

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.



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

As he got tired, the legions of FP people who flocked around one of the smaller deals they would do in that time frame gathered strength and revisited things that had been signed off as settled simply because they wanted to. An investment bank, given that much time, could presumably have merged the United States and Canada.

Someone with whom he had struck up a dialogue at FP told him they did things this way because they were part of an insurance company and all the risk they took was in writing coverage, not in helping dot-com millionaires placate their boards while getting cash to buy vineyards and more houses. Barber took the point.

After another meeting, Barber rode the train back to New York and thought of his experiences with AIGFP. He knew that the only other company that had a unit doing financial deals wholly apart from their main business was Enron. The comparison made Barber laugh; these guys were so unlike Enron it was ridiculous. The Enron guys would slit your throat for a dollar bill they found on the floor. The AIGFP guys would politely bend down and give it to you.

Years later, when AIGFP became a name more well known in Washington, D.C., than it was in Westport (and later Wilton), Barber recalled a conversation he had with a group of AIGFP traders later that autumn about Ramy Goldstein and the blowup of UBS's high-profile equity derivatives desk, a story that was the center of every trading desk's chatter.

In brief: Goldstein, a brilliant, Yale-educated PhD and former Israeli paratrooper, had led a team of equally talented traders who made markets in seemingly every option, at prices and in sizes no one else could match. Over four years, Goldstein's London-based desk seemed to capture every trade on the Street, booking hundreds of millions of pounds of profit before giving it all back (and more) in 1997 when a series of the group's longer-dated options trades went wrong and about \$430 million was lost. Tales were emerging from former colleagues at UBS about a mind-bending concentration of risk that was neither understood by management—nor really disclosed to it—and about reliance on trading models and risk management programs that were programmed with the most ludicrous assumptions. Because of the debacle, UBS, for centuries one of the world's most storied banking

franchises, had been forced into a hasty and unequal marriage with Swiss Bank Corporation, allowed to keep only its name.⁵

The reaction of the AIGFP traders was one of total, utter shock, Barber remembers. To a man, they would all question how even one of those problems could have occurred in a properly run firm—where was corporate management and their risk-controllers? How could anyone assume that volatility would always be in their favor? What about the hedges? Didn't anyone else at UBS understand these trades?

More elementally: How could one trading desk do a series of trades in such volume that the firm itself was at risk?

At AIGFP, you were forced to spend hours vetting the minutiae of ideas and trading strategy with, well, anyone who asked. From unit chief Tom Savage, to his deputy Joe Cassano, to risk management in New York, and (more often than you might suppose) the boss of bosses, CEO Maurice “Hank” Greenberg himself. It was a process that a 15-year veteran of FP described as “a sociopathic hunt for risk. It forced you to drop ideas you really liked for the ones that really worked. Along the way, you became an expert in every facet of the deal.”

What happened at UBS seemed, to the outsider at least, that no one questioned Goldstein because he made so much money, and only when that ended did questions about his strategy surface. A consensus emerged: a firm like that didn't even truly deserve consideration as a professional operation.

No one ever mentioned to Barber what he thought might be the obvious reaction: that it couldn't happen at AIGFP. Even in bantering about UBS's foibles, it seemed, there were things that were just beneath discussion. They might have answered the phones or called themselves “FP,” but no one ever seemed to forget that the letters “AIG” preceded them. To the age-old question, “What's in a name?,” Barber had come to realize that when it came to AIGFP, the answer was, “a lot.”



It is the mid-1980s and Hank Greenberg and Ed Matthews (the man who was, effectively, his second in command) are obsessed with diversification. Broadly, of course, all large businesses are. McDonald's pushes salads, bottled water, and yogurt to capture customers when

periodic nutritional concerns erupt over their fries, burgers, and shakes. Merrill Lynch, whose army of retail brokers and massive stock- and bond-trading desks traditionally had anchored the firm's profit line to the direction of the market, broadened out into managing retirement funds for unions, advising corporations on mergers, and processing trades for hedge funds.

They hunt for diversification because it often works: a whole new set of people came into McDonald's, stayed a while, and took their wallets out; Merrill got steady earnings and cash flows from businesses that required little real risk to its capital. In the language of finance, it was called noncorrelated earnings, and investors would readily pay a higher price-to-earnings (P/E) ratio for them.⁶ The diversified earnings didn't have to be massive, and in their own way could be cyclical, but they had to be on a different economic footing than the primary businesses of the corporation.

There was a catch. The quest for these elusive earnings flows put the corporate chief on the horns of a dilemma. If he went too far out on the limb for diversification, then he risked owning a business that he had no native expertise in for the sake of having its earnings. This was called *conglomeration* and brought a whole new set of headaches. Investors, at least since the 1960s, were dubious of conglomerates and would not pay a higher PE multiple for them, reasoning that the sum of the parts was almost always less than fair value. (In other words, they were buying a business that was not managing its assets effectively since it was too big.)⁷

Greenberg distrusted this theory of diversification as a way of managing the risk of particular business cycles. His business was risk and nothing else. Seen coldly, AIG was the endpoint of the financial equation every time an earthquake, car accident, or fire happened in more than 100 countries. AIG, as he conceived it, was a continent whose shores were buffeted by huge oceans of risk. So far, they had been fortunate. AIG was relentless in its geographic expansion and obsessed with writing the insurance others would not. He was baffled that his competitors still saw the consumer business in England or Canada as diversification; to him, Nigerian oil fields and Vietnamese small business was closer to the mark. Anybody could write life insurance for a lawyer in Scarsdale; he was writing it along the northern Manchurian border since the 1980s. This, combined with decent

underwriting practices, had acted as natural brakes on local and regional recessions. A keen student of the earnings of AIG's competitors, he knew he was better off than most, but that wasn't good enough. On good days, he knew AIG could do better, that there was always some other option to generate excess capital that they hadn't considered; on bad days, he pondered grimly what he always suspected would someday come—a fearful symmetry of concentric catastrophes and economic woes that could cut even AIG off at the knees.

What that nameless, shapeless evil was, he could not say. But Greenberg was a man who had detailed contingency plans for AIG's survival in the event of nuclear attack on New York City and for the collapse of the American political system. If diversification was gnawing at him, then it was for a good reason, even if he couldn't fully enunciate it yet.

So, throughout the mid-1980s, he and Ed Matthews pressed for options. There was no particular reason why that juncture in time saw Greenberg so concerned about diversification, other than to say that it was raw animal instinct. Sharks sensed the slight electrical pulses generated from a struggling fish a mile away, and Greenberg felt looming risk. It mattered nothing to the shark what was thrashing, only that he moved toward it; Greenberg did not reflect on why he badly needed to diversify in the winter of 1986, only that it be done.

Still, it was a problem not easily solved. They had grown large, very large, and he was not shy about telling Matthews that the days of swimming against the tide were long past. As Robert O'Harrow and Brady Dennis reported in a three-part *Washington Post* investigative series on the rise and fall of AIG Financial Products called "The Beautiful Machine" (December 2008–January 2009), Greenberg told Matthews, "We are the tide now."

While Greenberg was worried, he was also optimistic. Every time he faced a seemingly insolvable problem in business, Greenberg had seen his hard work, his eternal restlessness and curiosity pay off and a solution emerge. Suggestions to help AIG diversify, however, were met with a scowl. The idiots on Wall Street—the analysts and their constituents, portfolio managers—always thought consolidation and size were the answer. This left him agog. What good was massive size when a recession was in full swing and 20 percent of your customers were

behind in their premiums, and another 20 percent were scaling back coverage or not paying at all? If you wanted to move away from commercial insurance risk, he wasn't quite seeing the utility of being pitched a merger with a commercial insurer.

He formulated his responses with some decorum (having long ago learned to curb his desires to address the more clueless questioner—who, as he saw it, was simply passively phrasing a statement or a demand as a question—as “Moron” or “Jackass”) and replied that while scale certainly did have its place in business, simply becoming big in a sector was not always best for the enterprise longer term. He argued that even the largest life insurer in the United States or the largest financial services firm in western Europe, was going to have problems when those markets turned south and stayed there for three years.

Still, bankers proposed mergers, with each one—to the minds of Matthews and Greenberg—appearing stupider than the next. With his hands folded across his chest, he frowned as the bankers unfurled their spiel.

“Thirty percent growth!”

“New markets!”

“Cost savings!”

The bankers spewed their buzzwords, but Greenberg only saw trouble. How did a transaction help you pay a workforce you had grown 30 percent and who expected salary and benefits regardless of the economic cycle? Was this company doing something in some market that AIG wasn't? If you have just gotten bigger—and are having to consider a period of wrenching and expensive layoffs to boot—how are you saving on expenses?⁸

That's why so many of his competitors were in the end just crappy companies never too far from death or a merger—they couldn't even think a proposition this far through. They made deals because deals, they thought, were what they were supposed to make. The shape of the business in five years if the markets didn't grow as planned? An unlikely consideration.

Still, there was the not-so-small matter of diversification. Greenberg needed something that could be a sustainable business, where capital could be responsibly deployed to generate solid returns and yet was totally unconnected to insurance cycles. The capital markets were the

natural answer, but here—more so than even in the realm of potential competitor acquisitions—his natural instincts and the arched eyebrows of Ed Matthews warned him off. A naturally amiable and engaging man, the Princeton-educated Matthews had an excellent business mind and easily spotted the risks in the details of an issue that Greenberg hadn't.

A senior partner as an investment banker at Morgan Stanley in the late 1960s and early 1970s, Matthews was broadly considered to be among the handful of men who were in the running to helm the firm in the mid-1970s and beyond. An unapologetic partisan for the old, clubbier Wall Street, he had no love for its evolution into trading floors and cutthroat banking. He found honor in being a traditional investment banker and he was astounded at how many young bankers looked at the client's needs as an opportunity for a quick fee or, increasingly, an opportunity for their firm to take advantage of. Matthews shook his head at the explosion of capital deployed on the trading desks at Goldman Sachs, Salomon Brothers, and Morgan Stanley. Did any of the leaders at the big firms really get it? Did they understand that trading your equity-capital base several times over each day on three or four different continents was a recipe for disaster?

Matthews knew in his bones that it was almost certain to bring down one, if not more, of these shops. He had seen dozens of the old-line, preppy banking partnerships folded into the bigger firms—especially Merrill Lynch, which seemed to acquire an old-line firm weekly in the 1970s—when trading commissions were deregulated in 1975, with their partners happy to sell out for a fraction of their equity value. But this was different. If Goldman or Salomon collapsed, they would turn the marketplace upside down, all because they were chasing an extra buck.

This was premonition, though, and AIG was a place you didn't run on premonition. Moreover, Matthews shared Greenberg's view that they were missing something in the markets. The world was changing; having major units in London or Asia was no longer exotic. Capital flowed across borders in the dozens of billions of dollars every minute, offering limitless opportunity to the company with the strength and expertise to take advantage of discrepancies in asset prices. Greenberg had put him in charge of this project, if they could call it that, but Matthews was unsure how to go about it.

They had legions of traders, portfolio managers, and analysts at AIG investment management, and he couldn't see any of them coming up with any ideas on how to generate large amounts of revenue doing things unconnected to the capital markets cycle. Nor could he see them doing it without big-time risk.

This was not to knock them—as chief investment officer he was their boss, after all—but simply to say that looking to make more money doing more of what everyone else was doing could not work: trades became very crowded, and the larger you were, the harder it was to get out. They had grown mightily since he joined in 1973, and now they were the big fish, the whales, and they needed very deep water to maneuver. There were not many places left to find that sort of deep water in the 1980s without breaking new ground. Again, a dilemma emerged since AIG was an insurance company, and insurance companies, whatever one may say about them, were not known or valued for their commitment to financial innovation.

Matthews told Greenberg and his colleagues that having lots of cash was nice and having a triple-A rating gave them a head start in doing anything, but in the end, you simply made a few extra cents doing what everybody else was doing because you could do more of it or you could do it for a lower cost. They were looking to do something special, something no one else was doing, and finding those people was a rare thing.

Finding the concept would come, Matthews had thought to himself, but he fretted over the people issue. He couldn't recall how many great business plans he had seen wilt because people wanted more power, more credit, and, always, more money. There was no doubt about it.

As a former Wall Streeter himself, he would ensure that when they found what they were looking for in the markets, there would be no investment bankers and traders around to really screw it up.



In the winter of 1986, Abraham Ribicoff—the long-serving former Republican senator from Connecticut working as a senior adviser at the law firm Kaye Scholer, and who practiced the sort of law that was popular in certain Washington, D.C., and corporate circles, in which his

substantial Rolodex was deployed matching people with needs and problems to the people who could address them—called Hank Greenberg. Insofar as Greenberg had personal friends, Ribicoff was one—a sensible and level-headed senator who, as befitting a legislator from Hartford, had always worked hard to protect insurance company interests in Washington. Of course, Ribicoff had been a good ally for Greenberg, but he found the senator legitimately intelligent, able to see solutions to complex foreign policy problems. This was no minor compliment. AIG, with operations in over 100 countries in 1986, was tremendously levered to American foreign policy, and Greenberg spent much of his waking time navigating AIG through one political-diplomatic-financial brushfire after another. A person like Ribicoff, whom Greenberg saw as clearheaded and not given to cheap posturing, was valuable to AIG's interests.⁹

Greenberg took the call immediately. The senator, rather than calling in a small chit (another specialty of retired politicians) or passing on a tip about some pending nonsense in D.C., got right to the point.

“Hank, I wouldn't bother you with business issues,” Greenberg remembers Ribicoff saying, “but there are a few fellows that I think you'll want to meet.” He went on to tell Greenberg that a man named Howard Sosin had come to see him and that he seemed to be a mighty impressive fellow, even allowing for the fact that he had no real idea what the hell it was he did for Drexel Burnham Lambert, that high-flying Wall Street firm that was in the news all the time.

Ribicoff said Sosin was looking for an introduction to Greenberg and he was inclined to extend it, but that in listening to the man, it was really clear that he was, in a word, different. His resume included a stint at Bell Labs, then the most prestigious technological corporate research facility in the world and a PhD in the mathematically heavy field of derivative pricing theory. Though demonstrably brilliant, he presented himself well and seemed to have a very strong vision of what he wanted to do. To an outsider to the financial world, Ribicoff had said, he seemed more like an inventor who had come up with something no one else had dreamt of.¹⁰

Greenberg took the meeting and ordered Shake Nahepetian, his longtime assistant, to set it up straightaway. The premise of the meeting was an idea he had for a form of derivative, something that at first pass

left Greenberg cold. Still, they were in the market to do something different, and Ribicoff was a good sort, so he followed through.

After meeting Sosin, Greenberg recalled, “I told Ed to handle that since I had no deep-seated grasp of what they were going to do.”

“I guess what impressed me,” said Matthews, “was that he really was on to something that no one else was.” He continued, “They had a specific program no one else had . . . they had really thought it through. They didn’t care about other lines of business or what other people were doing.”

Both men’s affections would later shift, but pressed on the matter they acknowledged Sosin’s command of the subject matter and above all, his risk aversion. Greenberg and Matthews, veterans of hundreds of money-scheme pitches, were impressed with his emphasis on risk control and bear-market scenarios.

What Sosin was “on to” was to engage in long-dated interest rate option swaps. “Rate swaps,” or more colloquially, “swaps,” were not new to Wall Street; there was always someone wanting to swap out their floating rate (an interest rate that moved up or down according to some predetermined benchmark, such as 90-day Treasury bills) exposure for the predictability of a fixed rate. There just wasn’t really anyone interested in doing it for more than two years, and most market players wouldn’t conceive of it beyond one year. The reasoning, circa 1986, was fairly simple.

As an example, assume Corporation A pays a floating rate of about 4 percent for three-year debt and wants to swap into fixed-rate debt of 4.25 percent to better manage its interest expenses. Corporation B agrees to assume the floating-rate debt expense in return for receiving 4.25 percent in interest from Corporation A. If rates stay about the same, everyone is happy: Corporation A gets to better plan for its financing costs, and Corporation B is making 0.25 percent (or 25 basis points) on the swap. But rates rarely stay the same. If rates go to 5 percent, 6 percent, or more, Corporation B is losing cash every second of every day. Depending on the size of the loan, this could amount to some serious risk. Worse, there was no real secondary market for these loans, nor were there many ways of hedging this risk. To do the trade in a world like this, Corporation B would have to have a nearly religious conviction that rates weren’t going to go above 4.25 percent.

In 1986, there were very, very few financial managers willing to bet that rates couldn't increase sharply. After living through the massive interest rate increases of 1979–1980, when the Federal Reserve boosted interest rates to 17 percent in the fight against inflation, willingly assuming floating-rate risk for a long period of time with no real hedging ability was akin to a professional death wish.

But Sosin, as a veteran academic and trader, knew full well that fear did not necessarily translate into unwillingness. Since 1982, he had been on the other side of the phone from Drexel's corporate and trading-desk clients and a very interesting subset of them did indeed want the ability to convert some of their fixed 5- and 10-year debt into floating rate. They wanted it badly, in fact, and, he reasoned, likely would not be too hung up on the short-term cost of trading with whoever could facilitate this for them.

As hard as Sosin had worked to come up with a plan that made good business sense, Randy Rackson had labored to develop the sort of software that could easily and accurately calculate the costs and risks of doing those interest rate swaps. Barry Goldman, the quietest and most reflective of the three, had been busy as well. Drexel's interest rate option research chief, he had constructed any number of transactions they could offer potential clients and had, in conjunction with Rackson, looked at ways of developing software programs that took into account ways these deals could be hedged.

If Drexel seemed an unlikely place to have begun the mathematical and financial odyssey that would eventually put Sosin and his colleagues into Hank Greenberg's office—and the firm's fortunes were indeed tethered to the then-booming junk bond market—the practical structure of a place like Drexel made the threesome's ascension incrementally less baffling.¹¹

Shot through with ambition to overtake the likes of Goldman and Morgan Stanley as the banker to America's elite, Drexel (under the oversight of chief executive Fred Joseph and junk bond guru Michael Milken) was willing to invest its massive junk bond profits in the trading and underwriting of numerous securities that were then at best sidelines for Wall Street. Included in this was the then embryonic trading of interest rate swaps.

Joining the firm in 1982 after the bitter collapse of the options-trading partnership he had put together while at Columbia Business School (he would leave the school's faculty the same year) as a government bond arbitrage trader, Sosin had impressed his bosses and colleagues with his ability to theorize new uses of options and futures in hedging techniques. In this, Sosin and Wall Street were growing up at the same time. The path to success on Wall Street's trading floors had long been the willingness to take risk to execute large trades, which in turn brought in customers and their lower-margin but higher-volume business. As derivatives took hold in fits and starts in the early 1980s, customers became more eager to trade with the firms that had the most effective strategy for deploying them for risk management. And it was just fine with Sosin if everyone else at Drexel was focused on things like leveraged buyouts (LBOs) and the issuance and trading of junk and convertible bonds for their cash-desperate client base's designs on the American corporate landscape.

Though no one's idea of a traditional salesman, Sosin was direct and absurdly intelligent and looked at things—the interest rates, volatilities, and funding needs and liabilities that corporate treasurers and chief financial officers (CFOs) had to wrestle with—differently than the bankers most corporations dealt with. He actually, in the words of a former colleague, proposed solutions for the interest rate management problems of corporations that they hadn't necessarily heard a thousand times before, a small miracle in the herdlike confines of Wall Street. (That any solution Sosin proposed involved trading or banking with Drexel was both obvious and beside the point to the corporate executives.) The plain fact is that Sosin and a desk full of his colleagues built a derivatives business that was profitable from the get-go, grew in stature (and profits), and, increasingly, was doing business not with the fast-growing, junk debt-addicted companies that Drexel did most of its business with, but members of the establishment like IBM, Chase, and Phillip Morris. The operation Sosin built began to separate itself from the great mass of Wall Street trading desks, all of which were proficient at executing customer orders, by becoming problem solvers. He had come to understand that the real money on Wall Street wasn't in just doing what others were not, but in having some form of advantage

that dissuaded customers from doing business with all the competition that was sure to spring up.

By this time he and Rackson were close friends, and they would stroll lower Manhattan's harbor front during lunch breaks or after client meetings and wonder aloud about working for themselves. They pondered, and then rejected, an investment partnership—what we now call a hedge fund—since raising capital wasn't the biggest need they would have. They needed balance sheet. From there, they just had to calculate who had both the appetite and resources to handle what they were pondering on those walks.

None of that made him a man who, in the course of events, would ordinarily wind up being able to do business with Hank Greenberg, who controlled a company whose market capitalization in 1986 made it one of the largest in the Standard & Poor's 500. It did, however, ensure that Sosin had been battle tested. The academic theories from Bell Labs and Wharton that had intrigued him so had either been adapted to fit the reality of the market's violent crucible or they had been thrown out. Sosin had come to see something that was very important to Matthews and Greenberg: things went wrong, terribly and horribly wrong, in the markets and you had to have a good idea of how to get the hell out of whatever trade you started before you did some serious damage.

It did not hurt Sosin's cause that when asked about his views on trading strategy, he replied that he didn't have one. Before they could get a frown off, he told the pair that he thought trading as a way to make money was dangerous and ultimately counterproductive and that he planned on making money from hedging out risk and capturing price and cost-of-funding inefficiencies. This actually understates Sosin's antipathy to trading. Having sat on a Treasury-bond trading desk, he was appalled at how otherwise bright men wagered capital on bonds based on their guesses as to how the market reacted to any one of two dozen economic statistics. This wasn't a rational business; it was playing lottery tickets for a living.

Matthews, who was one of the handful of corporate executives in the United States in the 1980s who had taken part in some longer-dated swaps (though not with Sosin), saw true potential. AIG could make money acting as a matchmaker, pairing up companies who could swap

with each other directly; they could make money taking the other side of a transaction and hedging out the risk; they could make money trading different parts of the hedges; they could, in the safety of a business pitch on the 18th floor of AIG's headquarters, make money doing anything.

Something else was apparent to all involved: there was no law that said the software and business plans that were developed for interest rate swaps couldn't be applied to dozens of other thorny money problems. Businessmen first and foremost, Greenberg and even Matthews were certainly lost after about 15 minutes speaking to Sosin, Rackson and Goldman, but that mattered little. They would happily trade a disadvantage with the minutiae of mathematical jargon for a direct shot at having a captive customer base that included the world's largest and most prolific borrowers: the big banks, multinational manufacturing conglomerates, airlines, governments, Fannie Mae, and Freddie Mac.

They would all have to come to AIG. Better yet, they would all want to.

In private, Greenberg and Matthews began to sense that the three men from Drexel not only had a plan that took into account market corrections, but they were bringing in customers who really wanted the product. And while managing risk was a wonderful thing, making money was altogether more wonderful.

Hank Greenberg is often quoted as having said, "All I want from life is an unfair advantage."¹² He was about to get it—for a while at least.



The papers were drawn up as a joint venture. At the end of a round of negotiations, Sosin, his two colleagues Rackson and Goldman, plus another seven Drexel options and futures trading pros would become something called AIG Financial Products, and they would receive 38 percent of their net income. Ownership of the company would be 80 percent AIG and 20 percent Sosin. No one had ever driven a bargain anything like that with Greenberg—before or since—but at the outset he didn't complain. Five-eighths of a monopoly is still a pretty handsome competitive position.

Ribicoff, the battle-hardened veteran of decades of broken commitments and promises, told Sosin, “You let us draw up your marriage. Let us handle your divorce,” according to the *Washington Post*.¹³

There was a quirk to the structure of FP. From a regulatory perspective, it fell between most every crack. Though any U.S. domiciled institution is subject to any federal law, practically speaking, on a daily basis, it was as if FP didn’t exist. It wasn’t a money manager or a bank, so its operations would leave no real paper trail, and since it sought no commerce with the public or even most corporations, there was no sales or marketing literature to be filed. Its business activity would, according to plan, be something that most corporations would rarely disclose nor investors or media seek answers to. Even a hedge fund has a prime broker who clears its trades and secures its financing; FP wasn’t going to do much trading, and if anybody had any question about their credit quality, well, the phrase “triple-A” directly cleared up matters. There is no record of Sosin’s having designed this as such, but there is ample evidence that on many levels he was pleased with this sort of structure.

In late January 1987, Mike Milken made an impassioned phone appeal to keep Sosin, proffering a larger share of his profits, more power, guarantees, appealing to loyalty (“Hadn’t Drexel been fair to him?” and “What more could they do to keep him happy?”). Traders on his desk were impressed, as Milken rarely made a direct pitch like that. In the days before the explosion of private equity and hedge funds, leaving a plum position like Sosin’s was a risky move. Sosin was a partner in the firm and owned several million dollars of stock, in addition to his million dollars plus in annual compensation. In late 1986 there were rumors that Drexel would go public and, like Salomon Brothers in 1980, its partners would reap multiples of book value for their equity.¹⁴

But Sosin politely and quickly rejected the appeals, sharing little about his future plans, shaking hands, packing his boxes, and leaving.

When it became clear that Sosin was going, Drexel’s management offered Rackson a \$2 million guarantee (he had earned over \$1 million the previous two years) to run the department. He turned it down straightaway. Close with Sosin since the early 1980s, when he was at an economics consulting shop called Data Resources International,

trusting Sosin had worked out brilliantly for him. Having turned down an impressive guarantee from his then employer, the First Boston Corporation, of \$350,000 to stay there and co-run their financial futures department, he declined and took a salary of \$125,000 with no guarantees of a bonus in order to continue to ponder risk, derivatives, and the software they both felt was the future of Wall Street.

A year later, he was a millionaire.

They had crafted an oral agreement since Rackson's first day on the job in 1985. In return for being Sosin's junior partner, Randy would be paid 50 percent of whatever Sosin made. A certain type of trader would reject that deal out of hand, but that trader wasn't privy to what Rackson saw: everywhere Howard Sosin had been allowed to let his thoughts and visions play out, a lot of money had been made.

What Sosin didn't know, of course, was how close Drexel had come to suing him and AIG for "raiding" the firm. He took 10 men with him, all key producers or senior operations and analytics staff. Drexel went from a respected competitor in a high-margin business to virtually out of the business in the short term.

It would later (much, much later) be learned that Howard Sosin was a different sort of employee. He could make many millions of dollars for you in ways that you hadn't imagined, but when he left, there was a big crater and bad blood to spare.

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