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WORLD OF TROUBLE

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The investors that own many of the derivative securities at the center of American International Group's collapse are among the world's and this country's biggest investors, sources told The Post.

People familiar with the matter said buyers of AIG Financial Products' derivatives, which consist mostly of collateralized debt obligations tied to mortgages, include Middle Eastern sovereign-wealth funds and the Chinese and Indian governments, which are also among the biggest holders of US Treasury securities.

Exactly how much AIG has in derivative exposure is subject to debate. While AIG's beleaguered CEO Ed Liddy told a House subcommittee yesterday that the insurer's exposure is around $1.6 trillion, others have dismissed that figure as not reflecting actual losses.

"[If] somebody's got $1.6 trillion in notional exposure, they could potentially be at great risk, but we just don't know," Campbell Harvey, finance professor at Duke University said. "It's really hard to tell, and it's very frustrating. We own this firm but we're not privy to the information."

But others who know AIG's derivatives business model said the $1.6 trillion figure represents the total that AIG could be on the hook for if things go awry.

"If everything they wrote 'protection' on goes to zero, it would equal that [$1.6 trillion]," said one derivatives trader. "Generally they're not hedged."

In order to get a foothold into foreign markets, AIG structured complicated CDOs designed to generate returns that were greater than other derivatives sold on Wall Street.

While home prices soared, the strategy worked. But as home prices started sharply falling last June, the company structured ever more complicated CDOs to prop up declining values of mortgage securities backed by increasingly problematic loans.

By August, plunging home prices triggered the CDOs to start paying investors in order to cover losses on the mortgage securities. By mid-September, Federal Reserve Chairman Ben Bernanke stepped in to inject $85 billion into the company after AIG's credit ratings got downgraded.

Residential mortgages aren't the only potential landmine at AIG. The company is also worried about the commercial real-estate market, which has yet to record the same kinds of losses, but is very much a ticking time bomb.

According to internal documents assessing AIG's systemic risk, "AIG's original problem an overreliance on US residential mortgage-backed securities in its investment portfolios has now been deepened by weakness in the commercial mortgage-backed securities market."

AIGFP was started in 1987 by Joseph Cassano, who first began selling interest-rate swaps before expanding into other types of derivatives, including eventually CDOs.

Cassano resigned in February of last year, but is said to have paid out bonuses of more than $3.72 billion over the past eight years.

Even though he's left, Cassano is believed to be one of those individuals who received bonus payments at the center of the current firestorm.

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