RODDY BOYD

FATAL RISK

A CAUTIONARY TALE OF AIG'S CORPORATE SUICIDE

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Roddy Boyd

WILEY

John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:

Boyd, Roddy, 1968-
Fatal risk : a cautionary tale of AIG's corporate suicide / Roddy Boyd.
p. cm.
Includes index.
ISBN 978-0-470-88980-0 (hardback); ISBN 978-1-118-08429-8 (ebk);
ISBN 978-1-118-08427-4 (ebk); ISBN 978-1-118-08428-1 (ebk)
1. Insurance companies–United States–History. 2. American International Group, Inc.– History. 3. Federal aid–United States. 4. Financial crises–United States. 5. Global Financial Crisis, 2008-2009. I. Title.
HG8540.A43B69 2011
368.006′573—dc22

2011001512

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

To Laura: More than 20 years ago we said that even if we didn't have money or a plan, we had each other and that better days would come. We still have each other, and the better days are here. To enjoy them with you is a treasure and a privilege.

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Cast of Characters

AIG

Martin Sullivan Chief executive officer of AIG until 2008
Steven Bensinger Chief financial officer of AIG until 2008
William Dooley Head of AIG's Financial Services Division
Ernie Patrikis General counsel of AIG until 2006
Anastasia Kelly General counsel of AIG until 2009
Chuck Lucas Risk management chief of AIG until 2001 (consultant until 2007)
Robert Lewis Risk management chief of AIG until 2010
Kevin McGinn Credit risk management head of AIG
Win Neuger Global investment chief of AIG until 2009
Michael Rieger Mortgage-backed securities fund manager at AIG until 2007
Richard Scott Head of global fixed income at AIG until 2008
Elias Habayeb CFO of financial services
Chris Winans Vice president of media relations until 2008
Nicholas Ashooh Head of corporate communications until 2010
Edward Liddy CEO of AIG 2008–2009

International Lease Finance Corporation

Steven Udvar-Hazy   CEO of ILFC until 2009

AIG Financial Products

Howard Sosin   Cofounder, CEO of AIGFP until 1992
Randy Rackson   Cofounder AIGFP until 1992
Barry Goldman   Cofounder AIGFP until 1992
Tom Savage   CEO of AIGFP from 1994 to 2001
Joseph Cassano   CEO of AIGFP from 2001 to 2008
David Ackert   Former head of Transaction Development Group and Energy Group at FP until 2007
Jacob DeSantis   Head of Equities and Commodities at FP until 2008
Jon Liebergall   Former head of Municipal Group and co-head of North American Marketing at FP
Andrew Forster   Head of Asset Finance Group
Alan Frost   Former head of U.S. investment bank and structured securitizations effort
Gary Gorton   (consultant) Yale finance professor and author of FP CDO risk software
Eugene Park   Corporate marketer and former head of structured securitizations
Kelly Kirkland   Consultant and former head of European business at FP

AIG Trading

Gary Davis   Former cofounder AIG Trading
Robert Rubin   Former cofounder AIG Trading
Barry Klein   Former cofounder AIG Trading

AIG Board of Directors

Robert Willumstad   Former AIG CEO and chairman of the board
Frank Zarb   Former AIG chairman of the board
Carla Hills   Former U.S. trade representative
Richard Holbrooke   Former senior U.S. diplomat

Frederick Langhammer Former CEO at Estee Lauder Cos.
Stephen Bollenbach Former CEO of Hilton Hotels

C. V. Starr & Co. (ex-AIG)

Maurice "Hank" Greenberg Former AIG chief executive officer (until 2005)
Edward Matthews Former AIG vice chairman, finance
Howard Smith Former AIG CFO
Bertil Lundqvist General counsel at C. V. Starr

Goldman Sachs

Gary Cohn Goldman president and chief operating officer
Lloyd Blankfein COO
Craig Broderick Risk management chief
David Viniar CFO
Andrew Davilman Managing director, sales
Ram Sundaram Managing director, prop trading
Daniel Sparks Partner, mortgage trading

Boies, Schiller & Flexner LLP

David Boies Lawyer for Greenberg
Lee Wolosky Lawyer for Greenberg
Nick Gravante Lawyer for Greenberg

Simpson Thacher & Bartlett

Richard "Dick" Beattie Outside adviser to AIG board

Sard Verbinen & Co.

George Sard Public relations adviser to AIG

The Federal Reserve Bank of New York

Timothy Geithner President FRBNY
Sarah Dahlgren Head of supervision FRBNY
Thomas Baxter General counsel

Kynikos Advisers

Jim Chanos Kynikos general partner
Chuck Hobbs Kynikos research chief

Gradient Analytics

Donn Vickrey Cofounder and research chief

Fatal Risk

Introduction

Robert Willumstad viewed himself as one of the good guys. Most men do, of course, but he had tried to be one: forthright, a by-the-book kind of guy. He took pride in his handshake being valued in New York and even more pride in his hard work at being the engineer to Sandy Weill's dreamer in the construction of Citigroup. At that banking and financial giant, his unit was most assuredly *not* the one where the Securities and Exchange Commission and attorney general had had a field day; he generated *profits*, not subpoenas.

In a town full of executives, Willumstad was a businessman, or at least he tried to comport himself like one. Executives were appointed, carried out orders, and were paid what they were paid. A businessman built an enterprise, something that would outlast cycles and trends and perhaps even the man who built it. An executive focused on his mandate and cared for little else; a businessman had to be concerned with the totality of the company. Willumstad had always sought to keep perspective, to think a few moves ahead and solve the problem. That he had tried to do it as a human being and not a glory hound was a point of pride.

He thought of this as he sat in a lovely waiting room outside the president of the New York Federal Reserve's office in the middle of September 2008 for a chance to speak to Timothy Geithner. Willumstad, the chief executive of AIG, was there to inform the Fed president that all attempts to secure a solution in the private market were failing. Cash was running out, and when their debt was downgraded on Monday they were going to have to come up with at least $50 billion, maybe more. No one was willing to buy key units of the company and there were no loans possible. Recently stung by the public outrage over its role in setting up a $30 billion portfolio to take Bear Stearns's more troubled mortgage bonds off J. P. Morgan's books, Geithner had been very blunt in telling Willumstad that no Fed help was forthcoming.

Willumstad hadn't really wanted any. He had tried every route they could think of, including trying to become one of the 18 banks and securities firms that buy and sell bonds directly with the Fed. He had hoped this would allow AIG to access some of the funding programs the Fed had set up for these "primary dealers" to keep the markets vibrant. He never heard back. Hell, he couldn't even get Geithner to focus on the $2.5 trillion in derivative exposure AIG had when he had brought it up to him earlier in the week.

So now he was there to frame out for Geithner and his staff what had been unimaginable for all of his more than 40 years in the banking business: AIG was going to die. Hank Greenberg's company, the cornerstone of both the New York and American business communities, was going to die. Competitors and customers alike had once admired its verve and audacity, but now they just feared whatever crater it made when it died.

As he stared at the floor, he was struck at the spectacle of it all. The CEO of one of the most important companies on earth was stuck in a chair trying to grab a few minutes with a central banker to explain just what might happen to the American economy and the global capital markets when that company died.

A final thought crossed Willumstad's mind: he was hoping that he ran his own meetings more punctually than this. He did not want to think that he often kept people waiting; now that the shoe was on the other foot, he found he didn't really like waiting all that much.

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While much was surprising about what we now call the Credit Crisis of 2008, much fundamentally was not. A secret straw poll in 2005 of the globe's public- and private-sector financial leadership about which global firms would be in dire straits should there be a sustained real estate–driven liquidity crisis would have likely put Bear Stearns and Lehman Brothers at the top of the list. From there, the picks get more fractious, but eventually all would have had some combination of the other American investment banks—Morgan Stanley, Goldman Sachs, and Merrill Lynch—followed by the Bank of America, Royal Bank of Scotland, and UBS. Having access to cash and the short-term loan markets, balance sheet strength, and flexibility, the financial requirements for corporate survival in a market crisis were—then as now—widely seen things the major money center banks had in abundance. The investment banks, chief among them Goldman Sachs, would always be better places to work in the short and medium runs because of their incredible profit-generation capabilities, but a commercial bank could weather the proverbial "thousand-year storm."

Next to this in the firmament of the world's financial luminaries was AIG.

AIG simply stood apart. Everything that brought the globe closer together, or moved it away from the blood-drenched ideologies and feudalisms of the previous century, AIG seemed to have a piece of. The emergence of Russia and the Eastern bloc from its Communist brutality into a global trading partner was made much easier with AIG standing ready to insure what they had to trade. The same is true of China and other Southeast Asian states.

Where other underwriters of insurance and risk would not go, AIG gladly went on the view that someone willing to engage in commerce was a reduced threat to global safety. In a sense, no other company so readily represented American postwar power—the ready allure of national wealth via trading and the promise of safety from multinational engagement and cooperation. All of the globe's business leaders reckoned with AIG at some point in their workweek. Incredibly, one man had built it from its Chinese roots into a global company that every day insured more skyscrapers in Dubai or fuel exploration off the coast of Louisiana or Scotland even as its sprawling capital markets operations traded instruments unimaginable just months prior.

Maurice "Hank" Greenberg built this company according to a vision he alone seemed to possess, and yet he managed to keep its operations and business lines, ever more sprawling and diversified, under his thumb from his suite of offices on the 18th floor of AIG's 70 Pine Street headquarters. Eventually, though, mistakes in a litigious age got him removed from the company that he still views as his very flesh. The reins were turned over to men whose experience was narrow and who possessed none of the animal fear and innate aggression that he did.

The troubles of succession from business founder to the next generation are among the oldest dilemmas in human endeavor. But in AIG's case, there was an added wrinkle: In a bid to increase earnings and diversify from the risks that AIG had faced in being one of the largest insurance companies in the world, Greenberg led AIG into capital markets.

The returns were extraordinary, and cemented the reputation of Greenberg as a visionary without peer in industry. Yet as AIG grew in this area and allowed more of its balance sheet to be used in the guarantee business, as opposed to trading or insurance, the world's most important financial company became the terminus of its financial risk. In the late 2000s, that risk was defined by real estate, an asset that was often bought and traded based on leverage and borrowing costs.

More dangerous than that was that the men running AIG saw little of this risk for what it was, nor did they believe it when it was pointed out to them. The new stewards of AIG had had little of Greenberg's ruthlessness when faced with risk and none of his knowledge of business or markets.

And there was nothing Greenberg could do about it, since he had been banished from the kingdom he had built.

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All of this was what brought Bob Willumstad to the New York Fed in mid-September 2008. Warnings had been ignored while Greenberg and

AIG's management fought an all-consuming civil war. As management basked in bull markets that drove earnings to record sums and compensation packages hit the stratosphere, layer upon layer of risk was added to the balance sheet, and trading schemes devised by the Devil himself were implemented.

AIG was created to handle risk that others could not or would not. It prospered because its managers, Greenberg chief among them, correctly judged that while some Nigerian oil wells might explode or some Brazilian executives might be kidnapped, they would be the exception, not the rule. Yet they priced the coverage as if it were more than likely the case that oil wells and executives would be in trouble. The only way to guarantee that a company could be around to handle future risk was to earn a strong profit on the risk they insured today.

The collapse of AIG, Willumstad had learned, was an inside job. The men who had run AIG had forgotten a basic premise of risk: all risk was dangerous, but there were some risks that were more fatal than others.

Chapter 1

The (Noncorrelated) Dream Team

In May 1997, a young man armed with a keen mind and a desire to succeed got out of a taxi at a leafy office park on Nyala Farm Road in Westport, Connecticut. Despite its location across from the busy Connecticut Turnpike, it was a surprisingly serene locale. Visitors from the concrete canyons of Manhattan's financial district always remarked that they couldn't believe they were only an hour from Grand Central Terminal. In every sense of the word, it was the very embodiment of the phrase, "the nearest far-away place."

Andrew Barber, a 25-year-old options trader who had recently joined Prudential Securities, was more thankful than most to be enjoying the scenery. The breeze whistling through the trees, the absence of packed streets, and the quiet all were a thankful break from a big New York trading floor's steam-kettle life. Born and raised in a small western New York town not far from the Pennsylvania border, he loved getting out of the city and hoped eventually to move back there. For now, though, there was no small amount of work to be done. Heading up an embryonic trading desk in a securities trading outpost of a vast insurance colossus, he was grateful for the opportunity to get in front of some people he believed might know where he was coming from.

There was potential here, Barber thought, though he had no idea what sort of business he might plausibly drum up. The men he was going to see did not much care about Prudential's ability to sell securities in dozens of different countries, its huge balance sheet, or its boilerplate about putting the needs of the client first. They had heard variations on that pitch for around a decade now, and from men who had been at this game far longer than he had.

No, thought Barber, as he walked in the doors of a company called AIG Financial Products, none of those things appeared to matter very much to this place at all. Still, he was there, and just maybe that was enough.

Things happen here, Barber thought. It struck him that just getting in the door at places like this was a victory.

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There was no way for Barber to know it at the time but he had walked into a business that was arguably one of the most distinctive in the global financial landscape. Possessing no real corporate mandate—other than to make money without risking its gilt-edged, triple-A credit rating, the place, to Barber's way of thinking, was the financial equivalent of the National Security Agency. You were aware of it, but you had no idea what they did or how they did it. AIG Financial Products simply did as it pleased, whenever people there felt it was opportune, dealing with whomever they chose to, in the pursuit of making a buck however they saw fit.

AIGFP, or simply FP, as employees called it, had to do precious little. They had no need to pick up the phones to the big trading desks in New York and demand bids and offers for blocks of stocks and bonds, they had no outside investors fretting over last month's earnings numbers, and no corporate managements were seeking their advice on strategy. It is no understatement to say that you could have a pretty successful career on a Wall Street trading desk in the 1980s and 1990s and would never have once encountered AIGFP on the other side of a trade. As a number of its founders acknowledge, this was all part of their plan.

But with each passing month, it became more apparent to the observant that AIGFP was a very large player in parts of the financial landscape. Investment bankers would come down to the trading floor with puzzled looks, describing conversations they had just had with equally baffled public finance officials who were using AIGFP to manage their interest rate exposure. It seemed to the bankers—and their municipal clients—that AIGFP was somehow making a killing in offering towns and cities the ability to swap their fixed-rate debt costs out for an interest rate that floated as borrowing costs rose or sank. This swap idea was hardly new, but was rarely used since someone—and it was almost always the municipal borrower—invariably got killed when rates ran up and debt that had once been cheap became suddenly quite expensive. For an investment bank, it was a public relations headache, another example of the Street's sharks preying on the unsuspecting.[1] As the story went, though, AIGFP managed to hedge out its risk and was happily taking the other side of these trades. For a fee, it even helped the cities and towns hedge their exposure to this sort of volatility, minimizing costs from swings in interest rates.

In the early 1990s, bankers to technology companies began to tell their colleagues that their clients in the Silicon Valley and along Massachusetts's Route 128 were using AIGFP to turn their large blocks of company stock and options into ready cash. Instead of taking out a cash loan from a UBS or J. P. Morgan against their equity stake (a strategy fraught with risk since the bank could demand cash collateral or even seize the executive's stock when the value declined enough), AIGFP used options to help corporate executives raise cash from their holdings overnight without making investors worry over the message sent by the CEO's stock sales, or incurring the wrath of the taxman, who fretted over whether the stock had truly been sold and risk transferred.[2]

That interesting and lucrative things were happening at AIGFP was evident to a certain type of curious Wall Streeter—the sort who asked questions about why things were really happening, or conversely, why they were not. It was just that no one outside of Westport had answers to these sorts of questions.

This is where Andrew Barber came in because, like any dream factory, AIGFP needed a constant flow of dreamers. In this case, they needed puzzled bankers from Wall Street's transaction factories to make the pilgrimage to Westport and unpack their dilemmas. Usually, it was a client with a certain sort of problem not amenable to the typical Wall Street banker cure-alls: the issuance of stock or bonds, a merger or sale of a unit. Rather, bankers and corporate officials came to them with the thorniest of problems: an international corporation with huge tax liabilities in one currency and large tax benefits in another that needed to have its tax payments risklessly normalized and then converted into a third currency, a privately held company that needed to rapidly (and without the hassles of Securities and Exchange Commission [SEC] registration) turn its huge and profitable holdings in some publicly held companies into some ready cash without surrendering its equity stake. Wall Street, and thus the men and women who worked there, were the canvas for AIGFP to conjure up new ways to use AIG's rivers of cash and its titanium balance sheet to reap profits where others could not or would not.

A bright and creative thinker, Barber was just the sort AIGFP liked to deal with in the 1990s: smart enough to be doing the type of highly quantitative trading and analysis that was the sine qua non of their daily life, yet honest enough to know its limitations. Despite his relative youth, Barber was trying to build a business and was willing to talk to most anyone to see if he could get something going. This entrepreneurial spirit was a virtual necessity, since Prudential Securities—though part of a massive insurance company—was in reality a second-tier player (at best) in a financial system where first-tier firms like Goldman Sachs, Morgan Stanley, and Merrill Lynch garnered the lion's share of customer trades and investment-banking work. On a given day, Barber would trade, research his own trading ideas, peddle a few trades to his growing book of customers and then grab a quick sit-down with the corporate finance department to explain how options and other derivatives could factor into getting some corporate client business done. It was, he had come to realize, a job that was equal parts exhilarating and utterly thankless.

Word gets around quickly on Wall Street when someone's thinking is fresh or different. Astute investors remember when a sell-side trader challenges their assumptions or gets them to frame an investment dilemma in a different fashion. Traders are too often depicted as aggressive rogues, using bravado and ample amounts of capital to reroute a whirlwind market and carve out profits. The precise opposite is more often true: they are content to (nearly risklessly) execute trades between clients with differing investment views and goals and to hopefully earn a few cents' profit between the bid and offer prices. Many sell-side traders and sales staff are quite good at providing clients market intelligence but much less efficient at helping clients use current conditions to frame a sober view of the future. As such, rather than the proverbial "Masters of the Universe" stereotype, they are more akin to hot-dog vendors on a Manhattan street, competing in a ruthlessly efficient and crowded market, earning a precarious living on heavy volume and narrow margins.

Not Barber.

So when a marketer at AIGFP got wind of a guy who was looking at equity options and derivatives differently, a quick phone call was made and Barber happily hopped a train to Westport.

Passing through the doors, what struck Barber was what he didn't see at the place that a generation of Americans has now come to view with varying degrees of infamy. There were no packed trading floors, nor was there any false bravado or bonhomie among the people he met there. People were courteous, not because they particularly wanted anything from him—and he was in no position to be granting much in the way of the expensive, wheel-greasing perks institutional investors favor, like sports tickets or travel junkets—but because they seemed decent.

In fact, the more Barber thought about his time there, the feeling he got was that this was the most intentionally designed place he had ever been to in his life. Very little expense had been spared to create the perfect anti–Wall Street feeling: the main trading room, if indeed that's what it actually was, he thought, had been set up as a series of interconnected, but free-standing desks to intentionally avoid the institutional trading desk vibe. (To get a sense of what the place really was, he had to force his eyes to track the roughly congruent layout of stacked computers and Bloomberg terminals.)

The walls of the room contained row after row of books, from arcane academic works covering the mathematical shape of interest rate curves to works on admiralty law and even copies of the corporate tax code from the 1940s. They weren't for show; they were bookmarked, haphazardly stacked, and dog-eared, Barber noticed, and freshly so. People here wanted to know everything about subjects he hadn't much presumed existed, let alone seen as ripe for some money making.

There was a platoon's worth of dutiful analyst types studying those books, taking notes, comparing and contrasting things between volumes and between the book and their computers. Barber assumed they were the paralegals, junior assistants, and first-year researchers that all financial firms seem to run on. He would, in short order, learn how wrong he was.

The flatness of the organization was apparent almost immediately. While speaking with Jake DeSantis, one of the young derivatives traders he had come to know, one of the few senior managers there ambled by and, unprompted, opened up about a series of ideas he had. People walked by and talked about land purchases and shale, leases, and tax credit. Others floated into the conversation, and senior people ducked in and then out.

Were these potential trades or deals he was talking about, or simply random musings? Was Jake being asked to look into something, or was this just FP's version of water cooler talk? At FP, he would learn, these sorts of distinctions could be immaterial. The next trade or the next deal could come from anywhere, in any asset or market sector, so everyone was open to exploring anything.

Again, the contrasts between large Wall Street firms like Prudential (and PaineWebber, where he had started trading) were striking. At those places, you could occasionally have a rewarding conversation with a supervisor, but there were so many managers and so many different corporate and political distractions that it was easier and safer to limit your contact with them. Making solid money was the safest way to avoid becoming a casualty in some investment bank's corporate restructuring or a boss's ego power move, but even then, there were no guarantees. Wall Street, he was coming to learn, offered many ways to die.

There was an aquarium there—one of the largest freestanding saltwater tanks in the world—that contained a decent-sized shark.

A remnant from a previous tenant, the tank and its shark soon disappeared; when Barber asked why, he was told simply, "It's just not who we are." FP was wholly detached from the cultural norms of Wall Street and its boxing leagues, after-work drinking and strip clubs at conferences. Everything that was important to Wall Street simply got in the way at FP.

Barber would come to learn that AIGFP worked because it had the precise opposite ethos of the Wall Street salesmen who courted its business. The hustlers could keep their quick one-eighth- and one-fourth-point profits on a deal, or the extra nickels and dimes they captured on the spread between interest paid and interest received; AIGFP told people like Barber they wanted the risk because it was so often mispriced. This was a nicer way of FP's saying that they felt they had the brain and computer power to look five years down the road and make a profitable assumption about the likely range of a stock's price. A company with balance sheet, talented people, and a creative bent could make handsome returns over time when an executive, wanting to turn his options grants into some cash, allowed FP to strip out the volatility component of his options grant in return for cash.[3]

The surpassing strangeness of all this would only occur to Barber years later. In über-competitive Wall Street, where everything to do with business was held to be a secret or some proprietary formula, a customer had happily told him he could keep short-term profits and then told him that they make money—real money, into the tens of millions per trade—because they value something entirely differently than he does. Then, to complete the through-the-looking-glass aspect of it all, they told him how they do it.

On the way back to Prudential after a visit in 1998, Barber reflected on it. Am I a customer of theirs, or are they a customer of mine? He would learn the answer during his first transaction with them, a convoluted deal involving a method to extract the value from a rich dot-com executive's stock holdings without selling the stock or risking a decline in value or tax liability.

The answer was in their worldview: AIGFP had no customers, only counterparties. As cordial and engaging as everyone there was, as willing as they were to give away the things that everyone else on Wall Street valued, Barber quickly saw that they did not negotiate on the structure of a transaction. Ever. When Barber inquired about perhaps changing a minor point here or a detail there, the answer was a firm "no."

Everything AIGFP did was a "principal" transaction because AIG's balance sheet and credit were always theoretically at risk. In this environment, every deal is constructed to very exacting risk tolerances, and everything and anything was a possible threat.

He would see this utter aversion to risk in action. A dozen years later Barber says he is still astounded to recall it. There were conference calls with FP that spawned more conference calls, which in turn led to meetings and calls with tax lawyers who would ask the initial risk-review-type questions but from a tax-law precedent angle. After they were done, the corporate finance lawyers weighed in. Then accountants ran the numbers to scenarios that Barber viewed as more satire than fact—wholesale shifts in the tax code back to 1970s levels, huge swings in the stock market, total corporate disruption. After that, there were people who seemingly had no connection to the transaction but who had clearly studied the deal closely and had strongly held opinions. It never really ended. Line by line, word by word, the deal's papers were gone through, with the FP people always asking, "Do you understand?" and "Will there be a problem here?"

They were modeling the deal, he surmised, to protect themselves in the event Prudential or its customer weren't able to live up to their obligations for any reason known to man. This struck him as odd, since Prudential in 1998 had $200 billion in assets and their customer was, at least on paper, worth hundreds of millions of dollars. "How," he would ask colleagues many months later, "do you even develop a worldview that could model a trade to make money if a $750 billion institution failed?"

With a vetting process like this, Barber concluded, AIGFP's concern was the opposite of his—and thus the opposite of Wall Street—in that they did not fret over where revenue was going to come from; they fretted over whether they had properly analyzed and modeled the risk that everyone else supposedly did not understand. In the vernacular, Wall Street, and all of American business, looked at transactions and worried about "upside," wondering where additional profits could come from. At FP, people cared only about "downside," or what could go wrong, better known as "the fat tail."[4]