AIG's cds hoard: the great unraveling

Ben Levisohn

The process of unwinding AIG's credit default swaps isn't rocket science, but it is messy and expensive. Here's why.

Credit default swaps got American International Group (AIG) into its current mess. Unraveling them might get U.S. taxpayers out of it. But it won't be easy or cheap.

The white-hot furor over AIG's retention bonuses seems to have died down a bit. Last week the House of Representatives passed a watered-down version of the bill that was supposed to tax those payments out of existence. But AIG isn't leaving the bull's-eye anytime soon. The Government Accountability Office said on Mar. 31 that AIG should demand concessions from its trading partners and employees. On Apr. 2, deposed AIG Chief Executive Hank Greenberg paid a visit to Capitol Hill, blaming his successors for the company's failings and calling its government bailout a failure. And New York State Attorney General Andrew Cuomo is probing the $165 million bonus payments and the billions AIG transferred to such banks as Goldman Sachs (GS) and Société Générale (SOGN.PA).

Amid all this hubbub, AIG's employees plug away, trying to wind down the beleaguered company's remaining credit default swaps, which are basically insurance policies purchased against the default of various forms of debt.

So what's so hard about unwinding a CDS? And does it really take a financial rocket scientist, chained to a seat by a fat retention bonus? Or could it be done by some of the vast army of recently unemployed Wall Street workers?

Large, complex web of derivatives

Part of the problem is that not only are the financial instruments themselves complicated, but they involve tangled relationships of companies and investors, each with their own interests. AIG owns $1.5 trillion in derivatives, including CDSs, interest rate swaps, and currency swaps, among others. And these trades overlap in a large web across all its companies. Since everyone knows that AIG needs to rip up its contracts, its partners are holding out for the best deal possible.

The nastiest, most complicated, and most controversial types of AIG's CDSs have largely been taken off the company's books. Those swaps were customized by the insurance company to protect financial institutions from default in illiquid pools of mortgage-backed securities, the now infamous collateralized debt obligations, or CDOs. When the value of the CDOs tanked and AIG's credit rating was cut, the insurance company was forced to pay billions of dollars in collateral to companies known as "counterparties"—money it didn't have.

To exit the contracts, AIG used Federal Reserve and Treasury Dept. cash to pay the counterparties 43¢ on the dollar for the securities (which now reside on the Fed balance sheet as Maiden Lane III). Then the company paid off $26 billion in insurance on the same CDOs to Goldman Sachs ($5.6 billion) and Société Générale ($6.9 billion), among others. This cost taxpayers $46 billion.

That's not the end of the story, unfortunately. AIG's remaining credit default swaps may not be as toxic. Many of the remaining swaps are, in fact, what the industry calls "plain vanilla"—fairly standard, liquid contracts. But that doesn't mean they'll be easy to get rid of.

"Like you're flying blind in a 747"

There is no centralized market for derivatives, so AIG's traders in Wilton, Conn.; London; Paris; and Tokyo can't just look at a PC screen and see the current price, as a trader would do with a stock. Instead they look at the available data on such things as interest rates and the earnings of the companies whose debt is insured, and then use mathematical models to determine what they want to pay. Next they reach out to other traders to gauge what might be a reasonable price. At the same time, the trader has to figure out the overall impact the trade will have on AIG's book.

"It's like you're flying blind in a 747," says Marc Groz, a hedge-fund risk manager who now heads up risk management firm Topos. "You can only see what the instruments are telling you."

Because they are contracts between two parties, AIG's credit default swaps can't simply be sold. Some will expire on their own, like the $234 billion of swaps that are expected to come off the books in the next year and a half. Others will be terminated at the request of the owner. AIG can opt to let the contracts expire. But $34 billion worth of CDSs is set to run down over the next five—or more—years, which would seem to run counter to its avowed plan to wind the contracts down as quickly as possible. If AIG wants out, it will have to go back to the other side of those trades and negotiate an exit.

That won't be easy—or cheap. CDSs are still trading, but the spreads—the difference between what dealers are willing to pay to buy or sell—have widened, making it more expensive to get out.

Needed: steely nerves and keen math

"The Street knows they have to unwind positions," says TABB Group's Kevin McPartland, an analyst who specializes in derivatives. "It gives AIG little pricing power."

Working those deals doesn't necessarily require the same hands that put them together in the first place. But it's not a task for just any newly minted MBA. Wall Street has largely abandoned the shoulder-to-shoulder battle of the exchange floor for a more formula-driven mode of trading. Steely nerves are still required, but so is an acumen for high-level math.

Such skill sets are not necessarily uncommon on Wall Street but they're still in demand, despite waves of industry layoffs.

"The vast majority of professionals at AIG are just doing their jobs," says Rob Sloan, head of U.S. financial services at Egon Zehnder. "And many could get jobs elsewhere."

AIG declined to make its employees available to walk through its swap-unwinding operations, which are conducted through the financial products unit known within the company as FP. The company also declined to say just how far down it has managed to cut the pile. "FP's employees have made tremendous progress unwinding FP's trading positions, business books and lowering its risk," AIG said in an e-mail. "Despite this progress, the risks in the books at FP are still large, and require the skills and professionalism of the traders, marketers and support functions."

BusinessWeek, New York, 6 abr. 2009, top News, online. Disponível em <www.businessweek.com>. Acesso em: 7 abr. 2009.