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

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The American International Group is quietly running through its $123 billion in emergency lending provided by the Federal Reserve, raising questions about how a company claiming to be on the brink of insolvency 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 Gradient Analytics, an independent securities research firm in Scottsdale, Ariz.

Mr. Vickrey says he believes A.I.G. must have already accumulated losses of billions of dollars worth of losses by late September, when it came close to collapse and received an $85 billion emergency line of credit from the Fed. That line was later supplemented by a $38 billion lending facility.

He notes that so much took shape up to the company's financial filings, termed A.I.G.'s "cushion" by inside and outside auditors. The officials knew they had major losses months before the bailout.

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.

Taxing support for the argument comes from what appears to have been a behind-the-scenes clash at the company over how to value some of its derivatives contracts. An accountant brought in by the company because Mr. Vickrey's research suggested he could not be used to value the derivatives, and the company's outside auditor, PricewaterhouseCoopers, named of a material weakness months before the bailout.

The internal auditor resigned and is now at odds with the company, according to a former colleague. His account, a lawyer's report, was read by Representative Henry A. Waxman, Democrat of California and chairman of the House Committee on Oversight and Government Reform, in a hearing this month.

Continuing Risk

In addition to the huge losses that A.I.G. has revealed, there are also signs that the company may have accumulated huge losses in the past. "The company may not want to seek more money from the Fed, he may have to do so," said Edward M. Liddy, the insurance executive brought in by the government to restructure A.I.G., has already said that although he does not want to seek more money from the Fed, he may have to do so.

Mr. Liddy, who is rapidly running through $123 billion in emergency lending provided by the Federal Reserve, says he believes A.I.G. must have already accumulated losses of billions of dollars worth of losses by mid-September, when it came close to collapse and received an $85 billion emergency line of credit from the Fed. That line was later supplemented by a $38 billion lending facility.

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The 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 securities in shorter-term transactions. The borrowers are hedge funds setting up short trades, betting a stock's price will fall. To do it, they give A.I.G. cash or cashlike instruments in return. Then, while A.I.G. waits for the borrowers to bring back the securities, it invests the money.

In the last few months, borrowers came back for their money, and A.I.G. didn’t have enough to repay them because of market losses on its investments. Through the secondary lending facility, the insurer is now sending those investments to the Fed, and getting cash in turn to repay customers.

A spokesman for the insurer, Nicholas J. Ashooh, said A.I.G. did not anticipate having to use the other $38 billion facility. Nevertheless, A.I.G. had a shortfall of $18 billion in that program, which it says has grown to $27 billion. Another spokesman, Joe Norton, said the company was getting out of this business. Of the government’s original $85 billion line of credit, the company has drawn down about $72 billion. It must pay 8.5 percent interest on those funds.

An estimated $13 billion of the money was needed to make good on investment accounts that A.I.G. typically offered 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. business. 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 at the heart of the insurer’s near collapse and even A.I.G. does not know how much could be needed 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 its swaps were rock solid. A 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.

A.I.G. had come under fire for accounting irregularities some years back and had brought in a former accounting expert from the Securities and Exchange Commission. He began to focus on the company’s accounting for its credit-default swaps and collided with Joseph Cassano, the head of the company’s financial products division, according to a letter read by Mr. Waxman at the recent Congressional hearing.

When the expert tried to revise A.I.G.’s method for measuring its swaps, he said that Mr. Cassano told him, “I have deliberately excluded you from the valuation because I was concerned that you would pollute the

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process.”

Mr. Cassano did not attend the hearing and was unavailable for comment. The company’s independent auditors, PricewaterhouseCoopers, met with Mr. Sullivan late in November, urging him to take a “best estimate” that its credit-default swaps had lost about $6 billion in value by the end of November.

In February, A.I.G. and its regulatory filings had to be “Totally and separately” from its credit-default swaps, they had disclosed a loss of $1 billion, as previously reported, but by 12 a.m. on that date, the company’s accounting staff, PricewaterhouseCoopers, subsequently signed off on the company’s accounting while adding that the company would be publishing a revised estimate.

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 Losses Grow

Though spring and summer, the company said it was still gathering information about its swaps and tucked references of widening losses into the footnotes of its financial statements: $11.4 billion at the end of March, $20.6 billion at the end of March, $26 billion at the end of June. The company stressed that the losses were theoretical and no cash had actually gone out the door.

“We weren’t sure how much, why were you having to put up collateral to the counterparties?” Mr. Vickrey asked the company in a hearing. The fact that the concern had been raised suggested that the counterparties thought A.I.G. swaps losses were greater than disclosed, he said. “The net result, the losses had been forced to put collateral of $6 billion on the swaps.”

Though the company has not disclosed how much collateral it has posted over time, there was a large increase. In April, A.I.G. put forth in its financial statements a detailed list of all the swaps it had to post collateral for, many of them in the billions, suggesting that the counterparties had come to believe that A.I.G.’s losses were far greater than had been disclosed. By midyear, the insurer had been forced to post collateral of $16.5 billion on the swaps.

Though the company has not disclosed how much collateral it has posted since then, its $447 billion portfolio of credit-default swaps could require far more in the current economic conditions, where the default rates would be essentially $100 billion to $200 billion.

“We may be better off all in all the losses not being the losses we reported and losing the people who took the risk with these losses,” said Bill Bergman, senior equity analyst at Morningstar. 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 solving A.I.G.’s difficulties. That transaction was done out of court; the company did not file for bankruptcy.