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A Crack in The System

By 1998, AIG Financial Products had made hundreds of millions of dollars and had captured Wall Street's attention with its precise, finely balanced system for managing risk. Then it subtly turned in a dangerous direction.

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Second of three parts

For months, several executives at AIG Financial Products had pulled apart the data, looking for flaws in the logic. In phone calls and e-mails, at meetings and on their trading floor, they kept asking themselves in early 1998: Could this be right? What are we missing?

Their debate centered on a consultant's computer model and a new kind of contract known as a credit-default swap. For a fee, the firm essentially would insure a company's corporate debt in case of default. The model showed that these swaps could be a moneymaker for the decade-old firm and its parent, insurance giant AIG, with a 99.85 percent chance of never having to pay out.

The computer model was based on years of historical data about the ups and downs of corporate debt, essentially the bonds that corporations sell to finance their operations. As AIG's top executives and Tom Savage, the 48-year-old Financial Products president, understood the model's projections, the U.S. economy would have to disintegrate into a full-blown depression to trigger the succession of events that would require Financial Products to cover defaults.

If that happened, the holders of swaps would almost certainly be wiped out, so how could they even collect? Financial Products would receive millions of dollars in fees for taking on infinitesimal risk.

The firm's chief operating officer, Joseph Cassano, had studied the model and urged Savage to give the swaps a green light.

"The models suggested that the risk was so remote that the fees were almost free money," Savage said in a recent interview. "Just put it on your books and enjoy the money."

Initially, the credit-default swaps business would amount to a fraction of the half-billion dollars in Financial Products' revenue that year. It didn't seem to them like a major decision and certainly not a turning point.

They were wrong. The firm's entry into credit-default swaps would evolve into insuring more volatile forms of debt, including the mortgage-backed securities that helped fuel the real estate boom now gone bust. It would expose AIG to more than $500 billion in liabilities and entangle dozens of financial institutions on Wall Street and around the world.

When the housing market tanked, a statistically improbable chain of events began to unfold.

Provisions in the contracts kicked in, spurring collateral calls on swaps linked to $80 billion in questionable assets, requiring the firm and AIG to come up with billions of dollars in cash. They scrambled for almost a year to stave off the calls, but there were too many deals with too many counterparties.

In September, the Bush administration concluded that AIG's position at the nexus of the deals meant that it could not be allowed to fail, triggering the most expensive rescue of a private company in U.S. history. So far, the government has invested $152 billion in its efforts to save AIG. Federal investigators are sifting the carnage.

Credit-default swaps exemplify the contradictions of modern finance. At a basic level, they serve as insurance, but they aren't regulated as such. They have allowed companies to free up untold amounts of capital that otherwise would be tied up as collateral for loans. They were sold both to reduce risk and, in some cases, to give clients room to take on more risk -- a key component to making money on Wall Street.

But in the end, neither the buyers nor sellers truly understood the enormous risks they were creating. Anyone could sell such a swap, and anyone could buy one, even if he had no stake in the transaction. Some buyers used them to bet against failing companies, prompting a debate among state regulators about whether this type of swap was a form of gambling.

The very nature of credit-default swaps put Financial Products at odds with itself, requiring it to deviate from the disciplined system that had made it a pathbreaker. Everything about the company -- its technology, its people, its rigorous culture of transparency and caution -- was designed to minimize the various risks that it shouldered while solving problems for clients.

That meant hedging whenever possible, a Wall Street term for making offsetting trades to balance risk. For transactions involving credit and loans, it also meant building an escape route so that the firm could get out early if it saw a deal going bad.

With credit-default swaps, there was no way out, and the risk was so minute that hedging was considered unnecessary, as well as problematic. Savage remembers discussions about whether the firm's vaunted computer system could even come up with the proper values needed for the trades that hedging relied on.

All of that made Savage and the others wary. Skepticism was hard-wired into the company's culture, part of its mantra: Hedge if you can. Don't make speculative trades. Above all, protect AIG's reputation and its top-drawer Triple A credit rating, which gave Financial Products credibility and the ability to borrow money at the cheapest rates. The rating was the fuel for Financial Products' innovation and success.

AIG's chairman, Maurice "Hank" Greenberg, had once warned Savage that he would come after him "with a pitchfork" if Financial Products did anything to harm AIG's AAA rating. No one saw credit-default swaps as anything on that scale. After conversations that included AIG executives, Greenberg blessed the new line of business. "There was a long discussion about it," Savage recalled recently, "and he said it was fine."

Greenberg said recently, "I don't think going into it in '98 was wrong." During his tenure, he said, he and his risk managers kept close watch on the swaps and the exposure they created.

Savage retired from Financial Products in 2001. When he left, credit-default swaps were still a small portion of the firm's business. Not long ago, in the dining room of his golf club in Florida, he reflected on the significance of the decision that he and his colleagues made in 1998.

Like his bosses at AIG, he still thinks it made perfect sense to give swaps a try. "The credit derivative business had just begun and because of our role in the derivatives business, it was very natural for us to have some minimal participation," he said.

Savage says he now sees that the decision sent Financial Products down a path at odds with its guiding principles. The firm's success had been built on assessing data daily, recalibrating assumptions constantly, counterbalancing one risk against another and making the hedges. The credit-default swaps didn't require that sort of attention.

"The different nature of those trades from any other trades that FP had done," Savage said, "opened the door to all the problems that came about."

He added later: "In retrospect, perhaps those deals should never have been done."

2: 'A Watershed Event'

One of the firm's biggest advocates for credit-default swaps was Joseph Cassano.

Cassano, the feisty, hardworking son of a Brooklyn cop, did not have the pedigree of Financial Products' three founders, who hailed from places such as Bell Labs and the Wharton School. Cassano had worked with the trio at the junk-bond firm of Drexel Burnham Lambert, and had been one of 10 original recruits who left Drexel to start Financial Products.

A Brooklyn College graduate, the 42-year-old Cassano was not one of the "quants" who had mastered the quantitative analysis and risk assessment on which the firm had been built. He had no expertise in the art of hedging. But he had excelled in the world of accounting and credit -- the "back office," as it is known on Wall Street.

The founders of Financial Products made him the firm's chief financial officer. From the start, Cassano gained respect, in part because he and his team rarely made mistakes processing trades. He was smart and aggressive -- sometimes too aggressive, some executives thought. He had a mercurial temper, occasionally screaming at an underling. He swore, berated and moved on, sometimes leaving hard feelings in his wake.

"He was very, very good," recalled Edward Matthews, AIG vice chairman. "But he was arrogant."

He also was ambitious. He made plain to his bosses that he wanted more than the back office.

In 1994, Cassano got a chance.

The firm's founders had left in a bitter dispute with Greenberg, and Savage had taken the reins. He put

Cassano in charge of the Transaction Development Group, a new unit hunting for business involving energy products and tax credits in the United States and abroad. He was also made chief operating officer.

Cassano's portfolio included deals involving credit, so he played a key role in the credit-default swap debate going on inside the company. In 1998, when the investment bank J.P. Morgan came to Financial Products, seeking a credit-default swap arrangement, Cassano was among the most interested. After studying the proposals, he passed on the first deal. But he soon became a leading proponent.

J.P. Morgan wanted to package a variety of debt on its books and resell it. The debt would be turned into bond-like securities, and layered like a wedding cake so that investors in the top tiers were first to get their money back in case of default. Investors in lower tiers earned a higher interest rate for taking greater risk.

The "structured" deal had an unwieldy name, the Broad Index Secured Trust Offering, so it was called "Bistro" for short. Because the debt in Bistro was diverse, the investment was considered exceedingly safe; if one kind of debt went into default, it was unlikely other kinds would go under at the same time. As an extra measure of safety, the Bistro organizers wanted Financial Products to write credit-default swaps on the top tiers to further reassure skittish investors.

As private contracts, deals like Bistro could be financed with greater amounts of borrowed money than regulators would allow if the deals were publicly traded. This high degree of leveraging would come back to haunt the industry later.

The structure was an early form of collateralized debt obligations. CDOs were a hit almost from the start. It would take several years and a housing bubble for CDOs backed by mortgages to catch on. At Financial Products, the credit-default swap was only one of many innovations in play, but Cassano was passionate about how it could help the firm.

"It was a watershed event in 1998 when J.P. Morgan came to us, who were somebody we worked with a great deal, and asked us to participate," Cassano told an investment banking conference in 2007. "These trades were the precursors to what's become the CDO market today."

Even as Cassano spoke, the housing market was collapsing, the lack of diversity of the CDO debt was being exposed, and the risk for Financial Products was rising.

3: 'It's the Hardest Thing'

By summer 1998, after four years as president, Savage found himself thinking even harder about risk, particularly credit risk. It was often difficult to quantify the likelihood that someone would pay back a loan.

Savage kept his distance from developing trades, with the idea that he could better maintain his objectivity about potential pitfalls. He sometimes wondered whether Cassano's enthusiasm for the credit deals colored his ability to assess them. Cassano's lawyer, F. Joseph Warin, said in a recent interview that Cassano took care to follow procedures that minimized risk.

Greenberg, too, kept at Savage about the risk, even while keeping on the pressure for greater profits. On Wall Street, investment banks and other financial institutions were mad for private contracts called derivatives, Wall Street's jargon for a contract based on something trading now, but settling in the future. (A credit-default swap is a kind of derivative in which one company takes on the future credit risk of another.)

Derivative contracts accounted for more of the world's financial activity by the day. Some in Washington had taken notice, and thought investors and regulators needed to know more about these privately arranged deals that were cloaked from outside scrutiny and clouded by complexity.

Brooksley Born, the 57-year-old head of the Commodity Futures Trading Commission, argued forcefully for a public debate about whether derivatives posed an unknown and growing risk to the world's financial system. She testified at least 17 times before Congress on the subject.

Her campaign gained no traction. More powerful regulators, including Federal Reserve Chairman Alan Greenspan, Treasury Secretary Robert E. Rubin and Securities and Exchange Commission Chairman Arthur Levitt, opposed Born. They and others said her agency had no authority over derivatives and that her call for action was casting a "shadow of regulatory uncertainty over an otherwise thriving market."

Greenspan, in particular, argued a free-market view. He saw derivatives as a mechanism that unlocked efficiency, allowing dormant capital to flow into the system, greasing the gears of the world's economy. The Clinton administration and many congressional Democrats endorsed the notion that too much regulation stymied growth.

Greenspan pushed the idea that the marketplace was self-correcting, a view that he often espoused in speeches at economic conferences around the world. He invited Greenberg to attend one such meeting in Basel, Switzerland. Greenberg couldn't go, so he arranged for Savage to go. Chief executives of banks, investment firms and insurance companies, as well as U.S. and German regulatory officials, filled the room.

Greenspan, already celebrated as an economic guru, commanded attention every time he spoke. The question he posed that day resonated with Savage for a long time.

"Do you folks find that you have enough information to make credit decisions in your businesses?" Greenspan asked.

Mathis Cabiallavetta, chairman of the board for the giant Swiss bank UBS, responded that his company knew well what it was up against.

Not well enough, as soon became clear.

In September 1998, Long Term Capital Management, a heavily leveraged hedge fund with mountains of derivatives, told Federal Reserve officials that it could not cover $4 billion in losses. Russia, swept up in an Asian economic crisis, had defaulted on its debt, and Long Term was besieged with calls to put up more collateral for its investments. The collapse threatened the fortunes of investors from tycoons to pension funds.

UBS lost hundreds of millions of dollars. Cabiallavetta lost his job.

The exchange in Switzerland, and the Long Term debacle, fueled Savage's unease. His mind kept turning over the problem of how to calculate the risks of credit.

"I've always thought about that," he said. "At the highest level of finance, this is a question of interest. Are you getting enough information about the loans that you're making to corporations? It's the hardest thing. . . . You have to look beyond the credit-rating agencies and make your own decisions."

Savage recalled something that Greenberg had once told him.

"He said to me, 'I want you to understand that no matter what the credit rating is, no matter what other things you might understand, when a CEO owes you $100 million and is supposed to pay you on Friday, sometimes he just doesn't do it.' "

4: Exploiting A Seam

Financial Products' drive to keep ahead of its competitors took the firm in unexpected directions. It developed a reputation as an innovator with one of the most diverse toolboxes in the derivatives business.

That's how Cassano and his Transaction Development Group found coal.

For a group of financial wizards, the coal business seemed an odd turn. But it was a logical extension of what the firm had been doing all along: discovering gaps in regulations and markets.

A 1980 law, generated by the Carter administration, offered tax credits to companies as incentives to design and use synthetic fuel systems. The aim was to reduce U.S. dependence on foreign oil.

Associates at the Transaction Development Group had discovered that many energy companies were not making enough money to benefit from the tax breaks. But Financial Products' profitable parent, AIG, could use those credits to reduce its tax bill.

"One thing AIG had was ample income," Savage said. "So what we did is, we went out and we bought synthetic coal facilities."

The firm had no intention of becoming coal processors. Instead, it arranged to install the equipment -- bought for more than $225 million, as Savage recalls -- at coal facilities and power plants. The facilities leased and operated the machines at a discount, while AIG got millions in tax credits.

Financial Products hedged aspects of the deals and checked with government officials to make sure the arrangements qualified for the breaks. Savage said the idea was bold as well as clever. "We had the gumption to go out and take seven of these plants that were sitting around doing nothing," he said. "We carted [the machines] off to where they could be used, and it went on."

Greenberg, too, was taken with the gambit. "It was opportunistic," he said recently. He once joked that he wanted to ride shotgun in the truck carting the machines around, Savage said.

Over the next several years, AIG reaped $875 million in benefits from the deals. It was a coup for Cassano and his group. Although it wasn't Cassano's idea, Savage said, he guided it from concept to reality.

"He says he thought about it for six months," said Savage, who came to appreciate Cassano's single-minded focus. "He made a lot of money for the company."

5: 'It Would Be Joe'

In fall 2001, Savage decided to call it quits. He had moved his family to Florida and briefly considered whether he could manage the commute. The Sept. 11 attacks made that sort of arrangement seem impossible. He told Greenberg of his plan to leave.

Cassano emerged as Greenberg's candidate to take over. Some colleagues questioned his qualifications to manage a team that was heavily dependent on quantitative skills. Though he was the firm's chief operating officer, some colleagues thought he wasn't as conversant with the complex calculations of risk that remained at the heart of its business. Beyond that, few liked his chip-on-the-shoulder demeanor.

Greenberg had come to know Cassano through board meetings over the years. Cassano had won Greenberg's confidence. The two shared a number of qualities. Both were strong-willed, and both disliked criticism. Greenberg knew that, like him, Cassano had made AIG the center of his life. He knew about Cassano's temper, but he appreciated his grit and drive to make money in the derivatives field, which was becoming more crowded with competition.

Cassano had one other virtue that helped him land the top job: He followed directions from Greenberg and Matthews, the parent company's leaders.

"He told us that in no uncertain terms, that he was -- that all of his people up there were -- smarter than anybody we had at AIG," Matthews said. "And he made it clear that he listened only to two people: He listened to Hank Greenberg and he listened to me."

Cassano would need all the smarts he could muster. He was taking the reins at a challenging juncture. Financial Products was now a $1 billion operation with 225 employees working on a multitude of derivatives deals for clients, involving hundreds of billons of dollars in obligations. But in early 2002, when he replaced Savage, the derivatives industry was coming under a shadow.

A high-flying financial company called Enron was just starting to melt down. Because Enron had systematically abused derivatives as part of its fraudulent corporate accounting, some kinds of derivatives became the focus of regulatory scrutiny and fell out of favor. Structured deals for corporations were a large part of Financial Products' business.

The firm would need to make up lost revenue. "The response to Enron really reduced the toolbox for Financial Products," Savage said. "It wasn't at all clear to me where the profits were going to come from."

Under Cassano, Financial Products would grow, take on more risk and become more top-down than before. The culture that had characterized the firm from the outset -- one that relied on informed skepticism in which just about anyone could question dubious aspects of a trade -- would change, according to people who worked at the firm.

Cassano disputes the notion that the culture had changed, according to Warin, his lawyer. "FP worked closely and had healthy discussions with its internal auditors so they would fully understand the business and investments," Warin said. "Mr. Cassano encouraged this oversight, review and open communication."

6: Clearing The Way

In 2002, the regulatory debate over one of those lines of business, credit-default swaps, was going nowhere. The swaps had fierce critics. Some saw them as insurance deals that ought to be subject to the same regulation that governed the writing of homeowners' policies or car insurance. Others saw certain swaps as gambling: Because anyone could buy a swap, even someone who had no stake in a particular asset, some critics thought those swaps were like a poker game in which spectators placed bets among themselves on who would win the hand.

Some regulators had a hard time seeing the financial value in certain swaps -- especially in deals used to remove debts from a corporation's books.

But those regulators were fighting a lost cause. In the waning days of the Clinton administration, Congress had passed the Commodity Futures Modernization Act, which preempted derivatives from oversight under state gaming laws and excluded certain swaps from being considered a "security" under SEC rules.

While some regulators had expressed concerns about the act, President Clinton's economic team had agreed that derivatives should not be regulated. Clinton signed the measure, which was part of a larger bill.

"By ruling that credit-default swaps were not gaming and not a security, the way was cleared for the growth of the market," Eric Dinallo, the superintendent of New York State's insurance department, told a Senate committee during recent hearings on the role of derivatives in triggering the financial crisis. "None of this was a problem as long as the value of everything was going up and defaults were rare. But the problem with this sort of unregulated protection scheme is that when everyone needs to be paid at once, the market is not strong enough to provide the protection everyone suddenly needs."

7: 'We Made Some Mistakes'

In August 2002, one Financial Products' innovation caught the attention of federal investigators. The year before, Financial Products had been pitching a new way for companies to shed bad debts, and it had found a customer in PNC Financial Services Group, which had $762 million in underperforming assets it wanted to unload.

Ordinarily, the bank would need to account for the falling value of those assets, which would mean a hit to its profits. Associates at Financial Products, working with accountants, thought they had found a way to solve PNC's problem: Create "special-purpose entities" to take on the unwanted assets.

Federal investigators alleged, however, that the deals were a sham. To make the transactions look legitimate, Financial Products had set up a company to "invest" in the entities, while receiving an equivalent amount in the form of fees, according to the investigators. Structuring the deal this way violated securities laws, FBI agent Randy Tice asserted in an affidavit filed in federal court as part of the simultaneous settlement of a criminal case and an SEC civil complaint.

AIG and two Financial Products subsidiaries agreed to pay an $80 million fine and give back $39.8 million in the fees that it had earned, plus $6.5 million in interest. PNC paid a $115 million fine.

The government announced the settlement on Nov. 30, 2004. In the wake of Enron, the investigators were sending a message. "We are pleased that AIG has accepted responsibility," said Christopher Wray, an assistant U.S. attorney general. "There is no place in our markets for financial transactions that lack economic substance."

But authorities demanded more. The settlement also required AIG "to implement a series of reforms addressing the integrity of client and third-party transactions." A group of senior AIG executives would review complex transactions from the previous few years, working with an independent monitor chosen by the Justice Department, the SEC and the company.

In other words, the government had concluded that Financial Products' internal controls -- the disciplined system that had once made the company different from its competitors -- had faltered.

Cassano, who had not arranged the transactions but signed the settlement for Financial Products, later described the PNC deals as an anomaly. "We made some mistakes in those transactions, and we suffered dearly for that," he said in 2007 at an investors conference. "And we've gone to great lengths to correct the things that allowed the transactions to occur."

Greenberg said recently that Financial Products had consulted its legal and accounting experts before going forward with the special entities. The board of directors also had looked it over, Greenberg said. "We thought it was proper," he said.

The settlement is still a source of grief for the former AIG chief executive, who had to swallow the costly settlement and the independent monitor. "I took a bullet for them," he said. "I went out in front. I didn't have to do that. It was their deal."

But the case had another consequence for Greenberg. It brought AIG into the sights of another skeptical investigator: New York Attorney General Eliot L. Spitzer.

8: Foot Faults

After the PNC case became public, a tipster approached Spitzer's office. Insurance companies, the tipster said, were selling policies known as "finite insurance." The tipster thought the policies were a fraud.

Done right, finite insurance expressly limits the losses an insurer can suffer. Done wrong, it isn't insurance at all because neither side takes any risk. Instead, it's an accounting trick that can help both parties improve the appearance of their balance sheets.

The tipster urged Spitzer's office to examine finite insurance and suggested several companies for scrutiny, including AIG and Gen Re, another large insurance company. Spitzer's office sent subpoenas to companies, seeking more information. Not long after, a black binder from another tipster arrived at Spitzer's office in Lower Manhattan. Four inches thick, the binder held confidential documents from Gen Re. The documents appeared to show that Greenberg had arranged bogus transactions with Gen Re that made it look as if AIG had $500 million more in insurance revenue than it had actually earned.

Spitzer and his people could not believe their luck. It was a case on a silver platter. They decided to question Greenberg right away, instead of the usual approach of working slowly toward such a big potential target.

On Feb. 9, 2005, Spitzer told his people to begin work on a Greenberg subpoena.

That afternoon, coincidently, Greenberg announced AIG's latest earnings in a conference call with industry analysts and others. During the call, he complained indirectly about Spitzer's investigation of the insurance industry, suggesting that the probe was overkill and Spitzer was wasting his time.

"When you begin to look at foot faults and make them into a murder charge, then you have gone too far," Greenberg said.

Greenberg's remarks were reported online that afternoon and Spitzer happened to see them. Irked, he asked a deputy how soon the Greenberg subpoena could go out.

That evening, Spitzer was to speak at a dinner with senior executives at Goldman Sachs, in an elegant conference room at the investment bank's headquarters. Among those in the audience: Henry Paulson, then Goldman's chairman and chief executive. The next year, he would become Treasury secretary and head to Washington, where he eventually assumed the central role in dealing with AIG's near-collapse.

As Spitzer waited to deliver his remarks, a deputy came in and whispered into his ear: The Greenberg subpoena had been faxed to AIG. A few minutes later, Spitzer alluded to Greenberg's comments earlier in the day.

"These are not foot faults," Spitzer recalls saying. "But second, too many foot faults and you lose the match."

9: 'No Choice'

The end of Greenberg's reign at AIG came with a phone call March 13, 2005. He was in a private jet on his way back to New York from a visit to Key Largo, Fla. The AIG board of directors had called a meeting that Sunday to consider allegations from Spitzer that Greenberg had been personally involved in the fraudulent deal with Gen Re.

The board had asked Greenberg to call. Frank Zarb, a veteran Wall Street executive and board member, told Greenberg that Spitzer had issued an ultimatum: Greenberg had to resign.

"I had no choice," Greenberg said recently. "No choice."

Earlier this year, four Gen Re executives and an AIG executive were found guilty on federal fraud charges. Later, AIG restated earnings from 2000 to 2004.

Greenberg, referred to anonymously in federal documents as an unindicted co-conspirator, maintains that what "we did, from AIG's perspective, was perfectly proper." In a recent interview, he tore into Spitzer: "He destroyed a company. And for what?"

Spitzer said recently that the activities at AIG were too important to ignore. Events have solidified his view. "AIG, as we have now all seen," he said, "was at the center of the web of the entire financial system."

Greenberg blames others for his company's downfall. He says his forced departure left AIG without the strong hand it needed to protect against future excesses. He said AIG and Financial Products were prepared to hedge any transaction "if we thought there was going to be a potential problem."

Matthews put it this way: "What bothers us about this is we had a climate of risk management which seems to have evaporated after we left."

By then, though, the company had already taken a deeper dive into credit-default swaps, including an expansion into the subprime mortgage market that would eventually trigger the improbable.

The crack in the Financial Products system was about to get a lot wider.

Wednesday: Downgrades and downfall.

Staff writer Bob Woodward contributed to this report.