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From Free Lunch to Black Hole: Credit Default Swaps at AIG

Alan Frost, executive vice president for AIG Financial Products (AIGFP), was on vacation when he received a disturbing email from Andrew Davilman at Goldman Sachs in the evening of July 26, 2007 (see **Exhibit 1**).

In the years leading up to 2007, AIGFP had written $75 billon notional value of credit default swaps (CDS) tied to subprime mortgage-backed securities (MBS). Through these CDS, AIGFP provided credit insurance to its counterparties, meaning that AIGFP would absorb losses on the MBS underlying the CDS if homeowners defaulted on their mortgages.[1] Goldman Sachs was the counterparty for more than $20 billion notional value of these CDS contracts.[2] For several years, AIG had profited handsomely from these contracts and had judged that there was a virtually zero risk that AIG would ever have to make a payment on these CDS. But now, as housing prices started to fall, subprime borrowers began to default in greater numbers, and market values of the subprime MBS underlying the CDS dropped substantially. In Goldman Sachs' view, these circumstances were a clear indication that the marked-to-market value of the CDS contracts with AIG had shifted in Goldman Sachs' favor. Referring to the CDS contract terms, Goldman Sachs therefore asked AIG to provide collateral. On July 27, the day after Frost received the heads-up from Davilman about the forthcoming margin call, Goldman Sachs formalized its demand for collateral by sending AIGFP a collateral invoice requesting that the company provide it with collateral worth $1.8 billion.[3]

American International Group

In 2007, American International Group (AIG) was one of the biggest insurance companies in the world. It operated in 130 countries and employed close to 100,000 people.

AIG was founded in 1919 as an insurance agency in Shanghai. In wake of the revolution in China, the company moved to New York City in 1949. AIG went public in 1969, with Maurice R. Greenberg as CEO. Greenberg led the company through an enormous expansion until he was forced out in 2005 amid investigations into accounting irregularities by the New York Attorney General. Greenberg remained a large shareholder in AIG, and contested the charges of accounting irregularities and the circumstances of his forced departure from AIG.

After Greenberg's departure, Martin J. Sullivan, a long-time AIG employee, took over as CEO.[4]

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