Valley, north of Manhattan.

Dinallo, head of New York state's insurance department, got a briefing about AIG, where panicked executives were desperately trying to come up with a huge infusion of cash. They had heard the bond-rating agencies were going to downgrade the company's already ailing credit grade, which would trigger more collateral calls. "And if downgraded -- even like one notch --

they didn't have sufficient liquidity" to meet the calls, Dinallo said recently.

Dinallo recognized the danger. AIG had operated for so long at the center of the world's financial web, with so many counterparties, that its collapse would be felt in every corner of the globe. As insurance superintendent, Dinallo was aware of the previous calls. But he was still taken by surprise. "I never realized things were as bad as they were," he said. "I didn't realize how deep the hole was they had created."

AIG was going to try selling some of its life insurance affiliates. AIG officials also made a pitch for a $20 billion loan from the state insurance department. "They said, 'We will pay this loan quickly,' " Dinallo recalled.

Dinallo cut short his weekend plans and headed back to Manhattan early Saturday. By noon he had assembled a small team at AIG headquarters. Working on the 18th floor, not far from where Greenberg once reigned, Dinallo and his crew pored through AIG's books, looking for ways to raise money.

Meanwhile, Goldman Sachs and J.P. Morgan set to work on a $75 billion bridge loan from a syndicate of major financial institutions, which was intended to give AIG cash until it could sell enough assets to bail itself out.

The urgency and tension were palpable. New York's governor, David A. Paterson, called in. So did Timothy Geithner, head of the New York Federal Reserve. Geithner was swamped that day with the imminent collapse of Lehman Brothers, but he wanted constant updates.

By Sunday night, no solution emerged, and AIG executives were worried that the company's stock price would take another hit when the market opened on Monday.

On Monday morning, Paterson announced he would relax insurance regulations so that AIG could borrow up to $20 billion from its subsidiaries to cover operating expenses. Meanwhile, the Goldman-J.P. Morgan effort on the bridge loan wasn't coming together.

Hour by hour, it became clear that AIG was far more exposed by Financial Products' commitments than anyone realized. The next day, sensing disaster, the Federal Reserve Board, with the backing of the Treasury Department, stepped in and took control of what had been one of the most successful private enterprises ever.

"The Board determined that, in current circumstances, a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance," the Federal Reserve said.

7: 'An Unacceptable Situation'

In October, SEC chairman Christopher Cox appeared at a roundtable discussion that the agency was hosting at its Washington headquarters. He delivered a tough, grim message: The federal government had failed taxpayers by not regulating the swaps market.

"The regulatory black hole for credit-default swaps is one of the most significant issues we are confronting in the current credit crisis," Cox said, "and it requires immediate legislative action."

He tried to put the regulatory failure into context. "The market for CDS is barely 10 years old. It has doubled in size since just two years ago," he said. "It has grown between the gaps and seams of the current regulatory system, where neither the commission nor any other government agency can reach it. No one has regulatory authority over credit-default swaps -- not even to require basic reporting or disclosure."

He went on: "The over-the-counter credit-default swaps market has drawn the world's major financial institutions and others into a tangled web of interconnections where the failure of any one institution might jeopardize the entire financial system. This is an unacceptable situation for a free-market economy."

8: Recriminations

The question of what went wrong at AIG and its Financial Products unit provoked some finger-pointing in recent interviews with former executives.

Greenberg, the ousted AIG chairman, says that the responsibility rests with the people who ran the company after his forced resignation in 2005. He said that Cassano, the man he appointed to run Financial Products in 2001, never would have been allowed to do anything untoward under his leadership. "No. No," Greenberg said. "Because he was controlled."

His longtime deputy, former AIG vice chairman Edward Matthews, also blamed their successors. "When Hank and I left," he said, "those chains that bound Joe Cassano were off."

Cassano doesn't agree. Through his lawyer, F. Joseph Warin, he maintained that "every single super-senior CDS investment was authorized by AIG corporate."

Warin said, in a statement: "Regardless of what Mr. Greenberg says today, the facts speak for themselves: Mr. Cassano decided on his own, after Mr. Greenberg left AIG, to stop writing CDS [credit-default swap] protection. Mr. Cassano instructed his team to analyze the mortgage underwriting standards and then made the decision to exit the business in late 2005, all within months of Mr. Greenberg leaving the company."

As for the allegations that Cassano and others made misleading statements in December 2007, Warin has said, in a statement, his client acted lawfully and is cooperating with investigators. "He provided full and complete information to investors, his supervisors and auditors," Warin said.

Howard Sosin and Randy Rackson, two of Financial Products' founders, left the company in 1993 after a bitter dispute with Greenberg. Sosin lives in Connecticut, not far from Financial Products' headquarters. He traces the roots of the firm's demise to Greenberg's decision to force him out.

"We did really well with it. AIG did really well with it," Sosin said, adding that recent events could have been avoided with more attention to the firm's "core values." "It did not have to be this total failure of control."

In his brownstone on Manhattan's Upper West Side, Rackson said, "You put something together that was good, and then somebody takes the controls and drives it into the ground."
9: Epilogue

On Nov. 11, Gerry Pasciucco pulled open the front door of AIG Financial Products headquarters in Wilton, Conn. For much of Pasciucco's career on Wall Street, Financial Products had drawn some of the smartest, most ambitious people in the business, while doing pioneering work.

Now, it was in ruins.

Just weeks before, the 48-year-old Pasciucco, a vice chairman at Morgan Stanley, had heard from colleagues working with federal authorities that AIG was looking for someone to end Financial Products. He spoke with current AIG chief executive, Edward Liddy, who invited him to the Manhattan headquarters of the hemorrhaging insurance giant. Sullivan was gone; he had resigned as of July 1 with a $47 million severance package.

As Liddy and Pasciucco sat in the office once occupied by Greenberg, Liddy spelled out what he needed from Pasciucco: To identify Financial Products' outstanding obligations, resolve those transactions as profitably and quickly as possible, and then close the doors and turn out the lights.

Pasciucco had worked at Morgan Stanley for 24 years in capital markets and risk assessment. He had once been filmed by Harvard Business School for a case study on how to manage in a fast-paced financial market. But even with that background, he wondered whether he had the chops to sort out Financial Products' problems.

"How solvable is it?" Pasciucco recalled asking Liddy. "I'm up for a challenge, but there has to be a chance."

Liddy told Pasciucco to think about it. Back in his Morgan Stanley office, overlooking Times Square, Pasciucco did more homework. The organization was in desperate need of leadership and a game plan for unwinding its enormous book of transactions. Pasciucco came to believe that he could make a difference and decided to take the job, in part because he saw it as a chance to pitch in on the great economic crisis of his time.

Now, in Wilton for his first day on the job, Pasciucco knew from the demeanor of new colleagues that it was going to be even rougher than he thought. Their faces looked glum, their arms were crossed, and they seemed unsure of what to do.

He dove into the company's books. The story he found in the numbers was fascinating and daunting: Financial Products had $2.7 trillion worth of swap contracts and positions; 50,000 outstanding trades; 2,000 firms involved on the other side of those trades; and 450 employees in six offices around the world. The majority of the firm's trades had been hedged, essentially along the lines that Sosin, Rackson and others had laid out two decades before.

"The place made sense when I got here," Pasciucco said last week. "They were very, very smart."

But Pasciucco soon found evidence of a fatal miscalculation. It seems that as Financial Products ramped up its credit-default swap business, its leaders assumed that its parent, AIG, would always be as strong as it was the day it backed the firm's first big trade in 1987. He said they had failed to prepare for the possibility of a downgrade in AIG's credit rating.

The executives who had pushed or approved the credit-default swap business had placed too much faith in the math that told them the worst would never happen, that AIG and its deep pockets would be there to usher them through the trouble.

"When the unexpected happens and you have the biggest credit crisis since 1929, you have to be prepared to deal with it, and they weren't," Pasciucco said. "There was no system in place to account for the fact that the company might not be a Triple A forever."