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

By MARY WILLIAMS WALSH

OCT. 29, 2008

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 beyond the shadow of disaster could have developed such a big black hole in 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 huge losses of billions of dollars worth of losses by mid-September, when it came close to collapse and needed an $85 billion emergency line of credit by the Fed. That line was later supplemented by a $38 billion lending facility.

But losses on that scale did not show up in the company's financial filings. Instead, A.I.G. replenished its capital 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.

"You don't just suddenly lose $120 billion overnight," said Donn Vickrey, a forensic analyst, is skeptical of A.I.G.'s past reports. "You can't just suddenly lose $120 billion in the space of a week," he said.

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 holes in it before the bailout.

Testifying 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 A.I.G. needed a partner to conduct the validation on its books, and the company's outside auditor, PricewaterhouseCoopers, noticed of a material weakness months before the government bailout.

The internal auditor resigned and is not in testimony, according to a former colleague. Ms. Tavakoli, known as a practiced lawyer, was sued by Representative Henry A. Waxman, Democrat of California and chairman of the House Committee on Oversight and Government Reform, in a hearing this month.

"The accounting questions are of interest not only because investors are seeking (for A.I.G.'s A.I.G. but also because the post-bailout may be footing the bill at A.I.G. but also because the post-bailout may be footing the bill at A.I.G. and the company's trading partners — whose cash needs could easily exceed the existing government backstop if their losses were to increase, according to a former colleague.

Continuing Risk

Fear that the losses are bigger and that more surprises are in store is one of the factors behind the turmoil in the credit markets, market participants say.

"When investors don't have full and honest information, they tend to act emotionally, both too good and too bad," said Janet Tavakoli, president of Tavakoli Structured Finance, a consulting firm in Chicago.

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Ms. Tavakoli said her firm had warned the company in September that $90 billion of the $123 billion available has been drawn down. The Fed releases a weekly figure, most recently showing $85 billion in Fed's money. The company said it could not provide more information ahead of its quarterly report, expected next week, the first under new management. The Fed releases a weekly figure, most recently showing, that $90 billion of the $123 billion available has been drawn down.

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A.I.G. has outlined only broad categories: some is being used to shore up its securities-lending program, some to make good on its guaranteed investment contracts, some to pay the day-to-day expenses and — of perhaps greatest interest to watchdogs — tens of billions of dollars to post-collected with other financial institutions, as required by A.I.G.'s many derivatives contracts.

No information has been supplied yet about what these counterparties are, how much collateral they have invested in what additional securities may expire even more collateral if the housing market continues to slide.

Mr. Vickrey said the thought that instead of pouring in more and more money, the Fed should bring A.I.G. together with all its derivatives counterparties and post-collateralize the collateral directly. "We think that with A.I.G.,” he said, "including in A.I.G.'s capital holdings, a broad insurance company that are restructured in that way.”

For securities lending, an institution with a long time horizon makes extra money by lending out securities to shorter-term borrowers. The borrowers can then lend the securities out again, creating a multiple layer of lending. A.I.G. uses this facility to increase cash available to it. The company typically gets cash or cash-like instruments in return. Then, A.I.G. uses the money to lend to other institutions, to buy securities, or to pay off its own short-term debts.

In the last few months, the industry has been hit by a wave of defaults. The borrowers have been unable to pay back the securities, and A.I.G. has had to make up the difference. The company has drawn down its credit line from the Federal Reserve, and is now paying interest on the borrowed funds.

A spokesperson for the insurer, Nicholas J. Ashooh, said A.I.G. did not anticipate having to use the entire $38 billion facility. In Securities and Exchange Commission (S.E.C.) filings, A.I.G. has noted that it has drawn down $18 billion in cash from its credit line. The company has been able to pay back some of the money, but it is not clear how much.

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.

Gathering Storm

By fall, the mortgage crisis began spreading to financial institutions, insurance and investment bankers. In September, A.I.G. was one of the companies that were most affected. The company has been hit by losses on its investment portfolio, and it has been forced to raise cash by selling off its assets. The company has also been criticized for its accounting practices, and it has had to pay out billions of dollars in settlements.

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Mr. Cassano did not attend the hearing and was unavailable for comment. The company’s independent auditors, PricewaterhouseCoopers, met next to its own alarm, according to a transcript. They said that while circumstances for the markets were making it difficult to value its swaps, the unit had made a “best estimate” and concluded that its losses had increased by $3.6 billion as of Nov. 22.

In February, A.I.G. said in a regulatory filing that it needed to “clarify and expand” its disclosure of the swaps. It had disclosed a loss by its chief executive, but by its $3.6 billion as of Nov. 22. PricewaterhouseCoopers subsequently signed off on the company’s accounting while making reference to the material weakness.

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

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: $20.6 billion as of March 31, $26 billion as of June 30. The company stressed that the losses were theoretical and no cash had actually gone out the door.

“Where aren’t we unclear on why you have to post up collateral to the counterparties?” Mr. Vickrey asked in a recent interview. The fact that the insurer had to post collateral suggests that the counterparties thought A.I.G.’s losses were greater than disclosed, he said. By the end of June, the insurer had been forced to post collateral of $4.5 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 more than $230 billion in new cash if the economy continues to weaken. More federal assistance would then essentially flow through A.I.G. to counterparties.

“We may be better off in the long run not taking the losses on our books and letting the people who took the risk bear the loss, ” said Bill Bergman, senior equity analyst at the market research company Morningstar.

Correction: November 1, 2008

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.