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A Question for A.I.G.: Where Did the Cash Go?

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A Question for A.I.G.: Where Did the Cash Go?

The American International Group is rapidly running through $123 billion in emergency lending provided by the Federal Reserve, raising questions about how a company claiming to be solvent could have developed such a big hole by October. Some analysts say at least part of the shortfall must have been there all along, hidden by irregular accounting.

"You don't just suddenly lose $120 billion overnight," said Donn Vickrey of Standard Analytics, an independent research firm in Northfield, Ill.

Mr. Vickrey says he believes A.I.G. must already have accumulated losses of billions of dollars worth of losses by mid-August, when its stock fell to $10. A.I.G. made its capital injection by issuing $20 billion in stock and debt in May and reassured investors that it had an ample cushion. It also said that it was making its accounting more precise.

"But losses on that scale do not show up in the company's financial filings," he noted. A.I.G. rebuked his capital by moving its losses to stock and debt and reassured investors that it had an ample cushion. It also said that it was making its accounting more precise.

Mr. Vickrey and other analysts are examining the company's disclosures for clues that the cushion was threadbare and that company officials knew they had major losses months before the bailout.

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supplementary lending facility, was extended solely to prevent further
losses in the securities-lending business. So far, $18 billion has been
drawn down for that purpose.

For securities lending, an institution with a long time horizon makes extra
money by lending out collateral to shorter-term borrowers. The
borrowers are short-sellers who are betting a stock's price will fall. They
typically give A.I.G. cash or cashlike instruments in return. Then, while A.I.G.
sits on the securities in hopes of being repaid, it invests the money.

In the last few weeks, borrowers came back for their money, and
A.I.G. did not have enough to repay them because of market losses on
its investments. Through the secondary lending facility, the insurer is
covering those investments in the Fed, and getting cash in turn to repay
outstandings.

A spokesman for the insurer, Nicholas J. Ashooh, said A.I.G. did not
anticipate having to use the other $38 billion facility. According to
A.I.G., it had borrowed $6.5 billion in that program, which it says has
grown to $7 billion. Another spokesman, Joseph T. Forbo, said the
company was getting out of the business. Of the program’s original $85
billion line of credit, the company has drawn down about $60 billion.
Forecast of A.I.G. per share earnings on those funds.

Notwithstanding A.I.G.’s efforts to make good on an investment
account that A.I.G. typically offers to municipalities, called guaranteed
investment contracts, or G.I.C.’s.

When a local government issues a construction bond, for example, it places
the proceeds in a guaranteed investment contract, from which it can draw the
funds to pay contractors.

After the insurer’s credit rating was downgraded in September, its G.I.C.
customers had the right to pull out their proceeds immediately. Regulators
say that A.I.G. had to come up with $13 billion, more than half of its total G.I.C.
outstanding. Rather than liquidate some investments at losses, it used that
much of the Fed loan.

For $59 billion of the $72 billion A.I.G. has used, the company has
provided no breakdown. A block of it has been used for day-to-day
operations, a broad category that raises eyebrows since the company
has been tarnished by reports of expensive trips and bonuses for
executives.

The biggest portion of the Fed loan is apparently being used as
collateral for A.I.G.’s derivatives contracts, including credit-default
swaps. The swap contracts are of great interest because they are the heart
of the insurer’s near collapse and even A.I.G. does not know how much
it might need to support them. They are essentially a type of insurance that
protects investors against default of fixed-income securities. A.I.G. wrote
this insurance on hundreds of billions of dollars’ worth of debt, much of it linked to
mortgages.

Through last year, senior executives said that there was nothing to fear,
that the swaps were rock solid. The portfolio “is well structured” and is
subjected to “monitoring, modeling and analysis,” Martin J. Sullivan,
A.I.G.’s chief executive at the time, told securities analysts in the
summer of 2007.

Gathering Storm

By fall, as the mortgage crisis began roiling financial institutions,
internal and external auditors were questioning how A.I.G. was
measuring its swaps. They suggested the portfolio was incurring losses.
It was as if A.I.G. had insured beachfront property in a hurricane
zone without charging high enough premiums.

But A.I.G. executives, especially those in the swaps business, argued
that any declines were theoretical because the hurricane had not hit. The
underlying mortgage-related securities were still paying, they said, and
there was no reason to think that would stop doing so.

A.I.G. had losses earlier this year accounting for transactions in early years
which had brought in a fat accounting profit from the termination of
Exchanges and Commodity Transactions. In its latest filing as a bankruptcy
in its swaps business, AIG reported a $38 billion gain from its swaps
business.

When the report was filed in 2005, A.I.G. said it was essentially
writing off its swaps, and that it was a $38 billion loss. It now
reported a $38 billion gain.

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Mr. Cassano did not attend the hearing and was unavailable for comment. The company’s independent auditor, PricewaterhouseCoopers, was the next to raise an alarm. It briefed Mr. Sullivan late in November, warning that it had found a “material weakness” because the unit that valued the swaps lacked sufficient oversight.

About a week after the auditor’s briefing, Mr. Sullivan and other executives said nothing about the warning in a presentation to securities analysts, according to a transcript. They said that while disruptions in the markets were making it difficult to value its swaps, the company had made a “best estimate” and concluded that its losses had not yet peaked.

PricewaterhouseCoopers appears to have pressed for more. In February, A.I.G. said in a regulatory filing that it needed to “clarify and expand” its disclosures about its credit-default swaps. They had declined not by $1.6 billion, as previously reported, but by $5.9 billion at the end of November, A.I.G. said. PricewaterhouseCoopers subsequently signed off on the company’s accounting while making reference to the material weaknesses.

Investors shuddered over the revision, driving A.I.G.’s stock down 12 percent. Mr. Vickrey, whose firm grades companies on the reliability of their reported earnings, gave the company an F. Mr. Sullivan, his credibility waning, was forced out months later.

The Lessons Grow

Through spring and summer, the company said it was still gathering information about the swaps and tucked references of widening losses into the footnotes of its financial statements: $1.6 billion at the end of June, $3.9 billion at the end of July.

The company insisted that the losses were theoretical and that cash had actually gone out the door.

“Where’s that cash?” asked some investors who were baffled by the complexity of the financial statements. “It’s a billion dollars at the end of June,” said Mr. Sullivan. “It’s a billion dollars at the end of July.”

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Though the company has not disclosed how much collateral it has posted, it is clear that A.I.G.’s portfolio of credit-default swaps could require far more of the company’s resources than investors have previously estimated. The company’s losses would be estimated to be $20 billion at the end of December, according to sources familiar with the situation.

“We may be far richer if we clear the books and let the losses happen for real rather than to try to let the people who took the risk bear the loss,” said Bill Bergman, senior equity analyst at the market research company Morningstar.

Correction

An article on Thursday about the American International Group’s use of more than $120 billion in emergency lending from the Federal Reserve referred incorrectly to the 2007 restructuring of the bond insurance company ACA Capital Holdings, which some experts offer as a model for resolving A.I.G.’s difficulties. That transaction was done out of court; the company did not file for bankruptcy.

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