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Credit Default Swaps, the Collapse of
AIG and Addressing the Crisis of
Confidence

Five years ago, billionaire investor and American icon Warren Buffett suggested that financial derivative products were "*financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.*"

Five years ago, few people were paying attention, and even fewer understood what he meant. Even today, as the term *credit default swap* (CDS) is migrating from the financial cable networks to CNN, MSNBC and the mainstream media, the critical role of these arcane derivative products in the undoing of the financial markets is not well understood.

The term *derivative product* is a general term for a contractual agreement between two parties whereby the *counterparties* exchange -- or *swap* -- payments based some underlying benchmarks, applied against a contract *notional* amount.

The most widely used derivatives are *interest rate swaps*, which account for more than 75% of the global \$530 *trillion* derivatives market, compared to the 10% that comprise *credit default swaps*. In its most basic structure, an interest rate swap provides that Party A will pay Party B an amount equal to a fixed interest rate times the contract *notional* amount, and receive an amount equal to a variable interest rate times that same amount. Many businesses that borrow money from commercial banks at the variable prime rate use interest rate swaps to fix their annual cost of borrowing and avoid interest rate risk.

In contrast, *credit default swaps* are financial products that allows for the transfer of the default risk related to owning a corporate bond from one party to another. For example, imagine that before the current market meltdown, CalPERS -- the large California public pension fund -- owned \$100 million of IBM bonds, but wanted to insure against the risk of a bond default. CalPERS could accomplish this by negotiating a \$100 million, five-year credit default swap with AIG -- which up until a month ago was a global, triple-A rated financial institution.

Under the terms of the swap, CalPERS would make an annual swap payment to AIG equal to -- for example -- 1% of the \$100 million swap notional amount. In return, AIG would pay CalPERS the amount of any losses that CalPERS realized in the event of a default by IBM. For example, if IBM went bankrupt during the contract period, and bondholders were only repaid twenty cents on the dollar, AIG would pay CalPERS \$80 million. And to secure AIG's obligations, the swap contract would

require that if AIG were downgraded from triple-A level to below double-A, AIG would post collateral equal to 20% of the notional amount of the swap contract, or \$20 million.

Then came the AIG collapse.

While the general view of the AIG collapse is that it was a function of collapse of the mortgage-backed securities market, in truth it was a direct consequence of AIG's CDS exposure. Four weeks ago, AIG was a triple-A rated insurance company. Today, it is being dismantled. If AIG had large investment losses in mortgage-backed securities, but no CDS exposure, AIG would still be in business today.

In simple terms, AIG's collapse came as a result of the following sequence of events:

1. In the wake of the decline in real estate prices, the market value of mortgage-backed securities declined.
2. Under accounting rules that were established after the downfall of Enron -- implemented to require rapid disclosure of investment losses -- AIG marked down the value of its mortgage-backed securities portfolio.
3. These investment losses resulted in a reduction of AIG's capital reserves -- the core measure of its financial strength.
4. As a result of the decline in AIG's capital reserves, Standard & Poor's and Moody's Investors Service downgraded AIG from triple-A to the single-A level.
5. These rating downgrades to the single-A level triggered collateralization requirements under AIG's CDS contracts.
6. The amount of the collateral that AIG had to produce under its estimated \$450 billion of CDS contracts approximated \$100 billion.

And AIG did not have \$100 billion in available funds.

This was the explosive event that destroyed AIG. It was not the market losses on its investments in mortgage-backed securities. It was not payouts on CDS contracts where default events had actually occurred. It was a collateral call.

The AIG story illustrates two important aspects of the current crisis of confidence within the financial markets. First, AIG's collapse in a matter of days resulted from the collateral requirements under the terms of contracts that are opaque, unregulated and difficult to track on corporate financial statements. As Buffett and others have suggested, the risk in the AIG derivatives portfolio was explosive -- and ignored until it was too late.

Second, the AIG story illustrates how a collateral call under a CDS contract can have the effect of positioning the CDS counterparty -- the institution

on the other side that claims rights to the collateral -- senior to the AIG policy holders and bondholders.

As US and European central bankers are working to define a collective strategy to rebuild confidence in the financial system and to reinvigorate inter-bank lending, the destabilizing impact of the CDS market remains one of the central problems to be addressed.

The problem seems straightforward. After the AIG collapse, how does one institution trust its exposure to another? If CitiBank seeks a loan from JPMorgan, how does JPMorgan know whether some event might be looming that will result in a collateral call under some of the myriad derivatives contracts to which CitiBank is a party, a collateral call that in a matter of hours could bring Citibank to its knees.

The US has now signed on to the British plan to make direct investments in banks, but simply injecting liquidity and capital will not address this concern. But US officials appear to be resisting the second British proposal -- which provides for direct central bank guarantees of inter-bank loans. Like guaranteeing deposits, guaranteeing inter-bank loans would transfer the risk of the unknown from the banks to the central banks.

Paulson and Bernanke may view this last British proposal as one step too far in the socialization of the financial system. But until the CDS market is brought into an effective regulatory framework and the legal rights of creditors are clearly established, do we really have any choice but to take this next step?

It seems that long ago -- weeks maybe -- we stared the moral hazard issue in the eye. And we blinked.

Whatever the theoretical importance of letting people and institutions fail, it seems that we have already decided that as a matter of public policy and political priorities, we just can't take the pain.