WSJ(10/10) Further Loan To AIG Shows Fed Miscalculated Risks

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American International Group Inc. drew down another $9 billion in loans from the government to meet massive demands for cash from its trading partners as the company scrambles to sell off its assets.

The insurer has now borrowed $70.3 billion from the government in three weeks and is in a race against time to sell assets to pay off the loan as the financial markets tumble, making it harder for the company to find buyers for its units. The government originally said it would loan the company $85 billion but raised the amount to $122.8 billion on Wednesday.

Thursday, AIG shares closed down 25% to $2.39 in 4 p.m. composite trading on the New York Stock Exchange.

"The Fed had no idea the capital markets would seize up and the stock markets would keep falling; both put AIG in a severe cash bind," said a person involved in the rescue talks.

The lion's share of the Fed's original loan has gone for two things: providing collateral to AIG's trading partners on complex derivatives known as credit default swaps, and covering losses in AIG's securities-lending program. When the threat of losses from the lending program mounted, the Fed had to step in again this week.

Market prices of many corporate bonds and other debt securities have fallen sharply since the Sept. 16 rescue. For example, average prices of corporate bonds with high credit ratings have dropped 6% since then, an unusually large decline for such securities over a relatively short period. As many of AIG's swap agreements required it to post collateral to the owners of the swaps whenever prices of insured investments fell, the amounts it owed grew substantially over the past few weeks. In addition, some assets that AIG provided as collateral likely also fell in value amid the credit-market turmoil, triggering additional margin calls from its counterparties.

Securities lending involves both lending securities and investing collateral for a return. If the value of the collateral declines, as it has for AIG and other securities lenders, the investor needs to make up the difference when the borrower returns the securities. AIG's program had faced problems for months, but they intensified after AIG was downgraded by credit-rating agencies in September, just before the government rescue.

AIG's securities-lender clients flooded the program for their collateral, creating a "mini-run" on the bank, says Doug Slape, chief financial analyst of the Texas Department of Insurance. The company began drawing down on the Fed loan commitment to cover the collateral requests, it told Mr. Slape in recent conversations, he said. By Oct. 3, Moody's Investors Service said AIG's default-insurance and securities-lending program had experienced "substantial losses and write-downs" due to mortgage securities.

The Texas regulator grew concerned about the exposure in 2007. At the time, AIG told Texas it recognized that it needed to retain more cash, Mr. Slape said.

Securities lending has long been a reliable side business for life insurers, approved by state regulators. But Moody's warned in April about the risks that insurers were taking related to these programs.

Hampton Finer, a deputy to New York State Insurance Superintendent Eric Dinallo, said policyholders in AIG's life-insurance subsidiaries weren't at risk due to the securities-lending programs. But, he said, New York will review what types of assets insurers are allowed to invest securities-lending collateral in.

Mr. Slape said his team is keeping a close watch on three AIG insurance units

because of the securities-lending exposure. Ohio's Department of Insurance said it is investigating the securities-lending activities of at least one life insurer. Darrel Ng, a spokesman for the California Department of Insurance, said the state is "looking at the securities-lending practices of those insurers domiciled in California," along with AIG's.

According to AIG's quarterly report for the period ending June 30, the collateral for the securities-lending program shows investments totaling $36.2 billion in mortgage securities, $12.9 billion in corporate debt, and $10.5 billion in cash or short-term investments, for a portfolio totaling nearly $60 billion.

While insurance subsidiaries are regulated by the states, the federal government is now actively involved in AIG. Since the rescue, a large team from the Federal Reserve Bank of New York has been monitoring the company, with a dedicated office at AIG's headquarters in Lower Manhattan, on a different floor from the office of the company's new chief executive, Edward Liddy.

Staffers from the New York Fed, along with outside experts the Fed hired, are trying to assess how money is flowing within and from the company. The Fed also has been sending personnel to AIG divisions, such as the aircraft-leasing company, AIG Financial Products unit, American General Finance, and AIG offices around the world to assess the company's risks and its risk-management procedures.

Mr. Liddy and a top bank-supervision executive from the New York Fed communicate many times a day.

Market conditions aren't helping prospects for assets sales. In the current environment, with investors and credit-rating agencies voicing deep concern over the industry's capital reserves, potential suitors are holding back. AIG is also reluctant to part with businesses, many of which it built up over decades, at fire sale prices.

Insurance stocks were pummeled again Thursday, with Hartford Financial Services Group Inc. dropping 19% and Lincoln National Corp. losing 35%.

Sudeep Reddy, Monica Langley, Matthew Karnitschnig and Serena Ng contributed to this article.

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