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AIG Writedowns May Rise $30 Billion on European Swaps (Update1)

(Adds AIG statement in fifth paragraph.)

By James Sterngold

Dec. 17 (Bloomberg) -- American International Group Inc., which already has suffered more than $60 billion in writedowns and losses, may have to absorb almost $30 billion more because of flaws in the way its holdings are valued.

An examination of AIG's credit-default swaps guaranteeing more than $300 billion of corporate loans, mortgages and other assets not covered by a $152.5 billion federal rescue shows the New York-based insurer may value some of its positions at levels that don't reflect distress in the markets, according to an analyst at Gradient Analytics Inc. and a tax consultant who teaches at Columbia University Business School in New York. Executives at two firms that have similar investments say they account for the securities differently than AIG does.

"Every time I look at their statements I find something new," said Donn Vickrey, executive vice president of Gradient Analytics in Scottsdale, Arizona. He estimated that AIG may need to take at least $28 billion in additional writedowns on swaps covering European corporate loans and prime residential mortgages, as well as collateralized loan and debt obligations.

"It looks like they haven't written down these positions fully yet, and that could be a real problem," said Vickrey, who predicted correctly, as early as February 2008, that the company would have to report increases in its writedowns on its swaps.

Robert E. Lewis, AIG's chief risk officer, said the company has properly valued all of its swaps and underlying assets and doesn't need to take additional writedowns. In a statement the company issued today, AIG said it "reports all its derivatives at fair value in accordance with U.S. generally accepted accounting principles."

Rescue Package

The U.S. rescue plan announced in November, the government's second effort to save AIG, covers only its most troubled credit-default swaps, about 20 percent of the $377 billion on the insurer's books as of Sept. 30. Under the plan, a new government-backed entity will acquire collateralized debt obligations with a face value of $72 billion that had been insured by AIG swaps. An initial transfer of $46.1 billion of CDOs was announced on Dec. 2. A second fund bought troubled residential mortgage-backed securities with a face value of $39.3 billion, AIG said on Dec. 15.

Wider losses may cast new doubt on whether the federal funds will be enough to prop up AIG, the biggest U.S. insurer by assets. The U.S. package almost doubled from the $85 billion approved in September to save the company from bankruptcy. Previous miscalculations about the swaps contributed to the ouster of Chief Executive Officer Robert Willumstad and his predecessor, Martin Sullivan.

European Banks

In November 2007, when AIG reported a $352 million loss on its swaps, it said it was "highly unlikely" the insurer would have to make payments on them. And last December Sullivan assured investors that losses from swaps on U.S. subprime

mortgages were "manageable."

Credit-default swaps are contracts that protect investors who buy bonds or other securities. If a debt issuer or borrower misses payments, the seller of the contract -- in this case, AIG -- covers some or all of the losses. Even if a borrower doesn't default, accounting rules may require insurers to write down the swap contracts when the value of the underlying assets drops.

AIG swaps not covered by the government program include guarantees on $249.9 billion of corporate loans and residential mortgages, most of them made by banks in Europe, according to the company's third-quarter 10-Q filing. There are also swaps covering $51 billion of collateralized loan obligations, or CLOs, and $5 billion of lower-rated mezzanine tranches.

Record Swap Prices

Writedowns on these AIG holdings total less than $1.5 billion so far this year, according to company filings, compared with $20 billion for the swaps guaranteeing the $72 billion of CDOs being acquired under the federal rescue.

The declining market value of many of the underlying assets and a deepening recession may force AIG to take further writedowns, Vickrey said. Credit-default swap prices on the Markit iTraxx Europe index of 125 investment-grade companies set a record on Dec. 5, indicating increased investor concern about possible defaults.

Based on the loss AIG has reported, as well as indexes showing declines in the value of European corporate loans and prime mortgages, Vickrey estimated that AIG may face at least $15.6 billion of additional writedowns on its swaps with the banks. He said other swaps not covered by the government rescue, including those on CLOs and mezzanine tranches, may result in another $12.6 billion of losses.

"That's based on what we know currently, and it could be higher," he said.

'Limited Information'

Estimating the size of future writedowns is difficult because AIG doesn't disclose details about many of the underlying assets.

Lewis, the AIG risk officer, said in an interview that the company has "limited information" on which to base the value of most of the European loans and mortgages it has guaranteed. Though some assets underlying the swaps appeared to be declining in value, Lewis said the insurer followed accounting rules in providing its best estimates for the value of the assets and other securities on its books.

"Our methods have been thoroughly vetted and externally evaluated," Lewis said.

In its statement today, the company said that in determining the value of its assets it "considers all available information including but not limited to market available data, dealer provided prices, prices used for collateral posting and recent trades including early terminations initiated by counterparties."

Accounting Rules

AIG's view on valuing its swaps with European banks turns on an interpretation of accounting rules involving risk transfer.

Lewis said the insurer normally marks the value of the

assets underlying swaps to market levels since it is taking some risk in the transactions. The swaps with the European banks are different because they didn't insure against losses, he said. Instead, they were bought to take advantage of European accounting rules that allow the banks to use the swaps to reduce the capital they're required to set aside as loss reserves.

The swaps are kept in place only until new accounting rules, known as Basel II, are phased in. Those rules eliminate the ability of financial institutions to reduce the capital they need to set aside by buying swaps. Once the rules kick in, Lewis said the swaps will be terminated.

Fair Value

Lewis said the insurer had unwound $95 billion of these regulatory-capital swaps without any losses as of the end of the third quarter. And Gerry Pasciucco, hired from Morgan Stanley on Nov. 12 as interim chief operating officer of AIG's financial-products subsidiary, said the company continues to "experience early terminations according to our schedule at par."

As a result, Lewis said, even if the assets underlying the remaining swaps fall in value, AIG isn't required to mark them to lower market levels.

That's because, as the insurer said in its third-quarter filing, it "estimates the fair value of these derivatives by considering observable market transactions." And the only relevant transactions are the swaps AIG has successfully unwound with the European banks, according to the filing.

AIG's interpretation of accounting rules is different than that of Robert Willens, CEO of Robert Willens LLC, a corporate tax and accounting advisory firm in New York, and a professor at Columbia. He said AIG can't have it both ways, calling the transactions swaps and then saying there's no risk.

Transfer of Risk

"If these are bona fide swaps, you look at them like any other transaction of this type with a transfer of risk," Willens said. "If they do that, there would probably be very substantial writedowns because of what we're seeing in the markets. If you're using a different paradigm and saying there's no risk transfer, these aren't credit-default swaps. You're getting a fee for renting the counterparty your name. There's no third approach. The purpose of the swap is totally irrelevant."

Stephen Ryan, a professor of accounting at the Stern School of Business at New York University, said that if the swaps reduce potential losses faced by European banks there must be some transfer of risk and AIG must mark the assets to market by looking at a broad array of similar credit-default swaps, not just other swaps that were unwound without losses.

"I can't believe the banks' intent affects the contractual terms" of the swaps, Ryan said.

While Elias Habayeb, chief financial officer of AIG's financial-services division, acknowledged that valuing the underlying assets by referring to market indexes could produce writedowns, he said it would be misleading to do so because the swaps were intended to be terminated in a short period of time.

Radian, Primus

"Had we marked them down to the iTraxx or CDX indexes in our accounting," he said, "that would not have made sense because we would have had to book a gain on redemption."

Two other companies that sold swaps to European banks also disputed AIG's interpretation of accounting rules. C. Robert Quint, chief financial officer of Radian Group Inc. in Philadelphia, and Steven Kennedy, a spokesman for Bermuda-based Primus Guaranty Ltd., both rejected the idea that how a swap is used can affect its accounting treatment. They said their firms mark their swaps to market to reflect price declines.

"We did some of that business, but we're an insurance company, so we don't care what purpose the counterparty is using the swap for," Quint said.

Lewis said AIG would only have to revalue the underlying assets if the banks that bought the swaps no longer used them to meet capital requirements.

$397 Million Loss

That's what happened in this year's second quarter with one European bank that purchased a swap to cover $1.6 billion of mortgage-backed securities. When AIG determined the purpose of the swap wasn't to reduce capital requirements, it took a loss of $397 million, equal to about 25 percent of the face value of the assets, according to company filings.

AIG spokesman Nicholas Ashooh said the case was unusual because the swap covered mortgage-backed securities, not just pools of mortgages like the other European swaps. He added that even if other swaps required writedowns, the losses wouldn't necessarily be 25 percent of face value.

Ashooh also explained that, under the terms of most of the swaps, the European banks would have to absorb about 10 percent to 15 percent of any losses from defaults before they could turn to AIG. That also reduces the insurer's risk, he said.

'Significant Deterioration'

That's not how Vickrey of Gradient Analytics sees it. While the logic might be sound under normal circumstances, he said these aren't ordinary times. With economies shrinking and markets falling, the European banks that bought the swaps may face such high levels of defaults on their corporate loans and mortgages that they would need to alter the purpose of the swaps, requiring revaluations.

AIG acknowledges such a possibility in its 10-Q filing. "Given the significant deterioration in the credit markets and the risk that AIGFP's expectations with respect to the termination of these transactions by its counterparties may not materialize, there can be no assurance that AIG will not recognize unrealized market valuation losses," the company said. AIGFP is the insurer's AIG Financial Products unit that sold the swaps.

Valuing mortgage-backed securities and collateralized debt obligations was a challenge even before the credit crisis. The bankers who originated the securities and the agencies that rated them used sophisticated models that relied on assumptions about the future, including market liquidity, default rates and the risks of markets moving in tandem in the event of a credit squeeze. Calculations in the models have proven flawed, meaning many of the securities were improperly rated and priced long before the current crunch hit.

Flawed Models

Traders and salesmen had little understanding of the assumptions used in the models -- among them that house prices

wouldn't drop across the U.S. -- or how they might affect the performance of the securities.

"It's not that all of the models are wrong,' said Tanya Styblo Beder, chairman of risk-management adviser SBCC Group in New York. "The problem is that people made simplifying assumptions so the calculations were manageable and then had no warning labels to help the users understand the ramifications of these assumptions."

Gerald Rosenfeld, deputy chairman of Rothschild North America Inc. and co-director of New York University's program in business and law, said the current market meltdown is the fourth in 20 years exacerbated by a reliance on flawed computer models.

'Blind Faith'

The first was the stock market crash of 1987, when a computerized product called portfolio insurance contributed to an unanticipated cascade of selling, he said.

"We've had something like four 50-year events in the last 20 years because of this blind faith people put in the supposed accuracy and precision of models that, for the most part, their creators never intended," Rosenfeld said. "I don't think we've really identified the over-reliance on the models and the way they were the trigger points in all of this."

In a paper titled "The Economics of Structured Finance" that will be published in the Journal of Economic Perspectives, a group of Harvard Business School professors says the greatest problem in the market for CDOs and other structured securities isn't the decline in value of the underlying assets because of the credit crunch. It is that the securities were overpriced from the start because the models failed to assess the risks, the professors said.

Inflated Prices

"Almost lost in the shuffle and the talk of default rates has been the initial mispricing of these securities," said Joshua Coval, a professor of business administration at the Harvard Business School and one of the paper's authors.

In effect, Coval said, investors bought the CDOs and related assets at inflated prices from the start. The mispricing also increased losses for companies that sold credit-default swaps, since they guaranteed that values would not decline significantly from their inflated levels.

"The drop in price is due to market awareness that credit risk was mispriced at the outset," said Janet Tavakoli, president of Tavakoli Structured Finance in Chicago. "The practice was widespread."

Even if the credit markets were to stabilize, the valuations of structured securities are still far from where they should be, said Laurie Goodman, a former head of fixed-income research at UBS Securities LLC, who recently left to join Amherst Holdings LLC in Austin, Texas.

"The losses we've seen so far are a fraction of what we'll be seeing," she said.

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