SIGTARP
Office of the Special Inspector General for the Troubled Asset Relief Program
Advancing Economic Stability Through Transparency, Coordinated Oversight and Robust Enforcement

Factors Affecting Efforts to Limit Payments to AIG Counterparties

SIGTARP-10-003
November 17, 2009

SIGTARP

Office of the Special Inspector General for the Troubled Asset Relief Program

Summary of Report: SIGTARP-10-003

Why SIGTARP Did This Study

In September 2008, American International Group ("AIG"), was on the brink of collapse, unable to access credit in the private markets and bleeding cash. On September 16, 2008, the Federal Reserve Bank of New York ("FRBNY"), pursuant to the authorization of the Board of Governors of the Federal Reserve System ("Federal Reserve Board", and, collectively with FRBNY, "Federal Reserve") provided AIG with an $85 billion loan. On November 10, 2008, Federal Reserve and Department of the Treasury ("Treasury") announced the restructuring of the Government's financial support to AIG. As part of this restructuring, Federal Reserve Board authorized FRBNY to lend up to $30 billion to Maiden Lane III, a newly formed limited liability company. Pursuant to this authorization, FRBNY lent $24.3 billion to Maiden Lane III, which, in combination with a $5 billion equity investment from AIG, was used to fund the purchase of assets from counterparties of American International Group Financial Products ("AIGFP") having a fair market value of about $27.1 billion. In exchange for payment and being permitted to retain $35 billion in collateral payments (effectively being paid par or face value), the counterparties agreed to terminate their credit default swap contracts—insurance-like contracts intended to protect the underlying assets—with AIGFP.

In light of the extent of the U.S. government's assistance to AIG, numerous members of Congress asked SIGTARP to review the counterparty transactions. This report addresses (1) the decision-making processes leading up to the creation of Maiden Lane III, (2) why AIG's counterparties were paid at par value, and (3) AIG's current exposure to credit default swaps outside Maiden Lane III.

SIGTARP interviewed officials and reviewed documentation from Federal Reserve regarding efforts to negotiate concessions from the counterparties, as well as the rationale to pay counterparties at par. SIGTARP also met with officials of two of AIG's counterparties regarding termination of the credit default swaps. SIGTARP also interviewed officials and obtained information from AIG. Our work was performed in accordance with generally accepted government auditing standards.

November 17, 2009

FACTORS AFFECTING EFFORTS TO LIMIT PAYMENTS TO AIG COUNTERPARTIES

What SIGTARP Found

In the fall of 2008, the Federal Reserve and Treasury faced several key decisions about the future of AIG. After attempts to find private-sector financing failed, they chose to provide assistance to AIG rather than allow the company to file for bankruptcy. FRBNY officials believed that an AIG failure would pose considerable risk to the entire financial system and would have significantly intensified an already severe financial crisis. FRBNY was concerned about the effect of an AIG bankruptcy on key sectors of the market, such as retirement accounts and the credit markets. FRBNY adopted in substantial part the economic terms of a draft term sheet under consideration by a consortium of private banks, the terms of which included a very high interest rate. When it became apparent that AIG's liquidity crisis would continue despite FRBNY financing and that a further downgrade was coming, to avoid such a downgrade the Federal Reserve and Treasury decided to create a special purpose vehicle, called Maiden Lane III, that bought the underlying collateral of a portion of AIG's credit default swaps from a number of AIG's counterparties. Terminating these credit default swaps in this way prevented further collateral calls and eased AIG's liquidity pressures.

After limited efforts to negotiate concessions from the counterparties failed, FRBNY decided to pay AIG's counterparties at what was effectively face or "par value" — the fair market value of the counterparty assets plus the collateral payments they had already received — for the collateralized debt obligations underlying AIGFP's credit default swap portfolio. FRBNY was confronted with a number of factors that it believed limited its ability to negotiate reductions in payments effectively, including a perceived lack of leverage over the counterparties because the threat of an AIG bankruptcy had already been removed by FRBNY's previous assistance to AIG. On March 15, 2009, after significant public and Congressional pressure, AIG, after consultation with the Federal Reserve, publicly disclosed the identities of the counterparties. FRBNY officials state that they believe they will recoup the loan they made to Maiden Lane III over time. As of September 30, 2009, the current fair market value of the Maiden Lane III portfolio is $23.5 billion versus a loan balance of $19.3 billion.

Conclusions and Lessons Learned

SIGTARP concludes that: (1) the original terms of federal assistance to AIG, including the high interest rate it adopted from the private bank's initial term sheet, inadequately addressed AIG's long term liquidity concerns, thus requiring further Government support; (2) FRBNY's negotiating strategy to pursue concessions from counterparties offered little opportunity for success, even in light of the willingness of one counterparty to agree to concessions; (3) the structure and effect of FRBNY's assistance to AIG, both initially through loans to AIG, and through asset purchases in connection with Maiden Lane III effectively transferred tens of billions of dollars of cash from the Government to AIG's counterparties, even though senior policy makers contend that assistance to AIG's counterparties was not a relevant consideration in fashioning the assistance to AIG; and (4) while FRBNY may eventually be made whole on its loan to Maiden Lane III, it is difficult to assess the true costs of the Federal Reserve's actions until there is more clarity as to AIG's ability to repay all of its assistance from the Government. SIGTARP also draws lessons that should be learned regarding the importance of transparency and the enormous impact that ratings agencies had on the AIG bailout.

OFFICE OF THE SPECIAL INSPECTOR GENERAL

FOR THE TROUBLED ASSET RELIEF PROGRAM

1801 L STREET, NW

WASHINGTON, D.C. 20220

November 17, 2009

MEMORANDUM FOR: The Honorable Ben S. Bernanke, Chairman, Federal Reserve Board of Governors

Mr. William Dudley, President, Federal Reserve Bank of New York

FROM: Neil M. Barofsky – Special Inspector General for the Troubled Asset Relief Program (SIGTARP)

SUBJECT: Factors Affecting Efforts To Limit Payments to AIG Counterparties and Future Exposures (SIGTARP-10-003)

We are providing this audit report for your information and use. It discusses factors affecting efforts to limit payments to AIG counterparties. The Office of the Special Inspector General for the Troubled Asset Relief Program conducted this audit project 010-003 under the authority of Public Law 110-343, as amended, which also incorporates the duties and responsibilities of inspectors general under the Inspector General Act of 1978, as amended.

We considered comments from the Federal Reserve Bank of New York, the Federal Reserve Board of Governors, and the Office of Financial Stability when preparing the final report. The comments are addressed in the report, where applicable, and copies are included in the Management Comments appendices of this report.

We appreciate the courtesies extended to the staff. For additional information on this report, please contact Michael Kennedy (michael.kennedy@do.treas.gov) at (202)-622-9257.

cc: The Honorable Timothy F. Geithner, Secretary of the Treasury

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Factors Affecting Efforts To Limit Payments to AIG Counterparties

SIGTARP REPORT 10-003 **November 17, 2009**

Introduction

In September 2008, multiple U.S. financial institutions had failed or were on the brink of failure as a result of an escalating crisis in the financial markets. This ultimately led to enactment of the Emergency Economic Stabilization Act of 2008 ("EESA"), which provided the Department of the Treasury ("Treasury") with $700 billion to aid financial institutions under the Troubled Asset Relief Program ("TARP"). One of the companies that received the greatest assistance under TARP, and even greater assistance from the Federal Reserve Bank of New York ("FRBNY"), pursuant to the authorization of the Board of Governors of the Federal Reserve System ("Federal Reserve Board", and, collectively with FRBNY, "Federal Reserve"), was the insurance conglomerate American International Group ("AIG"). Beginning in 2007, AIG began experiencing a significant drain on its finances when, among other things, the company began paying increasing amounts of collateral[1] to counterparty institutions that had purchased insurance-like contracts called credit default swaps from AIG's subsidiary, AIG Financial Products ("AIGFP").[2]

By September 2008, bankruptcy loomed for AIG, in part because AIG was unlikely to be able to raise the capital needed to meet additional calls for large collateral payments in the case of an anticipated downgrade in its credit rating by credit rating agencies.[3] On the afternoon of September 15, 2008, the three largest credit rating agencies—Standard and Poor's Financial Services, Moody's Investors Service, Inc., and Fitch Ratings Ltd.—downgraded AIG. On September 16, 2008, because of concerns that an AIG bankruptcy could cause systemic risk to the entire financial system and the American retirement system, the Federal Reserve Board, with the support of Treasury, authorized FRBNY to lend up to $85 billion to the firm under Section

[1] Collateral generally means the property or assets that a borrower offers a lender in order to secure a loan or other obligation to pay.
[2] A credit default swap is an insurance-like contract in which the seller receives a series of payments from the buyer in return for agreeing to make a payment to the buyer if a particular credit event outlined in the contract occurs—for example, if a particular bond or loan goes into default or its credit rating is downgraded.
[3] Credit rating agencies are companies that provide investors with analyses and assessments of credit risk for a particular company or security. Credit ratings provide individual and institutional investors with information that assists them in determining whether issuers of debt obligations and fixed income securities will be able to meet their obligations with respect to those securities. Credit default swap contracts will often reference credit ratings in determining whether a credit default swap party needs to post collateral and how much. In addition, credit default swap contracts will also frequently provide that, as the market value of a particular bond declines, the seller may have to post collateral to the buyer in the amount of the decrease in value.

13(3) of the Federal Reserve Act.[4] This would be the first of several infusions of capital and loans to AIG, first by the Federal Reserve and then by Treasury.

Despite this initial Government assistance, AIG's financial difficulties continued, and there were concerns that a further downgrade was forthcoming. Additional downgrades, among other things, could trigger requirements for AIG to make additional collateral payments (referred to as "posting collateral") to AIG's counterparties. The downgrades could thus exacerbate the liquidity drain and the payments to swap counterparties. To help prevent further downgrades of AIG's credit rating that could lead to a disorderly bankruptcy with potentially destabilizing effects for the U.S. economy, in November 2008, the Federal Reserve and Treasury announced a restructuring of their official assistance. Among other measures, the Federal Reserve Board authorized FRBNY to create a special purpose vehicle ("SPV")[5] called Maiden Lane III and to lend it up to $30 billion to buy collateralized debt obligations ("CDOs") underlying the credit default swaps from AIG's counterparties.[6] In connection with this purchase, AIG's counterparties agreed to terminate the associated swaps with AIG in return for retaining collateral they had already received. This eliminated any future need for AIG to post additional collateral or make future payments on the credit default swaps related to the CDOs purchased by Maiden Lane III. The combination of the two components of the transaction equaled effectively the par (or face) value of the credit default swaps. Once these payments became publicly known, questions were raised about the propriety of paying the counterparties the equivalent of par value because the market value of the underlying CDOs had dropped precipitously and because some counterparties were already recipients of Treasury funding under TARP and the beneficiaries of other federal bailout programs. Likewise, there were questions whether these counterparty payments may also effectively have been paid using Government funding as a "backdoor bailout" of these counterparties.

Background

AIG is a global organization doing business in more than 130 countries and jurisdictions. In 2007, it was ranked the largest life insurer and the second largest property/casualty insurer by

[4] Section 13(3) of the Federal Reserve Act authorizes the Federal Reserve Board to make secured loans to individuals, partnerships, or corporations in "unusual and exigent circumstances" and when the borrower is "unable to secure adequate credit accommodations from other banking institutions." This authority, added to the Federal Reserve Act in 1932, was intended to give the Federal Reserve the flexibility to respond to emergency conditions. It was amended in 1991 to allow the Federal Reserve to lend directly to securities firms during financial crises.

[5] A special purpose vehicle is an off-balance sheet legal entity that holds transferred assets that are theoretically beyond the reach of the entities providing the assets.

[6] The Federal Reserve had earlier created two other SPVs, Maiden Lane I and Maiden Lane II, named after the downtown Manhattan street on which FRBNY's offices are located. In March 2008, FRBNY and JPMorgan Chase & Co. entered into an arrangement related to the financing provided by the FRBNY to facilitate the merger of JPMorgan Chase and the Bear Stearns Companies Inc. by moving approximately $30 billion of Bear Stearns assets into Maiden Lane, LLC ("Maiden Lane I"). On November 10, 2008, the Federal Reserve Board and Treasury announced the restructuring of the Government's financial support to AIG in order to facilitate its ability to complete its restructuring process. As part of this restructuring, the Federal Reserve Board authorized FRBNY to lend up to $22.5 billion to a newly formed Delaware limited liability company, Maiden Lane II LLC ("Maiden Lane II"), to fund the purchase of residential mortgage-backed securities from the securities lending portfolio of several regulated U.S. insurance subsidiaries of AIG. This was done to resolve liquidity pressures on AIG arising from losses on its securities lending program.

premiums written in the United States.[7] AIG offers a broad spectrum of insurance and asset management services. AIG's 116,000 employees work in four principal business units:

- Financial Services
- Asset Management
- Life Insurance & Retirement Services
- General Insurance

AIGFP, AIG's Financial Products subsidiary, offered a portfolio of products that included credit default swaps. Credit default swaps are insurance-like instruments that AIGFP issued to counterparty buyers such as financial institutions and investors. Under a credit default swap, AIG would receive a series of payments from the counterparties in return for AIG agreeing to make a payment to the counterparties if a particular defined credit event occurred with respect to an underlying security (for example, if the credit rating on a security is downgraded or the security goes into default). Credit default swaps are often used to hedge against a loss in value of asset-backed securities.[8] AIGFP sold credit default swaps that offered loss protection on assets such as multi-sector CDOs. CDOs are financial instruments that entitle the buyer to some portion of cash flows from a portfolio of assets, which may include bundles of bonds, loans, mortgage-backed securities, or even other CDOs.[9] A multi-sector CDO is a CDO backed by a combination of corporate bonds, loans, mortgages, or asset-backed securities.

Under the terms of AIGFP's credit default swap contracts, the counterparties purchasing the credit default swaps paid AIG regular insurance-like premiums and were entitled to require AIGFP to post collateral when certain events occurred relating to the underlying CDOs, including a decline in the market value of the CDO.[10] In addition, if the credit rating on the underlying CDOs were downgraded, AIGFP could also be required to post collateral.[11] The credit default swap contracts also included collateral posting provisions that provided that certain events related to AIG would also trigger an obligation for AIGFP to pay the counterparties cash collateral as evidence of AIGFP's ability to pay the counterparty in the event of a default. For example, a common provision provided that, in the event AIG's credit rating was downgraded,

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[7] AIG is supervised in the United States by a host of state insurance regulators. AIG's holding company is supervised by the Office of Thrift Supervision.
[8] Asset-backed securities are tradable securities backed by a pool of loans, leases or other cash-flow producing assets. Mortgage-backed securities are a type of asset-backed security representing claims to the cash flows from pools of mortgage loans. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization.
[9] The CDO can be split into different slices or "tranches" of securities that receive the cash flows from the underlying debt securities in varying priority. The senior tranche is typically highly rated; it is ranked first in the priority of payments of the tranches. The mezzanine tranche generally refers to the tranches rated lower than the senior tranche. The equity tranche is the residual cash flow produced by the CDO collateral that remains after expenses and senior and mezzanine tranches interest are paid.
[10] It is important to note that the credit default swap contract is not actually tied to a security, but instead references it. For this reason, the security involved in the transaction is called the "reference entity." A contract can reference a single credit event or multiple credit events.
[11] For more information about AIG's credit default swaps, including the terms of the contracts, see AIG's 2008 Annual Report, Form 10-K, Item 7.

AIGFP would have to post cash collateral to ensure payment. The amount of cash collateral AIGFP was required to post differed for each event and was calculated based on AIGFP's credit rating, the rating of the underlying security, the market value of the underlying security, and other terms set forth in the swap contract.

Although credit default swaps are sometimes referred to as insurance-like contracts, they are not technically considered insurance, and, unlike insurance contracts, credit default swaps are not regulated. As a result, AIGFP was not required to hold reserves to cover losses or other claims as it would if it was selling insurance policies. AIGFP was thus able to sell swaps on $72 billion worth of CDOs to counterparties without holding reserves that a regulated insurance company would be required to maintain if it had written an equivalent amount of insurance coverage.[12] Counterparties assumed that AIG, which was a highly rated company at the time it wrote the swaps, would be able to pay any claims on the swaps that might occur as required by the contracts.

Beginning in the third quarter of 2007 and continuing through 2008, AIG's financial condition deteriorated, causing a decline in market confidence that, in turn, triggered downgrades of AIG's credit rating. At the same time, the market value of the CDOs protected by AIGFP's credit default swaps declined. As a result, AIGFP was required to post collateral under the terms of its credit default swap contracts, typically the difference between the market value of the underlying CDO and its par value. By late summer 2008, however, AIG did not have nearly enough liquidity to post the required collateral and was on the verge of defaulting on its obligations to its counterparties, which would likely have forced AIG into bankruptcy. In response to the possible systemic implications and the potential for significant adverse effects on the economy if AIG failed, on September 16, 2008, the Federal Reserve Board, with the support of Treasury, authorized FRBNY to lend up to $85 billion to assist AIG in meeting its obligations and to facilitate the orderly sale of some of its businesses.

As AIG continued to experience problems in the fall of 2008, AIG received further government assistance. In November 2008, Treasury purchased $40 billion of newly issued AIG preferred shares under TARP's Systemically Significant Failing Institutions program. These funds went directly to FRBNY to pay back a portion of the funds previously provided to AIG by FRBNY and permitted FRBNY to reduce the total amount available under the credit facility from $85 billion to $60 billion.

At the same time, the Federal Reserve Board announced a number of other measures intended to put AIG on sounder financial footing. These included authorizing FRBNY to restructure the terms of its credit facility to AIG and to create, and lend to, an SPV called Maiden Lane II that was designed to resolve liquidity pressures stemming from AIG's securities lending programs.

[12] Although credit default swaps are subject to anti-fraud and similar provisions of the federal securities laws, these instruments are not considered securities or regulated as such. In 2000, the Commodity Futures Modernization Act ("CFMA") excluded credit default swaps from the definition of "security" under the Securities Act of 1933 and the Securities Exchange Act of 1934 and barred the regulation of credit default swaps and other derivatives. State regulation of credit default swaps is also limited; the CFMA barred most state regulation of credit default swaps. There is currently proposed Congressional legislation that would specify that credit default swaps fall within the definition of a security and should be regulated as such.

The Federal Reserve Board further authorized FRBNY to create, and lend up to $30 billion to, Maiden Lane III to buy the underlying CDOs from AIG's counterparties. These purchases were part of a transaction in which the counterparties, in exchange for agreeing to terminate their credit default swap contracts, would be allowed to retain collateral previously posted by AIG. Pursuant to this Federal Reserve Board authorization, Maiden Lane III was funded with $24.3 billion from FRBNY in the form of a senior loan and a $5 billion equity investment from AIG. Maiden Lane III paid the fair market value of the multi-sector CDOs, or $29.6 billion, in exchange for receiving CDOs with an approximate face value of $62.1 billion. Of the fair market value amount paid by Maiden Lane III, $27.1 was paid to counterparties and $2.5 billion was paid to AIGFP as an adjustment payment to reflect overcollateralization. In simultaneous transactions, the counterparties were allowed to keep the $35 billion in collateral that had been posted by AIG prior to the transaction in exchange for tearing up the associated credit default swap contracts. That collateral was funded in part by the original $85 billion line of credit advanced by FRBNY. As a result of combining the fair market value purchase of the CDOs and the retention of collateral postings already received from AIG, AIG's counterparties received $62.1 billion overall, effectively the par value of the credit default swaps. No TARP funds were directly used in the Maiden Lane III transaction.[13]

Objectives

Twenty-seven members of Congress asked SIGTARP to review the basis for these counterparty payments, whether they were in the best interests of the taxpayers, and whether they needed to be made at 100% of par value. SIGTARP also sought to determine to what extent AIG continues to have potential risk to other counterparty payments associated with their financial products. In addressing these issues, this report is organized around these questions:

- What were the key decisions that led to the creation of Maiden Lane III?
- Why were counterparties paid at effectively par value?
- What AIG exposures to credit default swaps exist outside of Maiden Lane III?

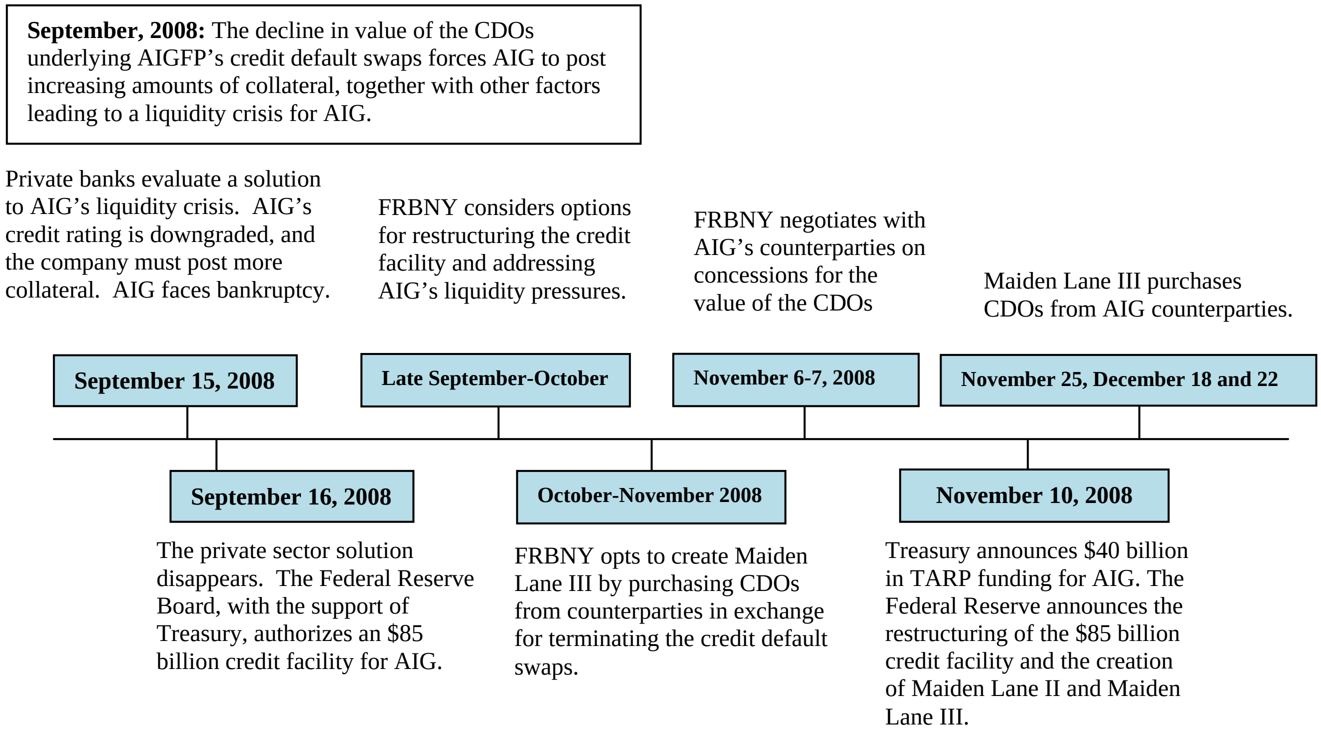
For a discussion of the audit scope and methodology, see Appendix A. For definition of the acronyms, see Appendix B. For the audit team members, see Appendix C. For a copy of comments from the Federal Reserve, see Appendix D. For a copy of the comments from Treasury, see Appendix E.

[13] AIG would eventually receive additional Government assistance when in March 2009, Treasury established an equity capital facility permitting AIG to access up to $29.8 billion in return for preferred shares in AIG. As of October 2, 2009, AIG had drawn down $3.2 billion from the facility.

Key Decisions That Led to the Creation of Maiden Lane III

This section addresses the circumstances and decisions that led to the creation of Maiden Lane III. AIG began suffering significant liquidity problems in September 2008 when it was required to post collateral to its counterparties to make up for, among other things, the rapidly declining value of the securities underlying its credit default swaps. On September 15, 2008, AIG's long-term credit rating was downgraded, and, without some kind of assistance, the company faced bankruptcy. FRBNY believed that a consortium of private banks would be able to offer assistance to AIG. The consortium, however, believed AIG's liquidity needs exceeded the value of the company's assets, and the private sector solution failed in the wake of the bankruptcy of Lehman Brothers. After the prospect of receiving private sector financing disappeared, AIG turned to the Federal Reserve. The Federal Reserve and Treasury considered the benefits of supporting AIG, including the impact that an AIG failure could have on the financial system as a whole and the risks of supporting AIG, which included increasing moral hazard. Because Federal Reserve and Treasury officials believed that an AIG bankruptcy could ultimately have a greater systemic impact than Lehman's bankruptcy one day before, they decided that additional Federal support was needed to maintain the overall stability of the financial markets. On September 16, 2008, the Federal Reserve Board authorized FRBNY to extend an $85 billion revolving credit facility to AIG. In a rush to take action quickly, FRBNY did not craft its own terms and instead simply adopted in substantial part the economic terms of a draft term sheet under consideration by a consortium of private banks, which included a very high interest rate. The terms of this agreement, including the substantial increase in the amount of AIG debt and the substantial interest rate, would later put AIG's credit rating in jeopardy once again, requiring additional Government action. FRBNY further determined that addressing AIG's credit default swap portfolios and assuming liabilities associated with AIG's most problematic credit default swap obligations, which continued to be a drain on AIG's liquidity, would be critical to any restructuring of the original agreement. Therefore, on November 10, 2008, the Federal Reserve Board authorized FRBNY to create Maiden Lane III to purchase the CDOs underlying certain credit default swap contracts from the counterparties. Figure 1 shows the timeline of events discussed in this section.

Figure 1: Timeline of Key Events Leading to the Creation of Maiden Lane III



AIG Suffers a Crisis in Liquidity in September 2008

AIGFP's liquidity issues resulted largely from its obligation to post collateral in connection with its credit default swaps. As the value of the underlying CDOs fell, AIG was contractually obligated to post collateral to its counterparties to make up for the difference in the drop in price of the securities. Some of the credit default swaps contracts also included a provision that if AIG's credit rating was downgraded, AIG would have to post additional collateral to provide assurances that AIG could pay if the underlying CDOs suffered a credit event such as a default. The amount of collateral posted varied from contract to contract. AIGFP's contracts were structured so that if the future value of the CDOs increases, AIGFP would be entitled to the return of this collateral.

AIG's significant collateral call problems began in the third quarter of 2007 and continued to escalate throughout 2008. Prior to September 2007, AIGFP had not posted any collateral related to its swap portfolio. Credit downgrades of AIG corporate debt and the precipitous decline in the value of the underlying CDOs resulted in rapidly increasing collateral calls by counterparties in the first three quarters of 2008, as seen in Table 1.[14]

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[14] Several other factors drove AIG's liquidity crisis. AIG also faced severe liquidity pressures arising out of its losses on residential mortgage-backed securities it had invested in as part of its securities lending program. The Federal Reserve Board twice authorized the FRBNY to take steps to alleviate these pressures: on October 8, 2009, the Federal Reserve Board authorized the FRBNY to establish a securities borrowing program, and on November 10, 2009, authorized the establishment of Maiden Lane II. Additionally, among other things, the deterioration in its financial condition and credit rating meant that AIG needed to fund collateral obligations under guaranteed

Table 1: AIG Collateral Postings from December 31, 2007, through September 30, 2008 (dollars in millions)

	Collateral posting during quarter ending			
Collateral Posting by Portfolio	**December 31, 2007**	**March 31, 2008**	**June 30, 2008**	**September 30, 2008**
Foreign Regulatory Capital [a]	0	212	319	443
Arbitrage – Multi-sector CDO [b]	2,718	7,590	13,241	31,469
Arbitrage – Corporate	161	368	259	902
Total Collateral Postings	**2,879**	**8,170**	**13,819**	**32,814**

Source: SIGTARP analysis of AIG data

[a] Foreign regulatory capital swaps portfolio refers to swaps written on diversified pools of residential mortgages and corporate loans (made to both large corporations and small to medium-sized enterprises). In exchange for a periodic fee, foreign financial institutions receive credit protection with respect to diversified loan portfolios they own, thus reducing their minimum capital requirements.

[b] Arbitrage portfolio refers to transactions written on multi-sector CDOs or designated pools of investment grade senior unsecured corporate debt or collateralized loan obligations.

On Friday, September 12, 2008, Standard & Poor's ("S&P") placed AIG on negative credit watch signaling a potential upcoming downgrade in the firm's credit rating as early as the following week. As described above, such a downgrade would have triggered additional collateral postings under AIGFP's credit default swap contracts. To prevent such a downgrade, during the weekend, AIG attempted to raise capital from private equity firms and other potential investors to address its liquidity crisis. AIG met with FRBNY officials to keep them abreast of the status of these talks. Although aware of the impending crisis, Federal Reserve officials believed that a private solution would be forthcoming and, as a result, did not foresee that Federal Reserve assistance would be necessary.

On Monday, September 15, 2008, after Lehman filed bankruptcy early in the morning, the private sector solution for AIG collapsed. That same day, then-FRBNY President Geithner spearheaded an effort to encourage a private solution to AIG's liquidity crisis. Mr. Geithner mobilized a consortium of banks led by representatives from JPMorgan Chase & Co. and Goldman Sachs to arrange private financing for a $75 billion loan to address AIG's liquidity crisis. The Federal Reserve believed that the bank consortium would provide the liquidity AIG needed. A JPMorgan Chase vice chairman noted that participants felt a sense of urgency to find an immediate solution to avert a potential downgrade by the credit rating agencies. The group developed a loan term sheet, but an analysis of AIG's financial condition revealed that liquidity needs exceeded the valuation of the company's assets, thus making the private participants unwilling to fund the transaction. FRBNY officials told SIGTARP that, in their view, the private participants declined to provide funding not because AIG's assets were insufficient to meet its needs, but because AIG's liquidity needs quickly mounted in the wake of the Lehman bankruptcy and the other major banks decided they needed to conserve capital to deal with adverse market conditions.

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investment contracts and to make capital contributions to a number of its subsidiaries in accordance with the requirements of applicable regulators.

On the afternoon of September 15, 2008, the three largest rating agencies, Moody's, S&P, and Fitch Ratings Services, downgraded the long-term credit rating of AIG. The rating downgrades, combined with a steep drop in AIG's common stock price, prevented AIG from accessing money in the short-term lending markets, and, without outside intervention, the company faced bankruptcy, as it simply did not have the cash that was required to provide to AIGFP's counterparties as collateral. On the morning of September 16, 2008, Mr. Geithner was informed that a private sector loan could not be arranged. That same day, the Federal Reserve Board, with the encouragement of Treasury, authorized FRBNY to make an $85 billion revolving credit facility available to AIG, so that it could make the collateral payments, meet the liquidity needs arising from AIG's securities lending programs, and meet other obligations necessary to avoid bankruptcy.

Federal Reserve and Treasury Consider the Benefits and Risks of Supporting AIG

In considering whether to rescue AIG, senior Federal Reserve and Treasury officials considered the pros and cons of lending to AIG and identified concerns about an AIG bankruptcy that they believed would be inevitable if AIG failed to make the collateral payments to counterparties. Senior FRBNY officials discussed disadvantages of lending to AIG including the perception that lending to AIG would be inconsistent with the treatment of Lehman, could diminish AIG's incentive to pursue private sector solutions, and could increase moral hazard. FRBNY also identified several major concerns about the widespread impact of not lending to AIG and a potential AIG bankruptcy: the impact on the American retirement system; the impact of AIG's commercial paper obligations,[15] the broader effect on the already frozen credit markets and money market mutual funds; and the considerable systemic risk to the global financial system.

First, Federal Reserve and Treasury officials believed that AIG's failure posed considerable risk to the entire financial system and would have significantly intensified an already severe financial crisis and contributed to a further worsening of global economic conditions. Federal Reserve Chairman Bernanke testified on March 24, 2009, before the House Financial Services Committee, that Federal Reserve and Treasury had agreed that AIG's failure "would have posed unacceptable risks for the global financial system and for our economy." Chairman Bernanke cited losses that would be incurred by state and local governments that had lent $10 billion to AIG; global banks and investment banks that had $50 billion in exposure to losses on loans, lines of credit and derivatives; losses of $20 billion in AIG commercial paper; and losses by workers whose 401(k) plans had purchased $40 billion of insurance against the risk that their values would decline in value. As Chairman Bernanke testified, "[c]onceivably, its failure could have resulted in a 1930s-style global financial and economic meltdown, with catastrophic implications for production, income, and jobs." Mr. Geithner, who had since become Secretary of the

[15] Commercial paper is an unsecured, short-term debt instrument used by companies to cover short-term obligations such as operating and payroll expenses, accounts receivable, and inventories. The debt is usually issued at a discount, reflecting prevailing market interest rates. Commercial paper is not usually backed by any form of collateral, so only firms with high-quality debt ratings will easily find buyers without having to offer a substantial discount (higher cost) for the debt issue.

Treasury, testified before that same Committee that the "collapse of AIG could cause large and unpredictable global losses with systemic consequences—destabilizing already weakened financial markets, further undermining confidence in the economy, and constricting the flow of credit." Secretary Geithner further testified that, "[a] disorderly failure of AIG risked deepening and prolonging the current recession." According to Congressional testimony of Donald Kohn, the Vice Chairman of the Federal Reserve, such a failure would also have further undermined business and household confidence and contributed to higher borrowing costs, reduced wealth, and a further weakening of the economy.

Second, the Federal Reserve and Treasury considered the effect an AIG bankruptcy could have on the American retirement system and determined that AIG's failure would have a global retail impact, notably on stable value funds and variable rate annuities. A stable value fund is an investment vehicle found in company retirement plans and IRA accounts.[16] Stable value funds are paired (or wrapped) with insurance contracts to guarantee a specific minimum return. AIGFP had written approximately $38 billion of stable value fund wrap contracts to more than 200 wrap contract counterparties, including trustees and investment managers of company retirement plans and 401k plans such as Fidelity, Vanguard, and the company retirement plans for AT&T, DuPont, Wal-Mart, Bank of America, and other large U.S. corporations. If AIG failed and the retirement plans could not secure new wrap contracts, the investment managers would be forced to sell assets in their plans at distressed prices, which could generate immediate losses in the stable value funds. Treasury and Federal Reserve officials were concerned that large, unrealized losses could lead to real economic losses within the retirement funds and cause a broader crisis of confidence in the American public about the security of retirement benefits.

Finally, Federal Reserve and Treasury officials were also concerned about the impact of an AIG default on its commercial paper obligations and on the already frozen credit markets and distressed money market mutual funds, particularly after observing the negative economic effects of Lehman's bankruptcy. Federal Reserve and Treasury senior officials believed that AIG's derivatives were more risky and unbalanced than Lehman's; that investors could lose confidence in AIG subsidiaries, which could lead to a liquidity shortfall; and finally, that AIG would fail to perform on annuities and stable value wraps. Further, Federal Reserve and Treasury officials discussed whether a default on AIG's commercial paper could lead to further "breaking-of-the buck" for money market funds. Money market funds are considered among the safest investments and maintain a net asset value of $1 per share. When the fund falls below $1 per share, it is known as "breaking the buck," an event that had not occurred in many years. After Lehman filed for bankruptcy, the Reserve Primary Fund, the oldest money market fund in the United States, was forced to write off debt issued by Lehman (about $785 million). As a consequence, on September 16, 2008, the Reserve Primary Fund dipped below $1.00 per share, thereby "breaking the buck," which further aggravated the credit crisis. The resulting market

[16] These funds seek to maintain a $1 share price calculated by dividing the total value of all of the securities in its portfolio (less any liabilities) by the number of shares outstanding. Stable value funds comprise mostly "synthetic guaranteed investment contracts" (known also as wrapped bonds) because of their inherent stability. Guaranteed investment contracts are insurance contracts that guarantee the owner a repayment of principal and a fixed or floating interest rate for a predetermined period of time. For example, if a company pension plan owns a bond with a face value of $1,000 and the price in the market is $950, AIGFP would pay the $50 difference between the face value and the market value. These bonds can be short or intermediate term with longer maturities than other choices such as money market funds.

anxiety contributed to a run on the Reserve Primary Fund in which investors attempted to withdraw their money quickly. In addition, large-scale redemptions caused money market mutual fund companies to hoard cash rather than invest in funding markets, such as commercial paper and certificates of deposit. AIG had approximately $20 billion in commercial paper outstanding that was owned by institutional investors and money market funds that would likely have taken losses had AIG failed. By contrast, in May 2008, Lehman had $8 billion in commercial paper outstanding, an amount that decreased in the months leading to Lehman's bankruptcy. Federal Reserve and Treasury officials were concerned that an AIG commercial paper default could force other money market funds to break the buck, which could cause investor panic and a run on each of the funds holding AIG debt.

In the final analysis, the Federal Reserve and Treasury believed that the risks of not rescuing AIG outweighed the risks associated with rescuing the troubled insurance company, and on September 16, 2008, the Federal Reserve Board authorized an $85 billion credit facility for AIG.

FRBNY and Treasury Officials Realized that the Structure of the Assistance Must Be Changed

Although FRBNY officials had been meeting with AIG management and advisors during the weekend of September 12, 2008, and over the following days, Secretary Geithner informed SIGTARP that he believed that the bank consortium led by JPMorgan Chase would provide the liquidity AIG needed. When the consortium declined to assist AIG and the three largest credit rating agencies downgraded AIG on September 15, 2008, the Federal Reserve and Treasury made the decision, within a matter of hours, that FRBNY would provide $85 billion in financing to AIG. FRBNY did not develop a contingency plan in the event that the private financing did not go through and did not conduct an independent analysis regarding the appropriate terms for Government assistance to AIG; instead it used in substantial part the economic terms of the private sector deal, albeit for $85 billion instead of the $75 billion prepared by JPMorgan Chase for the unsuccessful private sector solution. The deal gave FRBNY 79.9 percent equity in the shares of AIG and a floating interest rate calculated to be more than 11 percent.[17] An FRBNY official told SIGTARP that, by September 17, 2008—the day after FRBNY provided initial assistance to AIG and two days after AIG's downgrades—it was clear that the rating agencies were planning another downgrade of AIG because of the deteriorating financial condition of the company and the impact the $85 billion FRBNY loan could have on AIG's capital structure, including the high interest rate payments AIG would have to make to FRBNY.[18] FRBNY's General Counsel emphasized in an interview with SIGTARP that FRBNY "inherited the bank

[17] The rate was a floating rate calculated using the 3-month London Interbank Overnight Rate ("LIBOR") plus 8.5 percent which calculated to approximately 11.3 percent on September 17, 2008. The LIBOR is the rate of interest at which banks borrow funds from other banks, in marketable size, in the London interbank market.

[18] Capital structure is a mix of a company's long-term debt, specific short-term debt, common equity, and preferred equity. The capital structure is how a firm finances its overall operations and growth by using different sources of funds.

consortium deal," that the interest rate was too high, and that FRBNY recognized the need to restructure the deal by making it less onerous to AIG soon after the agreement was signed.[19]

Federal Reserve and FRBNY Officials Decide to Purchase Securities from Counterparties through Maiden Lane III

From the time FRBNY initially provided AIG with financing, FRBNY officials began meeting with AIG management to understand AIG's liquidity drain and to determine AIG's liquidity needs. S&P's September 15, 2008 downgrade triggered further collateral postings in AIGFP's credit default swap portfolio, and these continued even after FRBNY provided financing. Indeed, AIG needed billions of dollars a week to meet collateral calls and make payments to AIGFP's swap counterparties. As of November 5, 2008, AIG had drawn down approximately $61 billion of the initial $85 billion FRBNY line of credit.

FRBNY sought help in evaluating the CDOs underlying AIGFP's credit default swap contracts. Senior FRBNY officials learned that AIG had previously retained BlackRock Solutions ("BRS") to evaluate AIG's swap portfolios and underlying CDOs. A senior vice president of FRBNY confirmed with SIGTARP that BRS's knowledge of the portfolio and their analytical work were important to FRBNY's efforts to rescue AIG. As a result, FRBNY decided to hire BRS to assist FRBNY in its evaluation of AIG's liquidity needs.[20] A BRS managing director noted that AIG's swap exposure was complicated for two reasons. First, each swap contract had a different credit event that would trigger a collateral posting under the contract. Second, the counterparties had different mark-to-market valuations for the underlying CDOs than AIGFP, therefore making the swap exposures difficult to track.[21] For example, AIGFP could have marked a CDO at 85 cents on the dollar while the counterparty could have marked the CDO at 70 cents on the dollar on its own books, which, among other things, created potential disputes with the counterparties as to the amount of collateral owed. In late September, FRBNY asked BRS to help them analyze a portfolio of multi-sector CDOs that would eventually become Maiden Lane III.

On October 3, 2008, S&P revised its outlook for AIG to "negative" from "developing," and Moody's downgraded AIG's senior unsecured credit rating, citing AIG's plans to sell some of its businesses to pay debt, thus leaving AIG with fewer businesses to generate income. It was clear that the initial $85 billion line of credit had not sufficiently solved AIG's liquidity crisis, and, in some respects, actually exacerbated it as the high interest rate on amounts AIG drew down on the line of credit would have required significant annual interest payments by AIG. For example, the floating rate of interest was 11.3 percent as of September 17, 2008, and AIG's annual interest payment alone would have been $9 billion per year if AIG drew down the full line of credit. According to the Federal Reserve, the size and terms of the $85 billion loan increased AIG's leverage (the amount of debt AIG used to finance its assets) and lowered its interest coverage

[19] These changes, including a reduced interest rate, were reflected subsequently in the November 10, 2008, revised term sheet.
[20] BRS kept separate the work it continued to do for AIG. AIG's CEO, Edward Liddy, consented to the FRBNY's retention of BRS.
[21] Mark to market is the act of recording the price or value of a security, portfolio, or account to reflect its current market value, rather than its book value.

ratio (a measure of how easily AIG can pay interest on a debt),[22] two metrics that credit rating agencies use in assessing an issuer's financial strength. In addition, according to Donald Kohn, Vice Chairman of the Federal Reserve, the $19 billion decline in the market value of the CDOs underlying the credit default swaps and the decline of AIG's residential mortgage-backed securities portfolio in the third quarter of 2008 resulted in an erosion in AIG's capital that further placed AIG's credit ratings in jeopardy.[23] Further, the continued drain on AIG's liquidity from having to continue to make collateral payments to AIGFP counterparties also contributed to the danger of a downgrade. According to an FRBNY senior vice president, any further downgrades to AIG's long-term credit rating would have been catastrophic and would most likely have led to an AIG bankruptcy.

At this time, AIG was attempting to resolve its liquidity crisis caused by the collateral posting requirements by negotiating a cash payment to the counterparties in return for terminating the credit default swaps. AIG held bilateral discussions with counterparties about such terminations and kept FRBNY informed on the status of its efforts.

Because these negotiations were not bearing fruit, FRBNY asked BRS to begin looking at a number of options for dealing with AIG's multi-sector CDO counterparties. From late October to early November 2008, BRS presented three options for FRBNY to consider, but FRBNY, however, believed that the first two options had significant limitations:

- The first proposed option would have involved counterparties cancelling their credit default swaps and selling the underlying CDOs to an FRBNY-financed SPV, for total consideration of par, comprised of previously posted collateral, cash, and a mezzanine note in the SPV. The SPV would purchase the CDOs at market value, funded by a senior loan from FRBNY, the mezzanine notes held by the counterparties, and a subordinated loan from AIG. The mezzanine notes would be repaid from the cash flows of the CDOs after the FRBNY's senior loan was fully repaid, effectively leaving counterparties with a long-term risk position in the CDOs. FRBNY was uncertain whether the counterparties would be motivated to cancel the swaps if they were left with any un-hedged CDO risk associated with retaining the mezzanine tranche. In any event, FRBNY officials stated that this option would be time consuming and impracticable, given that the process would have required negotiations with each counterparty over the size of the mezzanine note in relation to the value of their swaps and the CDOs, complicated by market illiquidity that led to credit default swap valuation differences between counterparties and AIG. FRBNY believed it needed to gain the agreement of most major counterparties quickly to achieve the liquidity relief necessary to de-risk AIG and that there would be insufficient time to successfully negotiate this option.

- The second proposed option would have allowed the counterparties to keep their multi-sector CDOs and the protection provided by the credit default swaps, with the obligation to perform under the credit default swaps transferred from AIG to an SPV guaranteed by

[22] According to a November 10, 2008, Report by the Federal Reserve, Report Pursuant to Section 129 of the Emergency Economic Stabilization Act of 2008: Restructuring of the Government's Financial Support to the American International Group, Inc. on November 10, 2008, pg. 4.
[23] Statement of Donald L. Kohn, Vice Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 5, 2009.

the FRBNY, in exchange for counterparties agreeing to forego further collateral postings. Under this proposal, FRBNY would not own the underlying CDOs, but the FRBNY-funded SPV would only have to make payments as provided in the credit default swap contracts in the event of default on the underlying CDOs. FRBNY told SIGTARP that a perceived downside of this structure from FRBNY's perspective was that it could involve FRBNY in long-term credit relationships with supervised institutions. Given further that there was a lack of statutory authority of the Federal Reserve to provide such a guarantee, FRBNY determined that this option was also not viable.

- The third option, which FRBNY eventually selected, was to create an SPV to purchase the underlying CDOs from AIGFP's counterparties, in connection with a termination of the related credit default swaps. Within this option, BRS noted that counterparties could receive effectively par value or FRBNY could seek a reduction in the amount that counterparties would receive—otherwise known as concessions or a "haircut"—for the total of the CDOs and related swaps held by each of AIGFP's counterparties. FRBNY's AIG monitoring team explained that this structure had the benefit of minimizing valuation disputes with counterparties, because combining the payment by Maiden Lane III for the CDOs and the offset of collateral for the tear-up of the credit default swap contracts eliminated the need to agree with counterparties separately on the market price of the CDOs and the value of the credit default swap contracts. BRS assessed this option as having a "high certainty of execution" and the "simplest structure." FRBNY officials told SIGTARP that this structure was also attractive because it fit within the legal authorities of the Federal Reserve to lend against collateral.

While FRBNY was conducting analysis on alternative solutions, AIG's attempts to negotiate the termination of its multi-sector credit default swap book with its counterparties were failing. AIG requested FRBNY's assistance in securing these terminations.

Ultimately, on November 3, 2008, FRBNY decided to create Maiden Lane III, the SPV through which the CDOs underlying AIGFP's credit default swaps were purchased and subsequently managed. FRBNY officials concluded that, by purchasing the CDOs underlying AIGFP's credit default swaps from the counterparties and therefore compensating them at the equivalent of par, the counterparties would agree to cancel the credit default swap contracts, and thus AIGFP would no longer have to make collateral payments to the counterparties, which would ease the liquidity crisis at AIG and help avoid another credit rating downgrade. After consulting with staff at Federal Reserve Board and Treasury, FRBNY shared its proposal for resolving the multi-sector credit default swap book with AIG. On November 6, 2008, AIG formally requested that FRBNY engage in discussions with counterparties on its behalf. On November 10, 2008, the Federal Reserve Board authorized the FRBNY's establishment of, and loan to, Maiden Lane III. On November 25, 2008, Maiden Lane III was created and began purchasing the underlying CDOs from the counterparties. As discussed more fully in the next section, there were concerns, however, over the price paid for the credit default swaps.

FRBNY Decided to Compensate Counterparties Effectively at Par Value

This section addresses the reasons why AIG counterparties were effectively paid at par, or 100 percent of face value. After FRBNY decided to create Maiden Lane III, FRBNY officials attempted to obtain "haircuts," or voluntary concessions, from eight of AIG's largest counterparties; those efforts were not successful. In November and December 2008, Maiden Lane III paid AIG's counterparties $27.1 billion, the fair market value of their CDOs, and the counterparties were allowed to keep the $35 billion in collateral they had received prior to the transaction for a total of $62.1 billion or par value. Then-FRBNY President Geithner and the FRBNY General Counsel told SIGTARP that the financial condition of the counterparties was not a relevant factor in the decision to create Maiden Lane III and pay counterparties effectively at par. On March 15, 2009, after significant public and Congressional pressure, AIG, after consultation with the Federal Reserve, publicly disclosed the identities of the counterparties. FRBNY officials said that they believe they will recoup the loan they made to Maiden Lane III over time. As of September 30, 2009, the current fair market value of the Maiden Lane III portfolio is $23.5 billion, versus a loan balance of $19.3 billion.

FRBNY Efforts to Limit Counterparty Payments Were Unsuccessful

After FRBNY decided to create Maiden Lane III to buy the underlying CDOs, it attempted to obtain concessions from AIGFP's counterparties. FRBNY developed talking points for its staff for these negotiations. The talking points stressed that participation in concession negotiations with FRBNY was voluntary and asked the counterparties to consider the cost of the considerable direct and indirect benefits that the counterparties had derived from the Federal Reserve's support of AIG. FRBNY developed packets with detailed information about the CDO portfolio for each counterparty. The packets included valuations of the multi-sector CDO portfolios and identified possible opportunities for concessions.

On November 6 and 7, 2008, FRBNY assistant vice presidents, vice presidents, senior vice presidents, and executive vice presidents contacted eight of AIGFP's largest counterparties (Société Générale, Goldman Sachs, Merrill Lynch, Deutsche Bank, UBS, Calyon, Barclays and Bank of America) by telephone. They described a proposal under which each counterparty was asked to accept a haircut from par. Seven of the eight counterparties told FRBNY officials that they would not voluntarily agree to a haircut. The eighth counterparty, UBS, said that it would accept a haircut of 2 percent as long as the other counterparties also granted a similar concession to FRBNY. FRBNY officials told SIGTARP that their concerns about credit rating downgrades limited the time available for negotiation about reductions in payments. According to an FRBNY senior vice president, the counterparties that FRBNY approached that resisted being paid anything less than the equivalent of par in exchange for terminating their credit default swap contracts cited several reasons for this, including:

- They had collateral already posted by AIG to protect against the risk of AIG default. The combination of collateral in their possession plus the fair market value of the underlying CDOs also in their possession equaled the par value of the credit default swaps. Thus, from the counterparty's perspective, offering a concession would mean giving away value and voluntarily taking a loss, in contravention of their fiduciary duty to their shareholders.
- In addition to the collateral, they had a reasonable expectation that AIG would not default on any further obligations under the credit default swaps because the U.S. government had already demonstrated that it would not allow AIG to go bankrupt.
- They had already incurred costs to mitigate the risk of an AIG default on its obligations that would be exacerbated if they were paid less than par value.
- They were contractually entitled to the par value of the credit default swap contracts.

SIGTARP spoke with officials from Goldman Sachs and Merrill Lynch (two of AIGFP's largest domestic counterparties) to obtain their perspectives:

- **Goldman Sachs:** Goldman Sachs had approximately $22.1 billion of notional amount of outstanding credit default swap contracts with AIG, approximately $20 billion of which were against an underlying portfolio of CDOs. According to Goldman Sachs, it had one telephone conversation with FRBNY staff in which the possibility of concessions was mentioned. Goldman Sachs has since explained that it did not agree to concessions because it would have realized a loss if it had. Goldman Sachs did not hold the underlying CDOs but rather had sold equivalent credit protection to its clients who held those positions; Goldman Sachs then purchased the corresponding value in protection from AIG to hedge against its own exposure in the event of a default of the reference CDOs. Accordingly, Goldman Sachs was obligated to pay its clients in full on the other side of the derivative transactions, and, if it granted a haircut to FRBNY, it would have to realize that amount as a loss.

  In addition, Goldman Sachs informed SIGTARP that it had purchased additional credit risk protection against an AIG default. Of the $22.1 billion of credit default swaps outstanding in November 2008, approximately $13.9 billion was resolved through Maiden Lane III. For that portfolio, Goldman had already received $8.4 billion of collateral payments from AIG, representing AIG's calculation of the decline in the fair market value of the underlying CDOs. However, Goldman Sachs believed that the drop in value was actually $9.6 billion, and it purchased credit default swaps and other protection from third parties that would have paid Goldman Sachs slightly more than the difference ($1.2 billion) had AIG defaulted on its obligations. That additional protection, which related to all of Goldman Sachs' AIG hedges, cost Goldman Sachs more than $100 million.

Thus, according to Goldman Sachs, even if AIG defaulted, Goldman Sachs would be made whole on the Maiden Lane III credit default swaps in light of the collateral it already held ($8.4 billion), the additional protection it had purchased (totaling more than $1.2 billion), and what it calculated to be the value of the underlying CDOs ($4.3 billion). As a result, it did not consider itself materially at risk if AIG in fact defaulted.

Of course, notwithstanding the additional credit protection it received in the market, Goldman Sachs (as well as the market as a whole) received a benefit from Maiden Lane III and the continued viability of AIG. First, in light of the illiquid state of the market in November 2008 (an illiquidity that likely would have been exacerbated by AIG's failure), it is far from certain that the underlying CDOs could have easily been liquidated, even at the discounted price of $4.3 billion. Second, had AIG collapsed, the systemic implications on other market participants might have made it difficult for Goldman Sachs to collect on the credit protection it had purchased against an AIG default, although Goldman Sachs stated that it had received collateral from its counterparties in those transactions. Finally, if AIG had defaulted, Goldman Sachs would have been forced to bear the risk of further declines in the market value of the approximately $4.3 billion in CDOs that it transferred to the Maiden Lane III portfolio as well as approximately $5.5 billion[24] for its credit default swaps that were not part of the Maiden Lane III portfolio; Maiden Lane III removed any risk for the $4.3 billion within that portfolio, and continued Government backing of AIG provided Goldman Sachs with ongoing protection against an AIG default on the remaining $5.5 billion.

- **Merrill Lynch:** A managing director told SIGTARP that, on November 7, an FRBNY Vice President and Assistant Vice President called senior Merrill Lynch officials and asked if Merrill Lynch would consider accepting a discounted price to tear up the contracts. Senior Merrill Lynch officials told FRBNY that FRBNY would need to contact directly John Thain, Merrill Lynch's then-CEO, to discuss any potential discount. FRBNY stated that an executive vice president called Mr. Thain at the outset of the negotiations to request his cooperation. Later that night, FRBNY spoke by phone to a Merrill Lynch managing director and proposed a transaction in which Merrill Lynch would receive par for the contracts. The managing director told SIGTARP that Merrill Lynch was not receptive to FRBNY's request for concessions for reasons similar to those described above by Goldmans Sachs and because Merrill Lynch had already paid approximately $40 million in fees and to obtain credit protection and anticipated that it would have to pay an additional approximately $36 million in fees and costs to resolve the Maiden Lane III CDOs.

During these negotiations, an FRBNY executive vice president and senior vice president contacted the Commission Bancaire[25] to inform them that the FRBNY was conducting

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[24] Goldman Sachs calculated that the $8.2 billion in non-Maiden Lane III AIG credit default swaps had a market value of approximately $5.5 billion. It had received collateral or bought credit protection slightly in excess of the $2.7 billion difference.

[25] The Commission Bancaire is the French bank regulator. Its mission is to protect depositors and act as watchdog over the French banking and financial system to ensure its profitability and financial stability. The Commission has

negotiations with Société Générale and Calyon, two of the counterparties with the largest credit default swap contracts with AIG, and was requesting their support. The Commission Bancaire then contacted the firms. The Commission Bancaire spoke again with FRBNY and forcefully asserted that, under French law, absent an AIG bankruptcy, the banks could not voluntarily agree to less than par value for the underlying securities in exchange for terminating the swap contracts. Thus, the French banks claimed they were precluded by law from making concessions and could face potential criminal liability for failing to comply with their duties to shareholders.

At the end of the day on November 7, after FRBNY officials had received negative reactions from seven of the eight counterparties, including the French banks' formal refusal, senior FRBNY officials met with then-President Geithner. After discussing the counterparties' reactions, including UBS's conditional acceptance to give a 2 percent haircut,[26] the officials recommended to President Geithner that the Maiden Lane III transactions go forward without haircuts because it would be impractical to obtain haircuts from all the counterparties. Mr. Geithner concurred, and it was decided that FRBNY would cease efforts to negotiate haircuts and pay the counterparties the market value of the CDOs. When combined with the collateral already posted, this effectively meant that counterparties would be paid for the credit default swaps at par value. FRBNY officials then communicated this recommendation to officials of the Federal Reserve Board, who assented.

Then-President Geithner believed it was prudent for FRBNY to try to obtain haircuts but had little hope that the efforts would be successful because he felt that FRBNY had little available leverage. FRBNY officials have cited several reasons for this:

- The greatest leverage that FRBNY might have had – the threat of default and an associated AIG bankruptcy – was effectively removed by FRBNY's intervention in September, an intervention that the counterparties understood to mean that the U.S. government would not permit an AIG failure. The officials stated that ethical constraints prevented FRBNY from even suggesting that it would allow bankruptcy when it in fact would not do so.
- In addition, FRBNY was concerned that its use of a threat of an AIG default might introduce doubt into the marketplace about the resolve of the U.S. government in following through on its commitments in support of financial stability. FRBNY officials felt the introduction of such uncertainty might have been dangerous and potentially expensive for the U.S. economy in light of the precarious market conditions in November 2008 and the extraordinary official efforts that had been taken to support market functioning.
- FRBNY was further concerned – as it was throughout the AIG rescue – about the reaction of the rating agencies. While threatening not to support AIG might have been useful for purposes of forcing concessions by the counterparties, it could also have been

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the power to impose administrative penalties and financial sanctions to offenders (Article L613-1, Monetary and financial code).

[26] Secretary Geithner informed SIGTARP that while he has no reason to question the account of FRBNY officials regarding this meeting, he did not recall being informed that UBS had agreed to a conditional haircut. FRBNY officials who attended the meeting with Mr. Geithner, however, specifically recall briefing Mr. Geithner on the UBS offer.

viewed by the credit rating agencies as an indication that the FRBNY and the U.S. government was not standing fully behind AIG, which could have had a negative impact on AIG's credit rating.

- As a policy matter, FRBNY was unwilling to use its leverage as the regulator for several of the counterparties to compel concessions, in part because in the negotiations it was acting as a creditor of AIG and not as the counterparties' primary regulator.
- Also as a policy matter, FRBNY was uncomfortable with violating the principle of sanctity of contract.
- The refusal of the French banks to negotiate concessions played a significant role in complicating FRBNY's efforts. FRBNY views treating all parties equally as one of its "core values," and it did not want to be perceived as making a more favorable deal with the French institutions than with the domestic institutions. Indeed, FRBNY recently suggested that requiring concessions from some banks while not requiring concessions of others was not consistent with principles found in Section 4 of the Federal Reserve Act (requiring the Federal Reserve to treat member banks and banks equally) and the principles of national treatment and equality of competitive opportunity in the International Banking Act (requiring that domestic banks and branches of foreign banks be treated equally).
- Secretary Geithner further explained to Congress that "we explored at that time every possible means to reduce the drain on their resources including what you referred to. But again, because we have no legal mechanism in place for dealing with this, like we deal with banks, we did not have the ability to selectively impose losses on their counterparties."[27]

Thus, despite the willingness of at least one counterparty to engage in discussions about a potential haircut, all counterparties were paid effectively par value for the credit default swaps. Table 2 presents a complete list of payments from Maiden Lane III to AIGFP counterparties for the fair market value of the CDOs, which, in combination with the counterparties' retention of collateral previously posted by AIGFP, equaled effectively par value of the credit default swap contracts.

[27] Hearing before the Committee on Financial Services, *Oversight of the Federal Government's Intervention at American International Group*, U.S. House of Representatives, March 24th, 2009.

Table 2—Total Payments to AIG Credit Default Swap Counterparties (in billions)

AIG Counterparty	Maiden Lane III Payment	Collateral Payments Posted (as of 11/7)	Total
Société Générale	6.9	9.6	16.5
Goldman Sachs	5.6	8.4	14.0
Merrill Lynch	3.1	3.1	6.2
Deutsche Bank	2.8	5.7	8.5
UBS	2.5	1.3	3.8
Calyon	1.2	3.1	4.3
Deutsche Zentral-Genossenschaftsbank	1.0	0.8	1.8
Bank of Montreal	0.9	0.5	1.4
Wachovia	0.8	0.2	1.0
Barclays	0.6	0.9	1.5
Bank of America	0.5	0.3	0.8
The Royal Bank of Scotland	0.5	0.6	1.1
Dresdner Bank AG	0.4	0.0	0.4
Rabobank	0.3	0.3	0.6
Landesbank Baden-Wuerttemberg	0.1	0.0	0.1
HSBC Bank, USA	0.0*	0.2	0.2
Total	**27.1****	**35.0**	**62.1**

Source: SIGTARP analysis of AIG and FRBNY data
* Amount rounded down to $0.
** In addition to the $27.1 billion in payments to the counterparties, AIGFP received a payment of $2.5 billion as an adjustment payment to reflect overcollateralization.

In addition to the payments reflected in Table 2, there was a $2.5 billion payment to AIGFP that resulted from an agreement between AIG and FRBNY called the Shortfall Agreement. This document implemented the agreement of the FRBNY and AIG that Maiden Lane III would acquire the CDOs at their October 31, 2008, market value. Under this agreement, Maiden Lane III compensated AIGFP for the difference between the actual amount of collateral that AIGFP had previously paid to the counterparties and the fair market value of the CDOs as of October 31, 2008.

Federal Reserve and FRBNY Did Not Initially Disclose Information on the Counterparties or Their Decision to Pay Effectively at Par Value

Despite having made the decision to pay the counterparties effectively par value, the Federal Reserve and FRBNY made an initial decision not to reveal the identities of AIG's counterparties or the amount of individual payments. On March 5, 2009, Federal Reserve Vice Chairman Kohn testified before Congress about the decision to pay effectively par value to the counterparties, but refused to reveal the identities of the counterparties or payments made. At the hearing, Senator Christopher Dodd pressed for disclosure of AIG's credit default swap counterparties during a Senate Banking, Housing and Urban Affairs Committee hearing. Senator Dodd stated, "[t]his Committee would like to know, and the taxpayers certainly have a right to know who they are effectively funding and how much money has already been given. Again, AIG's trading partners are not innocent victims here. They were sophisticated investors who took enormous irresponsible risks with the blessing of AIG's AAA rating." Vice Chairman Kohn, however, expressed his judgment that "giving the names would undermine the stability of the company and could have serious knock-on effects to the rest of the financial markets and the government's efforts to stabilize them."

Ten days following the Senate hearing, and approximately four months after the first of Maiden Lane III's payments to counterparties, AIG, in consultation with the Federal Reserve, released the identity of the counterparties, as indicated in Table 2. On April 28, 2009, FRBNY provided further information about Maiden Lane III on its website. The information on the website includes a transaction overview, a portfolio breakdown by investment type, and ratings and vintage information on the CDO securities included in the portfolio. It does not appear that the disclosures had any of the negative consequences that Vice Chairman Kohn anticipated on AIG or on the markets generally.

Value of the Maiden Lane III Portfolio of CDOs

It remains to be seen what the ultimate financial costs and benefits of the Maiden Lane III transaction will be for the American taxpayers. AIG did not file for bankruptcy and has been able to significantly address its liquidity issues after Maiden Lane III.

The FRBNY has an outstanding recourse loan on its balance sheet to Maiden Lane III for the purchase of the CDOs.[28] As of November 4, 2009, the value of the CDO portfolio held by Maiden Lane III had a current market value of $23.2 billion, while the balance of principal and interest owed to the FRBNY on its loans to Maiden Lane III, after accounting for payments already made on the loan, was approximately $19.3 billion. This loan balance, which is lower than the original extension of credit to AIG, reflects $5.3 billion in repayments that FRBNY has received over the first year of its loan to Maiden Lane III. FRBNY told SIGTARP that these repayments are consistent with FRBNY's expectations at the time that it entered into the

[28] The loan is a recourse loan to the assets held by Maiden Lane III.

transaction. The Federal Reserve's assessment is that the Maiden Lane III portfolio will generate enough cash flow to repay the FRBNY's senior loan in full.

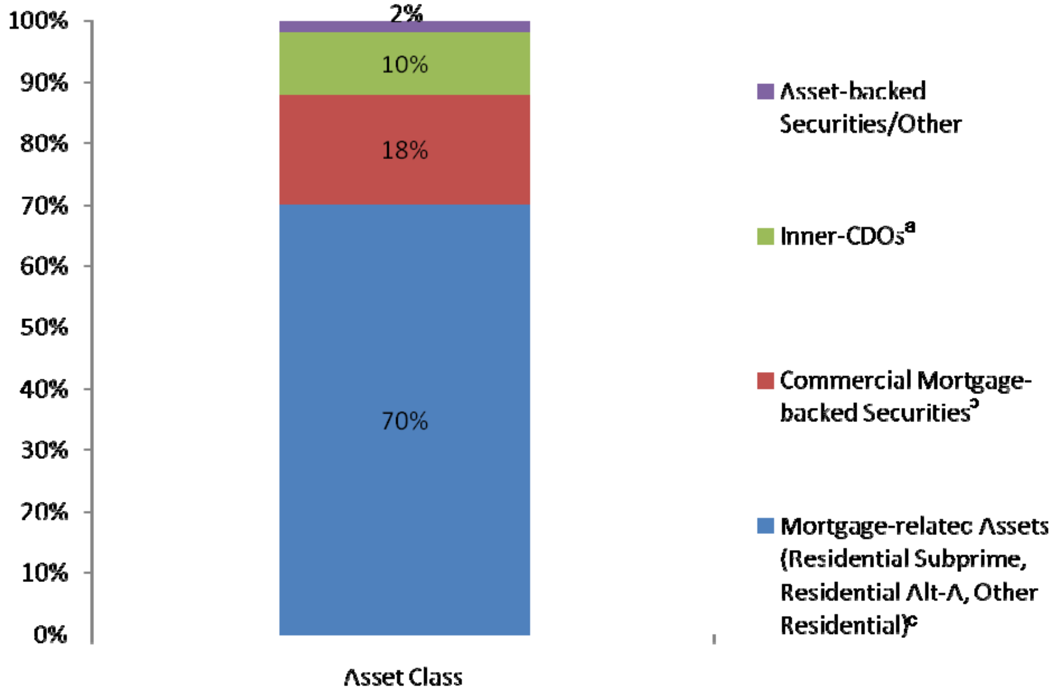
When FRBNY authorized the creation of Maiden Lane III in November 2008, it lent approximately $24.6 billion to the newly formed limited liability company, and AIG provided Maiden Lane III approximately $5 billion in equity. These funds were used to purchase CDOs from AIG counterparties worth an estimated fair value of $29.6 billion at the time of the purchases, which were done in three stages on November 25, 2008, December 18, 2008, and December 22, 2008. AIGFP's counterparties were paid $27.1 billion, and AIGFP was paid $2.5 billion per an agreement between AIGFP and FRBNY. The $2.5 billion represented the amount of collateral that AIGFP had previously paid to the counterparties that was in excess of the actual decline in the fair value as of October 31, 2008.

FRBNY's loan to Maiden Lane III is secured by the CDOs as the underlying assets.[29] After the loan has been repaid in full plus interest, and, to the extent that there are sufficient remaining cash proceeds, AIG will be entitled to repayment of the $5 billion that the company contributed in equity, plus accrued interest.[30] After repayment in full of the loan and the equity contribution (each including accrued interest), any remaining proceeds will be split 67 percent to FRBNY and 33 percent to AIG.

Approximately 70 percent of the multi-sector CDOs purchased by Maiden Lane III were based on pools of subprime mortgages,[31] Alt-A mortgages, and other residential mortgage-backed securities ("RMBS"), as shown in Figure 2 below. The portfolio contained 89 CDOs at the time of closing. The overwhelming majority of the investments are made up of Super Senior tranches. The Super Senior tranches are the highest-rated tranches in the CDO. [32]

[29] The loan was issued with a stated term of six years and may be extended at FRBNY's discretion. The interest rate on the loan is one-month LIBOR plus 1 percent.
[30] Interest accrues at a rate of one-month LIBOR plus 3 percent.
[31] A subprime mortgage is a type of mortgage for borrowers with lower credit scores. Conventional mortgages are not offered to borrowers with low credit scores because the lender views the borrower as having a larger-than-average risk of defaulting on the loan. Alt-A loans are a classification of mortgages in which the risk profile falls between prime and subprime. The borrowers behind these mortgages will typically have clean credit histories, but the mortgage itself will generally have some issues that increase its risk profile, including higher loan-to-value and debt-to-income ratios or inadequate documentation of the borrower's income.
[32] A Super Senior tranche is defined as a layer of credit risk senior to one or more risk layers that have been rated AAA by the credit rating agencies, or if the transaction is not rated, structured to the equivalent thereto.

Figure 2: Maiden Lane III Multi-sector CDO Portfolio



Source: SIGTARP analysis of FRBNY data
Notes:
[a] Inner-CDOs, or CDO-squared, is a CDO backed by other CDO tranches.
[b] Commercial Mortgage-backed Securities are financial instruments that are backed by a mortgage or a group of mortgages that are packaged together. These securities are often backed by commercial real estate loans.
[c] Mortgage-related assets refers to different types of residential mortgages.

FRBNY officials noted that because of the structure of the Maiden Lane III transaction, there are two sources of repayment for the funds that were used to compensate AIG's counterparties from the time of the Federal Reserve's intervention. One is repayment to FRBNY of the loan it made to Maiden Lane III through cash flows on the assets in the Maiden Lane III portfolio. The other is AIG's repayment to FRBNY of the funds it borrowed under its credit facility to meet its collateral posting obligations under the credit default swaps that were torn up as part of the Maiden Lane III transaction.

The fair market value has changed since the time of purchase as shown below:

- As of December 31, 2008, the fair value of the portfolio was $27.1 billion.
- As of March 31, 2009, the fair value of the portfolio was $20.7 billion.
- As of June 30, 2009, the fair market value of the portfolio was $22.4 billion.
- As of September 30, 2009, the fair market value of the portfolio was $23.5 billion.

The value of the portfolio over time has been affected, in part, by the amortization of assets in the portfolio as those assets have generated cash flows to pay down the loan extended by the FRBNY. As of September 30, 2009, the balance of principal and interest owed to the FRBNY in respect of its senior loan was $19.9 billion.

FRBNY has material asset and investment management control rights over the portfolio and is the managing member of Maiden Lane III LLC. FRBNY as lender to Maiden Lane III has a first priority security interest in all of the Maiden Lane III assets. FRBNY is also the controlling party for Maiden Lane III, with the right to make all decisions with respect to the assets whether or not there has been a default under the loan. FRBNY has created an Investment Committee of senior staff that is responsible for the investment management of Maiden Lane III. The investment committee is made up of senior FRBNY staff, and their primary strategy is to maximize the cash flows without disrupting the financial market.

According to an Investment Committee member, performance of the Maiden Lane III portfolio is dependent on the performance of the underlying assets and the resulting cash flows. FRBNY provided SIGTARP with two scenarios for modeling the cash flow performance of the Maiden Lane III portfolio: a base case modeled on the current performance and a stress case based on more adverse conditions. FRBNY stressed that these scenarios depend on many factors and have changed and will change over time, with the effect of changing the projected payoff dates.

- In the base case for the FRBNY loan to Maiden Lane III, the principal is expected to be paid by January 2014, and the accrued interest is expected to be paid in 2014.
- In the stress case, the principal and the accrued interest will not be fully paid until 2015.

Committee members said that they believe the cash flows received from the CDOs will be sufficient to pay down the loan over time.

Remaining AIG Credit Default Swap Exposure

This section discusses AIG's continuing credit default swap exposure. Maiden Lane III reduced, but did not eliminate, AIGFP's exposure to credit default swaps. AIGFP still had about $302 billion in swaps on its books even after Maiden Lane III was created. An FRBNY senior vice president stated to SIGTARP that FRBNY never considered using Maiden Lane III to resolve positions other than the multi-sector CDO book because the other swaps did not present an urgent problem for AIG. According to AIG's third quarter 2009 Securities and Exchange Commission ("SEC") Form 10-Q, AIGFP has been able to reduce its credit default swap exposure by $96 billion or 32 percent during the first nine months of 2009. According to AIG's Chief Risk Officer and AIGFP's CEO, AIGFP expects that the majority of its remaining credit default swap contracts will be unwound over the next several years. However, in recent SEC filings, AIG warned that, if credit markets continue to worsen, AIG could be exposed to these risks for a significantly longer period of time and experience additional losses. Currently, an onsite management team of FRBNY and Treasury officials is monitoring the financial health and stability of AIG, including the ongoing swap exposure.

AIGFP Has Reduced Credit Default Swap Exposure

Since the end of 2008, AIG's total credit default swap exposure has fallen about 32 percent—from about $302 billion to $206 billion, as is shown in Table 4 below.

Table 4—Changes to Value of AIGFP's Credit Default Swap Portfolios between December 31, 2008, and September 30, 2009 (dollars in millions)[a]

Type of Credit Default Swap Portfolio	December 31, 2008	March 31,2009	June 30,2009	September 30, 2009
Foreign Regulatory Capital	234,449	192,554	177,473	171,704
Arbitrage	63,051	61,585	50,092	30,751
Mezzanine tranches	4,701	4,217	3,501	3,504
Total	**$302,201**	**$258,356**	**$231,066**	**$205,959**
% decrease since 2008		**(15%)**	**(24%)**	**(32%)**

Source: SIGTARP analysis of AIG data

[a] Dates referenced are as of the last day of each calendar quarter.

As of September 30, 2009, AIG had $172 billion in exposure to swaps in its foreign regulatory capital portfolio. The portfolio contains swaps purchased by financial institutions, principally in Europe, to provide regulatory capital relief under Basel I. [33] AIGFP's COO informed SIGTARP in July 2009 that they expect that most of these swaps will be terminated by the end of the first quarter 2010 as most financial institutions complete their transition to Basel II. Currently, financial institutions are required to hold a certain level of capital against their assets, and one way for a financial institution to reduce the amount of capital is to purchase swap protection on its assets. However, new requirements decrease the level of capital required for such assets and, in most cases, there will be limited capital benefit to holding on to the existing swaps. Nonetheless, AIG warned in a June 29, 2009, SEC filing that if credit markets deteriorate, the company may recognize unrealized losses in AIGFP's regulatory capital credit default swap portfolio.[34] AIG could continue to be at risk if the swaps in its regulatory capital portfolio are not terminated by the end of first quarter 2010 as expected.

As of September 30, 2009, AIGFP had approximately $22.6 billion in its synthetic investment grade corporate arbitrage credit default swaps portfolio and $8.2 billion in its synthetic multi-sector CDO credit default swap portfolio. In addition, as of September 30, 2009, a total of $3.5 billion exposure on mezzanine tranches remains across different types of collateral classes.

According to an AIG SEC filing, an ongoing concern for AIGFP is whether it will have to post more collateral if credit markets continue to deteriorate. The amount of future collateral postings is partly a function of AIG's credit ratings, which may be affected by any further decline in AIG's financial condition. Given the current economic climate, AIGFP is unable to estimate accurately when it will be able to retire fully its credit default swap portfolio.

FRBNY, Treasury and AIG Are Monitoring AIGFP's Remaining Exposure

FRBNY has established an oversight team to monitor AIGFP progress in unwinding the remaining swap transactions, in consultation with the staff of the Federal Reserve Board. The team is comprised of senior vice presidents, attorneys from the Office of General Counsel, and other staff. FRBNY officials told SIGTARP that they receive daily risk reports from AIG and attend weekly meetings in which they discuss the details of the AIGFP credit default swap portfolio. Treasury officials also receive these reports.

[33] The first Basel Accord, known as Basel I, was issued in 1988; it focused on the capital adequacy of financial institutions. The capital adequacy risk—the risk that a financial institution will be hurt by an unexpected loss—categorizes the assets of financial institution into five risk categories (0 percent, 10 percent, 20 percent, 50 percent, and 100 percent). Banks that operate internationally are required to have a risk weight of 8 percent or less. The second Basel Accord, known as Basel II, is to be fully implemented by 2015. It focuses on three main areas known as the three pillars: minimum capital requirements, supervisory review, and market discipline. The focus of this accord is to strengthen international banking requirements and to supervise and enforce these requirements.

[34] AIG SEC Form 8-Ka, filed June 29, 2009. Subsequent to the June filing, European regulators adjusted the implementation timing of Basel II, potentially affecting the holders of AIGFP's regulatory capital swaps to hold beyond previously anticipated termination dates.

AIGFP has also established various committees to ensure that the remaining swaps are terminated on terms most favorable to and in the interest of the U.S. government, as described below. These meetings are observed by a senior member of the FRBNY oversight team.

- The Termination Risk Review Committee, made up of AIGFP traders and risk management staff, meets weekly to review AIGFP's positions.
- The Risk Oversight Transaction Committee, made up of senior traders and risk management staff, meets as needed to review and approve swap trades.
- The Steering Committee, made up of senior AIG and AIGFP staff (including the CEO and COO of AIGFP), meets weekly or on an ad hoc basis to review the credit default swap portfolio. These meetings are observed by the FRBNY oversight team.

Conclusions and Lessons Learned

Conclusions

When first confronted with the liquidity crisis at AIG, the Federal Reserve Board and FRBNY, who were then contending with the demise of Lehman Brothers, turned to the private sector to arrange and provide funding to stave off AIG's collapse. Confident that a private sector solution would be forthcoming, FRBNY did not develop a contingency plan; when private financing fell through, FRBNY was left with little time to decide whether to rescue AIG and, if so, on what terms. Having witnessed the dramatic economic consequences of Lehman Brothers' bankruptcy just hours before, senior officials at the Federal Reserve and Treasury determined that an AIG bankruptcy would have far greater systemic impact on the global financial system than Lehman's bankruptcy and decided to step in to prevent that result. Not preparing an alternative to private financing, however, left FRBNY with little opportunity to fashion appropriate terms for the support, and believing it had no time to do otherwise, it essentially adopted the term sheet that had been the subject of the aborted private financing discussions (an effective interest rate in excess of 11 percent and an approximate 80 percent ownership interest in AIG), albeit in return for $85 billion in FRBNY financing rather than the $75 billion that had been contemplated for the private deal. In other words, the decision to acquire a controlling interest in one of the world's most complex and most troubled corporations was done with almost no independent consideration of the terms of the transaction or the impact that those terms might have on the future of AIG.

The impact of those terms, however, soon became apparent to FRBNY. In a matter of days, FRBNY officials recognized that, although the $85 billion credit line permitted AIG to meet billions of dollars of collateral calls and thus avoid an immediate bankruptcy, its terms were unworkable. Among other things, the interest rate imposed upon AIG was so onerous that, if unaddressed, the burden of servicing the FRBNY financing greatly increased the likelihood that there would be further credit rating downgrades for AIG, a result that FRBNY officials believed would have "devastating" implications for AIG. For this and other reasons, modification of the original terms thus became inevitable. One example of such modification was Treasury's $40 billion investment in AIG in November 2008 through the Troubled Asset Relief Program — which was used to pay down the FRBNY loan in part. Another was termination of a portion of AIG's credit default swap obligations made possible through the creation of Maiden Lane III.

A significant cause of AIG's liquidity problems stemmed from its obligations to post collateral (cash payments that equaled the drop in value of the securities) in connection with AIGFP's credit default swap contracts. To avoid the necessity for AIG to continue to post collateral and to reduce the danger of further rating agency downgrades, by early November 2008, FRBNY decided to create Maiden Lane III, a special purpose vehicle, to retire a portion of AIG's credit default swap portfolio by purchasing the underlying CDOs from the swap counterparties, which eased pressure on FRBNY's credit line and transferred the issues with these contracts off of AIG's balance sheet and on the Federal Reserve's. When negotiating the amount of payment for the underlying CDOs, FRBNY contacted by telephone eight of AIG's largest counterparties over a two-day period and attempted to obtain concessions, or so-called "haircuts," from the counterparties. Although one counterparty, UBS, was willing to make a modest 2 percent concession if the other counterparties did so, FRBNY's attempts to obtain concessions from the others were completely unsuccessful, and FRBNY decided to pay the counterparties the full market value of the CDOs, which, when combined with the already posted collateral, meant that the counterparties were effectively paid full face (or par) value of the credit default swaps, an amount far above their market value at the time.

In pursuing these negotiations, FRBNY made several policy decisions that severely limited its ability to obtain concessions from the counterparties: it determined that it would not treat the counterparties differently, and, in particular, would not treat domestic banks differently from foreign banks — a decision with particular import in light of the reaction of the French bank regulator which refused to allow two French bank counterparties to make concessions; it refused to use its considerable leverage as the regulator of several of these institutions to compel haircuts because FRBNY was acting on behalf of AIG (as opposed to in its role as a regulator); it was uncomfortable interfering with the sanctity of the counterparties' contractual rights with AIG, which entitled them to full par value; it felt ethically restrained from threatening an AIG bankruptcy because it had no actual plans to carry out such a threat; and it was concerned about the reaction of the credit rating agencies should imposed haircuts be viewed as FRBNY backing away from fully supporting AIG. Although these were certainly valid concerns, these policy decisions came with a cost — they led directly to a negotiating strategy with the counterparties that even then-FRBNY President Geithner acknowledged had little likelihood of success.

FRBNY's decision to treat all counterparties equally (which FRBNY officials described as a "core value" of their organization), for example, gave each of the major counterparties (including the French banks) effective veto power over the possibility of a concession from any other party. This approach left FRBNY with few options, even after one of the counterparties indicated a willingness to negotiate concessions. It also arguably did not account for significant differences among the counterparties, including that some of them had received very substantial benefits from FRBNY and other Government agencies through various other bailout programs (including billions of dollars of taxpayer funds through TARP), a benefit not available to some of the other counterparties (including the French banks). It further did not account for the benefits the counterparties received from FRBNY's initial bailout of AIG, without which they would have likely suffered far reduced payments as well as the indirect consequences of a potential systemic collapse.

Similarly, the refusal of FRBNY and the Federal Reserve to use their considerable leverage as the primary regulators for several of the counterparties, including the emphasis that their participation in the negotiations was purely "voluntary," made the possibility of obtaining concessions from those counterparties extremely remote. While there can be no doubt that a regulators' inherent leverage over a regulated entity must be used appropriately, and could in certain circumstances be abused, in other instances in this financial crisis regulators (including the Federal Reserve) have used overtly coercive language to convince financial institutions to take or forego certain actions. As SIGTARP reported in its audit of the initial Capital Purchase Program investments, for example, Treasury and the Federal Reserve were fully prepared to use their leverage as regulators to compel the nine largest financial institutions (including some of AIG's counterparties) to accept $125 billion of TARP funding and to pressure Bank of America to conclude its merger with Merrill Lynch. Similarly, it has been widely reported that the

Government, while arguably acting on behalf of General Motors and Chrysler, took an active role in negotiating substantial concessions from the creditors of those companies.

Questions have been raised as to whether the Federal Reserve intentionally structured the AIG counterparty payments to benefit AIG's counterparties — in other words that the AIG assistance was in effect a "backdoor bailout" of AIG's counterparties. Then-FRBNY President Geithner and FRBNY's general counsel deny that this was a relevant consideration for the AIG transactions. Irrespective of their stated intent, however, there is no question that the *effect* of FRBNY's decisions — indeed, the very *design* of the federal assistance to AIG — was that tens of billions of dollars of Government money was funneled inexorably and directly to AIG's counterparties. Although the primary intent of the initial $85 billion loan to AIG may well have been to prevent the adverse systemic consequences of an AIG failure on the financial system and the economy as a whole, in carrying out that intent, it was fully contemplated that such funding would be used by AIG to make tens of billions of dollars of collateral payments to the AIG counterparties. The intent in creating Maiden Lane III may similarly have been the improvement of AIG's liquidity position to avoid further rating agency downgrades, but the direct effect was further payments of nearly $30 billion to AIG counterparties, albeit in return for assets of the same market value. Stated another way, by providing AIG with the capital to make these payments, Federal Reserve officials provided AIG's counterparties with tens of billions of dollars they likely would have not otherwise received had AIG gone into bankruptcy.

Any assessment of the costs of these decisions to the Government and the taxpayer necessarily must look beyond FRBNY's loan to Maiden Lane III to also take into account both the funds that FRBNY previously loaned to AIG and the subsequent TARP investments. All of these infusions to AIG are linked inextricably: more than half the total amounts paid to counterparties in connection with the credit default swap portfolio retired through Maiden Lane III did not come about through the Maiden Lane III CDO purchases, but rather from AIG's earlier collateral postings that were made possible in part by the original FRBNY loan, which was, in turn, paid down with TARP funds. Because of this linkage, the ultimate costs to the Government and the taxpayer cannot be measured in isolation. Stated another way, irrespective of whether FRBNY is made whole on its loan to Maiden Lane III, we will only be able to be determine the ultimate value or cost to the taxpayer after the likelihood of AIG repaying all of its assistance can be more readily determined.

Lessons Learned

The remarkable narrative surrounding the AIG loans and the creation of Maiden Lane III set forth in this audit gives rise to two additional lessons learned. First, AIG stands as a stark example of the tremendous influence of credit rating agencies upon financial institutions and upon Government decision making in response to financial crises. In the lead-up to the crisis, the systemic over-rating of mortgage-backed securities by rating agencies was reflected in the similarly over-rated CDOs that underlied AIGFP's credit default swaps. Once the financial crisis had come to a head, the credit rating agencies downgrades of AIG itself and of the underlying securities played a significant role in AIG's liquidity crisis as those downgrades and the related market declines in the securities required AIG to post billions of dollars in collateral. The threat of further rating agency downgrades due to the onerous terms of the initial FRBNY financing, among other things, led to further Government intervention, including the TARP investment in AIG and the necessity to do something with the swap portfolio, *i.e.*, Maiden Lane III. And the concern about the reaction of the credit rating agencies played a role in FRBNY's decision not to pursue a more aggressive negotiating policy to seek concessions from counterparties. All of these profound effects were based upon the judgments of a small number of private entities that operate, as described in SIGTARP's October 2009 Quarterly Report, on an inherently conflicted business model and that are subject to minimal regulation. Without drawing any conclusions about the particular actions taken by the rating agencies in the case of AIG, this report further demonstrates the dramatic influence of these entities on our financial system.

Second, the now familiar argument from Government officials about the dire consequences of basic transparency, as advocated by the Federal Reserve in connection with Maiden Lane III, once again simply does not withstand scrutiny. Federal Reserve officials initially refused to disclose the identities of the counterparties or the details of the payments, warning that disclosure of the names would undermine AIG's stability, the privacy and business interests of the counterparties, and the stability of the markets. After public and Congressional pressure, AIG disclosed the identities. Notwithstanding the Federal Reserve's warnings, the sky did not fall; there is no indication that AIG's disclosure undermined the stability of AIG or the market or damaged legitimate interests of the counterparties. The lesson that should be learned — one that has been made apparent time after time in the Government's response to the financial crisis — is that the default position, whenever Government funds are deployed in a crisis to support markets or institutions, should be that the public is entitled to know what is being done with Government funds. While SIGTARP acknowledges that there might be circumstances in which the public's right to know what its Government is doing should be circumscribed, those instances should be very few and very far between.

Management Comments

SIGTARP received official written responses to this report from the Board of Governors of the Federal Reserve and the Federal Reserve Bank of New York (collectively, "Federal Reserve"), and the Department of Treasury ("Treasury"). The Federal Reserve generally agreed with the information presented in the report but provided some comments about the conclusions and lessons learned. Treasury concurred with the report's two lessons learned and also pointed to a third lesson relating to its current legislative efforts to obtain regulatory reform.

Copies of the responses are attached as Appendices D and E.

Appendix A—Scope and Methodology

We performed the audit under authority of Public Law 110-343, as amended, which also incorporates the duties and responsibilities of inspectors general under the Inspector General Act of 1978, as amended. The audit reports on payments to AIGFP counterparties. Our specific objectives were to determine:

- the key events that led to the creation of Maiden Lane III
- why counterparty claims were paid at 100 percent of face value
- AIGFP's remaining exposure to credit default swaps

We performed work at the Federal Reserve Board, Federal Reserve Bank of New York, U.S. Treasury Office of Financial Stability, and AIG corporate headquarters in New York.

To determine the key events that led to the creation of Maiden Lane III, we interviewed officials from the FRBNY Office of General Counsel who were involved in the decision-making process, other FRBNY officials and then-FRBNY President Timothy Geithner. We also interviewed officials from BlackRock Solutions who advised FRBNY on solutions to remove AIG's toxic assets. We reviewed congressional testimony by key FRBNY and AIG officials, as well as correspondence and other documents from FRBNY.

To determine why counterparty claims were paid at 100 percent of face value, we interviewed FRBNY officials from the Office of General Counsel who were involved in making the decision to pay at face value. We also reviewed correspondence and documents provided by FRBNY. Furthermore, we interviewed the Chief Financial Officer of Goldman Sachs and a managing director of Merrill Lynch to obtain their views on FRBNY efforts to negotiate concessions and the rationale for paying counterparty claims at 100 percent of face value.

To determine the AIGFP's remaining credit default swap exposure, we reviewed AIG SEC filings that report AIG's exposure on a quarterly basis. We also reviewed these SEC filings to gain an understanding of the details of AIG's credit default swap exposure. Furthermore, we interviewed the CEO of AIGFP, AIG's Chief Credit Officer, and several officials from the Office of Compliance to determine their plans for unwinding the remaining credit default swaps.

This performance audit was performed in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Limitations on Data

We reviewed email correspondence among FRBNY officials during the key months of September through November of 2009. However, because much of the communication among decision-making officials was via telephone during these dates, we relied on testimonial evidence from these officials to develop an understanding of the key events and decision-making processes during the AIG crisis.

Internal Controls

As part of our review of the decision making process for providing assistance to AIG and paying the counterparties at par, we examined the government's criteria and rationale behind these decisions as a measure of controls over the decisions of Federal Reserve and Treasury.

Use of Computer-Processed Data

We relied on AIG's quarterly and annual filings with the U.S. Securities and Exchange Commission. That information is generally regarded as best representing the institutions' financial standings because they are required by law to submit these financial documents.

Appendix B—Acronyms

Acronym	Definition
AIG	American International Group
AIGFP	American International Group Financial Products, Inc.
CDO	collateralized debt obligation
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CMBS	Commercial Mortgage-backed Security
EESA	Emergency Economic Stabilization Act of 2008
FRB	Federal Reserve Board
FRBNY	Federal Reserve Board of New York
LIBOR	London Interbank Offered Rate
MBS	Mortgage-backed Securities
S&P	Standard & Poor's
SIGTARP	Special Inspector General for the Troubled Asset Relief Program
SPV	special purpose vehicle
TARP	Troubled Asset Relief Program
Treasury	U.S. Department of the Treasury

Appendix C—Audit Team Members

This report was prepared and the review was conducted under the direction of Barry Holman, Audit Director, Office of the Special Inspector General for the Troubled Asset Relief Program.

The staff members who conducted the audit and developed the report include:

Leah DeWolf

Michael Kennedy

Christopher G. Poor

Amy Poster

Appendix D—Management Comments from Federal Reserve

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

Federal Reserve Bank of New York
33 Liberty Street
New York, N.Y. 10045-0001

November 15, 2009

Special Inspector General Neil Barofsky
Office of the Inspector General for the
Troubled Asset Relief Program
1801 L Street, N.W.
Washington, D.C. 20220

Dear Mr. Barofsky:

On behalf of the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York (collectively "Federal Reserve"), we write in response to your draft report titled "Factors Affecting Efforts to Limit Payments to AIG Counterparties and Future Exposures" ("Report"). We appreciate the effort that your team has put into learning the complicated set of facts surrounding the Treasury's and Federal Reserve's work to stabilize American International Group ("AIG"). Our comments center primarily on the Conclusions and Lessons Learned section.

I. The Context

As your Report describes, the events that unfolded over the weekend of September 13, 2008, and continued through the week of September 15 were unprecedented. Two very large, systemically important financial institutions, Lehman Brothers and AIG, neither of which were regulated by the Federal Reserve, faced failure within days of each other. During the weekend of September 13, 2008, the Federal Reserve received repeated assurances from the New York State Insurance Department that AIG was managing its situation both through the state insurance regulators and through a private sector consortium of banks who would provide the capital AIG needed. As your report notes, Federal Reserve Bank of New York President Geithner encouraged a private solution to AIG's liquidity needs. However, when Lehman Brothers failed, the willingness of private sector banks to lend to AIG disappeared.

As the Report notes, the Federal Reserve's decision at this point to provide financial assistance was motivated by a broad range of systemic concerns about the effect of a default on AIG's creditors. These creditors include not only AIG's Credit Default Swap ("CDS") counterparties, but also holders of insurance policies and annuities issued by AIG insurance companies, retirement and 401(k) plans that had purchased stable value wraps from AIG, municipalities that held AIG Guaranteed Investment Contracts, and numerous other entities that are important threads in the fabric of the American economy.

The Federal Reserve's intervention in AIG was designed to prevent a system-wide collapse and achieved that end. Importantly, the Federal Reserve's Revolving Credit Facility is fully secured by a pledge of AIG assets, and we anticipate that the loan under that Facility will be fully repaid.

II. The Terms of the Original Loan to AIG Were Appropriate in Light of the Circumstances at the Time

The Report notes that the terms of the original AIG loan were based on a proposed private sector financing arrangement that was not consummated. The Report also suggests that those terms were too severe and were adopted with almost no independent consideration of the impact that those terms might have on the future of AIG.

While the terms of the transaction between the Federal Reserve and AIG were based in part on the economic terms proposed by a private sector consortium, those terms were adopted by the Federal Reserve after consideration of the best way in which to prevent the disorderly collapse of AIG while simultaneously protecting taxpayers' interests. The Federal Reserve judged at the time, and continues to believe, that it would have been inappropriate for the Federal Reserve to extend credit to AIG on terms that were more favorable to AIG than those developed under the circumstances by the private consortium. As the Report recognizes, economic conditions at AIG unrelated to the Federal Reserve's original loan continued to deteriorate and required the injection of capital and the restructuring of the Federal Reserve's credit in November.

III. The Federal Reserve Acted Appropriately in Attempting To Obtain Concessions from AIG Counterparties

As part of the November restructuring of the AIG loan, the Federal Reserve created the Maiden Lane III ("ML III") facility to address the increasing liquidity strains faced by AIG resulting from its obligation to post collateral with counterparties of CDS it had written on multi-sector collateralized debt obligations. As the Report recognizes, in connection with this restructuring to terminate the AIG CDS, the Federal Reserve actively undertook to obtain concessions from the CDS counterparties, but was unable to obtain any such agreements.

We believe that the Federal Reserve acted appropriately in conducting these negotiations and that our negotiating strategy, including the decision to treat all counterparties equally, was not flawed or unreasonably limited. After the U.S. Government had determined that AIG was systemically important and had acted to prevent its disorderly failure, it was natural for all of AIG's creditors, including its counterparties on multi-sector CDS, to expect full payment from the company and to believe that the company would not be in a position to demand concessions from its counterparties on their claims. As noted above, the counterparties included a wide range of creditors, including holders of insurance policies and annuities issued by AIG, retirement and 401(k) plans that had purchased stable value wraps from AIG, municipalities that held AIG Guaranteed Investment Contracts, and numerous other entities.

As the Report correctly acknowledges, the Federal Reserve should be cautious not to misuse its supervisory leverage over a regulated entity. We believe that it would not have been appropriate to use our supervisory authority on behalf of AIG to obtain concessions from domestic counterparties in purely commercial transactions in which some of the foreign counterparties would not grant, or were legally barred from granting, concessions. To do so would have been a misuse of our supervisory authority to further a private purpose in a commercial transaction and would have provided an advantage to foreign counterparties over domestic counterparties. In contrast, supervisory authority is designed and specifically intended to be used to further the safety and soundness of supervised institutions, for example to require supervised institutions to raise capital as protection against current or expected losses.

We agree with the observation in the Report that the ultimate cost or benefit of the CDS transactions with AIG counterparties depends on the repayment of the loan to ML III and the other federal assistance to AIG, and on the value of the assets securing that credit. Based on available data and models, the Federal Reserve anticipates that the loan to ML III will be repaid and U.S. taxpayers will not incur any net loss on the loan. The assets of ML III will either mature or be sold in an orderly fashion and AIG's $5 billion subordinated position is available to absorb the first loss should any ultimately be incurred by ML III. Because the Federal Reserve is entitled to a portion of any residual cash flow generated by the assets, the ML III loan may yield a profit for the taxpayers. As of September 30, 2009, the fair market value of the assets ML III purchased exceeded the balance of ML III's loan by $3.6 billion.

IV. The Federal Reserve Supports the Need for Appropriate Transparency

The Report addresses the value of transparency, which we share. We have taken a number of significant steps with the objective of increasing the information publicly available about the Federal Reserve and its lending programs so that the Congress and the public can more effectively assess our efforts in pursuit of financial stability and monetary policy objectives. Among these steps is regular publication on our website of comprehensive information about ML III and the other Federal Reserve facilities. Altogether, we now provide more information about the operations of the Federal Reserve than ever before, and we continue to explore whether additional information can be provided without jeopardizing the effectiveness of our efforts.

V. Conclusion

In his testimony on AIG before the House Committee on Financial Services on March 24, 2009, our Chairman identified two additional lessons from the AIG experience that should inform the ongoing discussions on regulatory reform in Congress and elsewhere. First, AIG highlights the urgent need for new resolution procedures for systemically important nonbank financial firms. If that tool has been available in September, 2008, it could have been used to put AIG into conservatorship or receivership, unwind it slowly, protect policyholders, and impose haircuts on creditors and counterparties as appropriate. Second, the AIG situation highlights the need for strong, effective consolidated supervision of all systemically important financial firms. AIG built up its concentrated exposure to the subprime mortgage market largely out of the sight of its functional regulators. More effective supervision might have identified and blocked the extraordinarily reckless risk-taking at AIG. These two changes could measurably reduce the likelihood of future episodes of systemic risk like the one presented by AIG.

Sincerely,

Scott G. Alvarez

General Counsel
Board of Governors
of the Federal Reserve System

Thomas C. Baxter, Jr.
(SGA)

General Counsel
Federal Reserve Bank
of New York

Appendix E—Management Comments from Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

November 16, 2009

Neil M. Barofsky
Special Inspector General
Office of the Special Inspector General for the Troubled Asset Relief Program
1500 Pennsylvania Ave., NW, Suite 1064
Washington, D.C. 20220

RE: SIGTARP Official Draft Report

Dear Mr. Barofsky:

We write to respond to your office's report titled "Factors Affecting Efforts to Limit Payments to AIG Counterparties and Future Exposures" (the "Report"). The Report provides a useful history of the actions that required the federal government to intervene to support American International Group, Inc. ("AIG") and the steps taken to provide such support. We also agree with the lessons of the Report with respect to the need to look at the influence of credit rating agencies and the need for transparency. However, we think the central lesson that should be learned from these events is overlooked by the Report.

The circumstances that forced the government to act developed extremely quickly. Government officials with the Federal Reserve System (the "Board"), the Federal Reserve Bank of New York (the New York Fed and collectively with the Board the "Federal Reserve"), and the Treasury had no intention of providing support to AIG going into the weekend of September 13-14, 2008. After Lehman Brothers filed for bankruptcy, however, financial markets were shaken, AIG's condition worsened dramatically and the prospects of private sector support for the company vanished. Literally overnight, government officials were faced with a difficult choice, and a choice that had to be made immediately: either let AIG go bankrupt or provide support.

As the report notes, in light of the circumstances at the time, a bankruptcy of AIG would have had disastrous consequences. Chairman Bernanke has stated that it could have "resulted in a 1930s-style global financial and economic meltdown, with catastrophic implications for production, income, and jobs." Credit markets were already frozen, money market funds were already experiencing runs and interbank lending had already ceased. The global scope of AIG, its importance to the American retirement system, and its presence in the commercial paper and other financial markets all contributed to a situation where the risks of an AIG bankruptcy were simply too great.

The report focuses on "FRBNY's negotiating strategy" in dealing with AIG's counterparties. What must be remembered is that the decision by the government not to let AIG go bankrupt meant that AIG had to meet its contractual obligations. The government could not unilaterally impose haircuts on creditors, and it would not have been appropriate for the government to pressure counterparties to accept haircuts by threatening to retaliate in some way through its regulatory power. If the government had chosen to not pay some of AIG's creditors, such action would have led to defaults and cross-defaults and would have in all likelihood precipitated credit rating downgrades and the very action that the government sought to prevent, which was a bankruptcy of AIG and the consequences of such a bankruptcy to the financial system as a whole.

Therefore, we believe the central lesson to be learned from the AIG experience is that the federal government needs better tools to deal with the impending failure of a large institution in extraordinary circumstances like those facing us last fall. It is for these reasons that the Obama Administration has proposed a regulatory reform agenda that includes giving the government the emergency authority to resolve a significant, interconnected financial institution. This authority would allow the government to dissolve or break up failing firms in an orderly way, with the costs borne by the firm's shareholders and creditors (not by the taxpayers), and without disrupting the broader financial system. This authority would include the power to impose haircuts on creditors as appropriate. This authority would supplement (rather than replace) the existing bankruptcy laws and be modeled on the existing resolution authority for insured depository institutions.

In addition, given the size and interconnectedness of AIG, it should never have been allowed to escape tough, consolidated supervision at the holding company level. Due to loopholes in the bank holding company act, it was treated as a thrift holding company -- with limited consolidated supervision and no capital requirements at the holding company level. Our reforms would make any firm that owns an insured depository become a bank holding company, and give regulators the authority to subject any financial firm, regardless of corporate form, to heightened supervision by the Federal Reserve.

We thank you for the opportunity to comment on the report and look forward to continuing to work with you.

Sincerely,

Herbert M. Allison, Jr.

Herbert M. Allison, Jr.
Assistant Secretary for Financial Stability

SIGTARP Hotline

If you are aware of fraud, waste, abuse, mismanagement, or misrepresentations associated with the Troubled Asset Relief Program, please contact the SIGTARP Hotline.

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By Fax: (202) 622-4559

By Mail: **Hotline: Office of the Special Inspector General**
for the Troubled Asset Relief Program
1801 L Street., NW, 6th Floor
Washington, D.C. 20220

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