CONGRESSIONAL OVERSIGHT PANEL

JUNE OVERSIGHT REPORT*

THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT'S EXIT STRATEGY

JUNE 10, 2010.—Ordered to be printed

*Submitted under Section 125(b)(1) of Title 1 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110–343

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Glossary of Terms

ABS	Asset-backed securities
AGF	American General Finance
AGP	Asset Guarantee Program
AIA	American International Assurance Company
AIG	American International Group, Inc.
AIGCFG	AIG Consumer Finance Group
AIGFP	AIG Financial Products
AIGIP	AIG Investment Program
AIG FSB	AIG Federal Savings Bank
AIRCO	American International Reinsurance Co.
ALICO	American Life Insurance Company
AMLF	Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility
CBO	Congressional Budget Office
CDO	Collateralized debt obligation
CDS	Credit default swap
CLO	Collateralized loan obligation
CMBS	Commercial mortgage-backed securities
CP	Counterparty
CPP	Capital Purchase Program
CPFF	Commercial Paper Funding Facility
DIP	Debtor-in-possession
EESA	Emergency Economic Stabilization Act of 2008
EU	European Union
FDIC	Federal Deposit Insurance Corporation
FRBNY	Federal Reserve Bank of New York
GAO	U.S. Government Accountability Office
GIA	Guaranteed Investment Agreements
ILFC	International Lease Finance Corporation
ISDA	International Swaps and Derivatives Association
LIBOR	London Interbank Offered Rate
LTCM	Long-Term Capital Management
ML2	Maiden Lane II
ML3	Maiden Lane III
NAIC	National Association of Insurance Commissioners
OIS	Overnight Index Spread Rate
OMB	Office of Management and Budget
OTS	Office of Thrift Supervision
RCF	Revolving Credit Facility
RMBS	Residential mortgage-backed securities
ROE	Return on equity
S&P	Standard & Poor's
SBF	Securities Borrowing Facility
SEC	U.S. Securities and Exchange Commission
SIGTARP	Special Inspector General for the Troubled Asset Relief Program
SPA	Securities purchase agreement
SPV	Special purpose vehicle
SSFI	Systemically Significant Failing Institution Program
TARP	Troubled Asset Relief Program
TIP	Targeted Investment Program
TruPS	Trust preferred securities

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EXECUTIVE SUMMARY*

At its peak, American International Group (AIG) was one of the largest and most successful companies in the world, boasting a AAA credit rating, over $1 trillion in assets, and 76 million customers in more than 130 countries. Yet the sophistication of AIG's operations was not matched by an equally sophisticated risk-management structure. This poor management structure, combined with a lack of regulatory oversight, led AIG to accumulate staggering amounts of risk, especially in its Financial Products subsidiary, AIG Financial Products (AIGFP). Among its other operations, AIGFP sold credit default swaps (CDSs), instruments that would pay off if certain financial securities, particularly those made up of subprime mortgages, defaulted. So long as the mortgage market remained sound and AIG's credit rating remained stellar, these instruments did not threaten the company's financial stability.

The financial crisis, however, fundamentally changed the equation on Wall Street. As subprime mortgages began to default, the complex securities based on those loans threatened to topple both AIG and other long-established institutions. During the summer of 2008, AIG faced increasing demands from their CDS customers for cash security—known as collateral calls—totaling tens of billions of dollars. These costs put AIG's credit rating under pressure, which in turn led to even greater collateral calls, creating even greater pressure on AIG's credit.

By early September, the problems at AIG had reached a crisis point. A sinkhole had opened up beneath the firm, and it lacked the liquidity to meet collateral demands from its customers. In only a matter of months AIG's worldwide empire had collapsed, brought

*The Panel adopted this report with a 4–0 vote on June 9, 2010.

down by the company's insatiable appetite for risk and blindness to its own liabilities.

AIG sought more capital in a desperate attempt to avoid bankruptcy. When the company could not arrange its own funding, Federal Reserve Bank of New York President Timothy Geithner, who is now Secretary of the Treasury, told AIG that the government would attempt to orchestrate a privately funded solution in coordination with JPMorgan Chase and Goldman Sachs. A day later, on September 16, 2008, FRBNY abandoned its effort at a private solution and rescued AIG with an $85 billion, taxpayer-backed Revolving Credit Facility (RCF). These funds would later be supplemented by $49.1 billion from Treasury under the Troubled Asset Relief Program (TARP), as well as additional funds from the Federal Reserve, with $133.3 billion outstanding in total. The total government assistance reached $182 billion.

After reviewing the federal government's actions leading up to the AIG rescue, the Panel has identified several major concerns:

The government failed to exhaust all options before committing $85 billion in taxpayer funds. In previous rescue efforts, the federal government had placed a high priority on avoiding direct taxpayer liability for the rescue of private businesses. For example, in 1998, the Federal Reserve pressed private parties to prevent the collapse of Long-Term Capital Management, but no government money was used. In the spring of 2008, the Federal Reserve arranged for the sale of Bear Stearns to JPMorgan Chase. Although the sale was backed by $28.2 billion of federal loans, much of the risk was borne by private parties.

With AIG, the Federal Reserve and Treasury broke new ground. They put U.S. taxpayers on the line for the full cost and the full risk of rescuing a failing company.

During the Panel's meetings, the Federal Reserve and Treasury repeatedly stated that they faced a "binary choice": either allow AIG to fail or rescue the entire institution, including payment in full to all of its business partners. The government argues that AIG's failure would have resulted in chaos, so that a wholesale rescue was the only viable choice. The Panel rejects this all-or-nothing reasoning. The government had additional options at its disposal leading into the crisis, although those options narrowed sharply in the final hours before it committed $85 billion in taxpayer dollars.

For example, the federal government could have acted earlier and more aggressively to secure a private rescue of AIG. Government officials, fully aware that both Lehman Brothers and AIG were on the verge of collapse, prioritized crafting a rescue for Lehman while they left AIG to attempt to arrange its own funding. By the time the Federal Reserve Bank reversed that approach, leaving Lehman to collapse into bankruptcy without help and concluding that AIG posed a greater threat to financial stability, time to explore other options was short. The government then put the efforts to organize a private AIG rescue in the hands of only two banks, JPMorgan Chase and Goldman Sachs, institutions that had severe conflicts of interest as they would have been among the largest beneficiaries of a taxpayer rescue.

When that effort failed, the Federal Reserve decided not to press major lenders to participate in a private deal or to propose a rescue that combined public and private funds. As Secretary Geithner

later explained to the Panel it would have been irresponsible and inappropriate in his view for a central banker to press private parties to participate in deals to which the parties were not otherwise attracted. Nor did the government offer to extend credit to AIG only on the condition that AIG negotiate discounts with its financial counterparties. Secretary Geithner later testified that he believed that payment in full to all AIG counterparties was necessary to stop a panic. In short, the government chose not to exercise its substantial negotiating leverage to protect taxpayers or to maintain basic market discipline.

There is no doubt that orchestrating a private rescue in whole or in part would have been a difficult—perhaps impossible—task, and the effort might have met great resistance from other financial institutions that would have been called on to participate. But if the effort had succeeded, the impact on market confidence would have been extraordinary, and the savings to taxpayers would have been immense. Asking for shared sacrifice among AIG's counterparties might also have provoked substantial opposition from Wall Street. Nonetheless, more aggressive efforts to protect taxpayers and to maintain market discipline, even if such efforts had failed, might have increased the government's credibility and persuaded the public that the extraordinary actions that followed were undertaken to protect them.

The rescue of AIG distorted the marketplace by transforming highly risky derivative bets into fully guaranteed payment obligations. In the ordinary course of business, the costs of AIG's inability to meet its derivative obligations would have been borne entirely by AIG's shareholders and creditors under the well-established rules of bankruptcy. But rather than sharing the pain among AIG's creditors—an outcome that would have maintained the market discipline associated with credit risks—the government instead shifted those costs in full onto taxpayers out of a belief that demanding sacrifice from creditors would have destabilized the markets. The result was that the government backed up the entire derivatives market, as if these trades deserved the same taxpayer backstop as savings deposits and checking accounts.

One consequence of this approach was that every counterparty received exactly the same deal: a complete rescue at taxpayer expense. Among the beneficiaries of this rescue were parties whom taxpayers might have been willing to support, such as pension funds for retired workers and individual insurance policy holders. But the across-the-board rescue also benefitted far less sympathetic players, such as sophisticated investors who had profited handsomely from playing a risky game and who had no reason to expect that they would be paid in full in the event of AIG's failure. Other beneficiaries included foreign banks that were dependent on contracts with AIG to maintain required regulatory capital reserves. Some of those same banks were also counterparties to other AIG CDSs.

Throughout its rescue of AIG, the government failed to address perceived conflicts of interest. People from the same small group of law firms, investment banks, and regulators appeared in the AIG saga in many roles, sometimes representing conflicting interests. The lawyers who represented banks trying to put together a rescue package for AIG became the lawyers to the Fed-

eral Reserve, shifting sides within a matter of minutes. Those same banks appeared first as advisors, then potential rescuers, then as counterparties to several different kinds of agreements with AIG, and ultimately as the direct and indirect beneficiaries of the government rescue. The composition of this tightly intertwined group meant that everyone involved in AIG's rescue had the perspective of either a banker or a banking regulator. These entanglements created the perception that the government was quietly helping banking insiders at the expense of accountability and transparency.

Even at this late stage, it remains unclear whether taxpayers will ever be repaid in full. AIG and Treasury have provided optimistic assessments of AIG's value. As current AIG CEO Robert Benmosche told the Panel, "I'm confident you'll get your money, plus a profit." The Congressional Budget Office (CBO), however, currently estimates that taxpayers will lose $36 billion. A large portion of the funds needed to repay taxpayers will be generated through the sale of assets bought by the government to assist AIG, assets still held by AIG, and units of AIG sold to third parties or to the public through initial public offerings. The uncertainty lies in whether AIG's remaining business units will generate sufficient new business to create the necessary shareholder value to repay taxpayers in full. AIG's management is unsurprisingly bullish on that prospect, where the CBO does not attempt to forecast such expansion in revenues and instead relies on a baseline estimate. For now, the ultimate cost or profit to taxpayers is unknowable, but it is clear that taxpayers remain at risk for severe losses.

The government's actions in rescuing AIG continue to have a poisonous effect on the marketplace. By providing a complete rescue that called for no shared sacrifice among AIG's creditors, the Federal Reserve and Treasury fundamentally changed the relationship between the government and the country's most sophisticated financial players. Today, AIG enjoys a five-level improvement in its credit rating based solely on its access to government funding on generous terms. Even more significantly, markets have interpreted the government's willingness to rescue AIG as a sign of a broader implicit guarantee of "too big to fail" firms. That is, the AIG rescue demonstrated that Treasury and the Federal Reserve would commit taxpayers to pay any price and bear any burden to prevent the collapse of America's largest financial institutions, and to assure repayment to the creditors doing business with them. So long as this remains the case, the worst effects of AIG's rescue on the marketplace will linger.

In this report, the Panel presents a comprehensive overview of the AIG transactions based on a review of many thousands of documents. In addition to reviewing the likelihood of repayment from AIG, the Panel focuses on the decisions by the Federal Reserve and Treasury to rescue AIG and the ways they executed that rescue. Their decisions set the course for the AIG rescue and the broader TARP and raise significant policy questions that the Federal Reserve and Treasury may face again—questions that are best answered in careful consideration of the aftermath of AIG's rescue rather than in the throes of the next crisis.

Through a series of actions, including the rescue of AIG, the government succeeded in averting a financial collapse, and nothing in

this report takes away from that accomplishment. But this victory came at an enormous cost. Billions of taxpayer dollars were put at risk, a marketplace was forever changed, and the confidence of the American people was badly shaken. How the government will manage those costs, both in the specific case of AIG and in the more general case of TARP, remains a central challenge—one the Panel will continue to review.

FIGURE 1: OVERVIEW OF THE AIG TRANSACTIONS

The government's rescue of AIG involves several different funding facilities provided by different government entities, with various changes to the transactions over time. The following tables summarize the sources of funds for AIG's rescue and the current status of that assistance, as well as the uses to which those funds were put. The report discusses these transactions in more detail.

Transaction Date	Type of Transaction/Security	Length of Loan/ Term of Investment	Capital/Available Credit to AIG or ML entity	Interest Rate	Oversight	Changes to Previous Transactions	Status Over Time: Exposure at Height; Total Current Exposure
Federal Reserve Revolving Credit Facility							
9/16/2008	FRBNY received Series C Perpetual, Convertible, Participating Preferred Stock convertible into 79.9% of issued and outstanding common shares.	2 years	Up to $85B	3-month LIBOR + 8.5% on drawn funds; 8.5% fee on undrawn but available funds; one-time commitment fee of 2% of loan principal.	3 independent trustees to oversee equity interest for duration of loan.	N/A	Exposure at height of facility: $72B (10/2008) Total current exposure: $26.1B outstanding as of 5/27/2010
11/25/2008	Reduction in loan ceiling and interest rate.	Extended to 5 years.	Reduced to $60B.	3-month LIBOR (with a minimum floor of 3.5%) +3% on drawn funds; 0.75% fee on undrawn funds.		Loan term extended; credit available reduced; interest rate reduced; fee on undrawn funds reduced by 7.75% points to 0.75%.	
4/17/2009	Reduction in interest rate			3-month LIBOR (no floor) + 3% on drawn funds; 0.75% fee on undrawn funds		Removed minimum 3.5% LIBOR borrowing floor; permitted issuance of preferred stock to Treasury.	
12/1/2009	Debt for equity swap		Reduced to $35B.			Reduced loan ceiling by $25B in exchange for FRBNY obtaining a preferred interest in AIA and ALICO SPVs.	
5/6/2010	Reduction in loan ceiling		Reduced to $34B.			Reduced loan ceiling due to sale of HighStar Port Partners, L.P..	
Federal Reserve Securities Borrowing Facility							
10/8/2008	FRBNY borrowed investment-grade, fixed income securities from AIG in exchange for cash collateral.		Up to $37.8B ...				Exposure at height of facility: $17.5B (10/2008) Total current exposure: None; became Maiden Lane II Facility creates better terms for AIG, as the company is effectively the lender of securities for cash

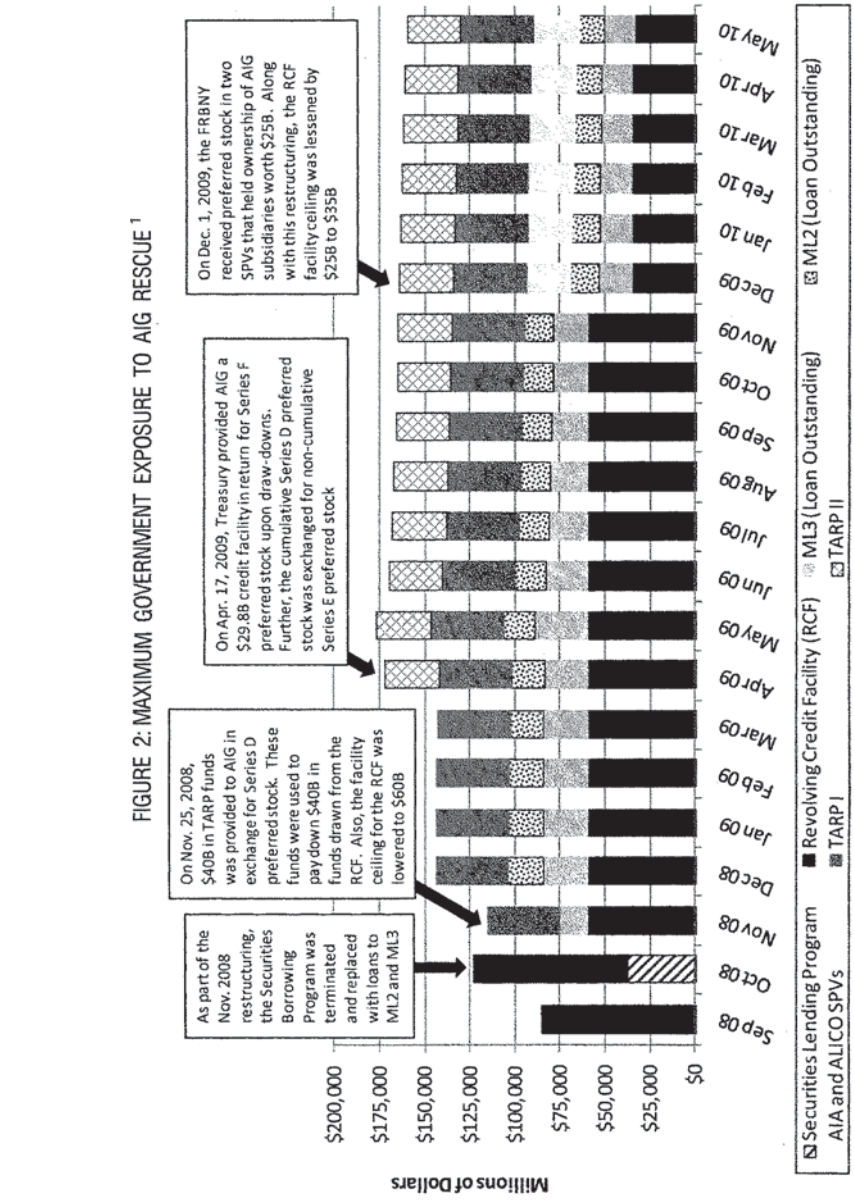
Transaction Date	Type of Transaction/Security	Length of Loan/ Term of Investment	Capital/Available Credit to AIG or ML entity	Interest Rate	Oversight	Changes to Previous Transactions	Status Over Time: Exposure at Height; Total Current Exposure
			TARP-SSFI/AIGIP				
11/25/2008	Treasury purchased Series D Fixed Rate Cumulative Preferred and Warrants for common stock.	Perpetual Life (Preferred); 10-year life (Warrants).	$40.0B ..... 10% quarterly dividends, cumulative.	Treasury		Total current exposure is highest to date. Treasury holds:. —$40B in Series E Fixed Rate Non-Cumulative Preferred Stock. —$7.5B in Series F Fixed Rate Non-Cumulative Perpetual Preferred Stock. —Warrants equal to 2% of common shares outstanding. Accrued and unpaid dividends from original Series D Preferred Stock of $1.6B outstanding must be paid at redemption. Additional $0.2B commitment fee to be paid from AIG's operating income in three equal installments over 5-year life of revolving credit facility. Capital used to pay down original Fed credit facility; Trust ownership percentage on conversion becomes 77.9%, with Treasury holding warrants equal to an additional 2% common stock ownership.	

Transaction Date	Type of Transaction/Security	Length of Loan/ Term of Investment	Capital/Available Credit to AIG or ML entity	Interest Rate	Oversight	Changes to Previous Transactions	Status Over Time: Exposure at Height; Total Current Exposure
4/17/2009	Treasury exchanged Series D for Series E Fixed Rate Non-Cumulative Preferred Shares and Warrants for common stock.	Perpetual Life ..		10% quarterly dividends, non-cumulative.	Treasury	Treasury exchanged Series D Preferred Shares for Series E Fixed Rate Non-Cumulative Preferred Shares. Accrued and unpaid dividends of $1.6B from Series D shares must be paid at time of Series E redemption.	
4/17/2009	Treasury purchased additional Series F Fixed Rate Non-Cumulative Preferred Shares and Warrants for common stock.	Perpetual Life (Preferred); 10-year life (Warrants).	$29.8B	10% quarterly dividends, non-cumulative.	Treasury	Additional capital injection that reflects a commitment of up to $30.0B reduced by $0.2B in retention payments made by AIGFP to employees in March 2009.	
				Maiden Lane II			
11/10/2008	FRBNY formed LLC to purchase RMBS from AIG insurance subsidiaries, lending money to the LLC for this purpose.	6 years, to be extended at FRBNY's discretion.	Up to $22.5B ...	1-month LIBOR + 100 bps (loan by FRBNY); 1-month LIBOR + 300 bps (deferred purchase price to AIG subs).	FRBNY with asset management by BlackRock Financial Management.	Terminates Securities Borrowing Facility. Formation of an LLC to be lent money from FRBNY to purchase RMBS from AIG insurance subsidiaries. AIG sub receives a 1/6 participation in any residual portfolio cash flows after loan repayment. FRBNY receives 5/6 of any residual cash flows.	Principal balance exposure at closing (height): $19.5B on Fed senior loan Total current exposure on outstanding principal amount and accrued interest due to FRBNY: $14.9B as of 5/27/2010, with deferred payment and accrued interest due to AIG subsidiaries of $1.1B as of 5/27/2010

Maiden Lane III

11/10/2008	FRBNY formed LLC to purchase multisector CDOs from counterparties of AIGFP, lending money to the LLC for this purpose.	6 years, to be extended at FRBNY's discretion.	Up to $30.0B ...	1-month LIBOR + 100 bps (loan by FRBNY); 1-month LIBOR + 300 bps (repayment to AIG of equity contribution amount).	FRBNY with asset management by BlackRock Financial Management.	Same as above, only for purchase of multisector CDOs from counterparties of AIGFP. AIG and FRBNY receive 33% and 67%, respectively, of any remaining proceeds after repayment of loan and equity contribution.	Principal balance exposure at closing (height): $24.3B on Fed senior loan Total current exposure on outstanding principal amount and accrued interest due to FRBNY: $16.6B as of 5/27/2010, with outstanding principal and accrued interest on loan due to AIG of $5.3B as of 5/27/2010

FIGURE 2: MAXIMUM GOVERNMENT EXPOSURE TO AIG RESCUE [1]



[1] For ML2 and ML3, the FRBNY loan amount outstanding with respect to a given month is used instead of the original full value of the facility in order to more accurately reflect the funds at risk.

FIGURE 3: GOVERNMENT ASSISTANCE TO AIG AS OF MAY 27, 2010 [2]

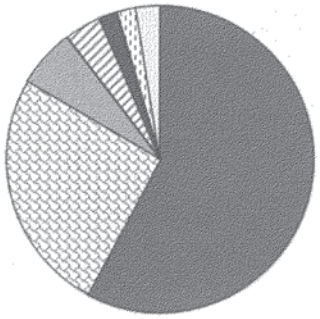
[Dollars in millions]

	Amount Authorized	Assistance Amount Outstanding as of 5/27/10
FRBNY		
Revolving Credit Facility	$34,000	$26,133
Maiden Lane II: Outstanding principal amount of loan extended by FRBNY	22,500	14,532
Net portfolio holdings of Maiden Lane II LLC	—	15,910
Accrued interest payable to FRBNY	—	342
Maiden Lane III: Outstanding principal amount of loan extended by FRBNY	30,000	16,206
Net portfolio holdings of Maiden Lane III LLC [3]	—	23,380
Accrued interest payable to FRBNY	—	427
Preferred interest in AIA Aurora LLC	16,000	16,266
Accrued dividends on preferred interests in AIA Aurora LLC		125
Preferred interest in ALICO SPV	9,000	9,150
Accrued dividends on preferred interests in ALICO Holdings LLC		70
Total FRBNY	111,500	83,251
TARP		
Series E Non-cumulative Preferred stock	40,000	40,000
Unpaid dividends on Series D Preferred stock		1,600
Series F Non-cumulative Preferred stock	29,835	7,544
Total TARP	69,835	49,144
Net borrowings	181,335	129,831
Accrued interest payable and unpaid dividends		2,564
Total Balance Outstanding	$181,335	$132,395

[2] U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending May 26, 2010,* at 18 (May 28, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-28-10%20Transactions%20Report%20as%20of%205-26-10.pdf) (hereinafter ''Treasury Transactions Report''); Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (May 27, 2010) (online at www.federalreserve.gov/releases/h41/20100527/) (hereinafter ''Federal Reserve H.4.1 Statistical Release'').

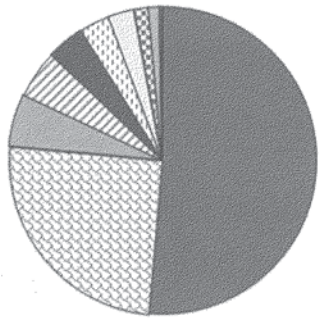
[3] Federal Reserve H.4.1 Statistical Release, *supra* note 2 (''Dividends accrue as a percentage of the FRBNY's preferred interests in AIA Aurora LLC and ALICO Holdings LLC. On a quarterly basis, the accrued dividends are capitalized and added to the FRBNY's preferred interests in AIA Aurora LLC and ALICO Holdings LLC.'').

FIGURE 4: AIG USE OF GOVERNMENT ASSISTANCE IN 2008 AND 2009* *(millions of dollars)*



2008

- Loans to AIGFP for collateral postings, GIA and other debt maturities: $46,997
- Capital contributions and loans to insurance companies: $20,850
- Funding of equity interest in ML3: $5,000
- Repayment of obligations to securities lending program: $3,160
- Repayment of intercompany loans: $1,528
- Contributions to AIGCFG subsidiaries: $1,672
- Debt payments: $2,109



2009

- Loans to AIGFP for collateral postings, GIA and other debt maturities: $50,605
- Capital contributions and loans to insurance companies: $24,718
- Debt payments: $5,448
- Funding of equity interest in ML3: $5,000
- Loans to ILFC: $3,900
- Repayment of obligations to securities lending program: $3,160
- Intercompany purchase of ILFC equity ownership: $2,722
- Repayment of intercompany loans: $1,528
- UGC related restructuring transactions: $1,132
- Contributions to AIGCFG subsidiaries: $222
- Temporary paydown of FRBNY Credit Facility: $101

*American International Group, Inc., *Form 10-K for the Fiscal Year Ended December 31, 2009*, at 44-45 (Feb. 26, 2010) (online at www.sec.gov/Archives/edgar/data/5272/000104746910001465/a2196553z10-k.htm).

SECTION ONE:

A. Overview

At the height of the government support, AIG and its affiliates had received $89.5 billion in loans from the Federal Reserve, $43.8 billion through Maiden Lanes II and III, and $49.1 billion in investments from Treasury. The government outlay remains high, with $26.1 billion in loans outstanding from the Federal Reserve's Revolving Credit Facility as of May 27, 2010, $25.4 billion in preferred holdings of AIG related special purpose vehicles (SPVs), and the same Treasury support outstanding as at its height. The government controls 79.8 percent of AIG's equity and has appointed 2 of its 13 directors. Only Fannie Mae and Freddie Mac, institutions in government conservatorship, have received more money from the government.

This report examines how AIG, a unique amalgamation of insurance and other financial companies, got into trouble, and looks at some of the regulatory challenges presented by such an entity. It follows the taxpayers' money. And it examines the actions taken by various governmental entities, primarily the Federal Reserve Bank of New York (FRBNY),[4] which took the lead in the AIG rescue, the reasons those entities gave for the various decisions taken in the rescue, and the effectiveness of the government in achieving its objectives. The report also examines how those actions were explained to the taxpayer both contemporaneously and subsequently.

The government chose to rescue AIG in full, rather than conditioning any rescue on shared losses with the creditors, whether through negotiation or bankruptcy. The significance of this choice cannot be overstated. The decision determined the parameters of all subsequent actions and decisions, and thus the report examines the choice in detail. Because the government chose to rescue AIG as a whole, all AIG's creditors were paid off in full. The report explains how the government's funds were used and who benefitted. It also asks how those results might have differed if bankruptcy, or some other option than wholesale rescue, had been chosen.

Looking forward, the report examines AIG's plans to repay the taxpayers and the government's plans to exit its AIG holdings.

The Panel's mandate is to review the use by the Secretary of the Treasury of his authority under the Emergency Economic Stabilization Act of 2008 (EESA) and his administration of the TARP. Treasury's actions, and the role Treasury chose to play with respect to AIG, cannot be understood except in the context of the actions taken by the Board of Governors of the Federal Reserve System (the Board) and FRBNY. The report therefore looks at the actions taken by all these governmental entities. Although the roles of the various parties are set out in the report, the governmental entities worked together closely and, for the ease of reading, are in some places referred to collectively as "the government."

The report builds on the work done by other oversight bodies and will later this year be supplemented by a wide-ranging report on all aspects of the AIG rescue by the Government Accountability Office (GAO). The Financial Crisis Inquiry Commission has also held

[4] FRBNY is one of 12 regional banks within the Federal Reserve System.

hearings looking into the role of complex derivative securities in the financial crisis and the part played by AIG. The Special Inspector General for the Troubled Asset Relief Program (SIGTARP) has initiated an investigation into the manner in which public disclosure of the identity of certain of AIG's counterparties was delayed.

As those future reports and investigations will show, the AIG story is not yet complete. The complexities of the company, and its cross-holdings and cross-subsidizations, discussed in the report, may mean that some time will elapse before the true financial position of AIG and its subsidiaries and their future are clear. Moreover, analysis of the rescue is dependent to some extent to the narrative framework presented by the government. While the report tests some of the assertions made by the various government entities—and reflects a review by the Panel staff of thousands of government documents—it is inevitably dependent to some extent on the information that those entities are willing to share and the manner in which they present the facts examined. The Panel has no subpoena power, and as a result it is entirely dependent upon the goodwill of private entities. AIG has provided extensive documentation to the Panel. Some of AIG's counterparties have not provided all documentation requested by the Panel.

Context is everything with AIG. The government's later actions were shaped by the policy decisions it made and the actions it took in one turbulent week in September 2008. Its involvement was dictated by the unique threat to financial stability that it believed AIG's situation posed. It is therefore crucial to understand the nature of AIG, the ways different parts of AIG were regulated, and the state of affairs in the world when the government first contemplated the prospect of AIG's failure.

B. AIG Before the Government Rescue

1. AIG's History

At its peak, AIG was one of the largest publicly traded companies in the world, whose principal businesses included insurance and financial services. Hank Greenberg, the long-term CEO of AIG, was chosen to succeed Cornelius Starr, the founder of the company, after leading AIG's North American operations. During his tenure, which ran from 1968 until 2005, the company grew considerably, diversified its product offerings, and expanded to more than 100 countries around the world. On March 14, 2005, AIG's board forced Greenberg to step down amid increased scrutiny, followed by then New York Attorney General Eliot Spitzer and later the U.S. Securities and Exchange Commission (SEC) filing civil charges against Greenberg for his role in fraudulent business practices and accounting fraud that misrepresented AIG's earnings.[5]

AIG Financial Products (AIGFP), which contributed to the liquidity crisis at AIG, was created in 1987. AIGFP, as well as other swap dealers, rely heavily on the credit rating of the parent company. A triple-A rating usually affords the entity considerable leverage in negotiating contracts. Specifically, a triple-A rating pro-

[5] Securities and Exchange Commission, *SEC Charges Hank Greenberg and Howard Smith for Roles in Alleged AIG Accounting Violations* (Aug. 6, 2009) (online at www.sec.gov/news/press/2009/2009-180.htm).

vides leverage regarding if and when collateral is to be posted and the trigger and amounts of collateral, and it offers latitude in negotiations when problems arise. In the spring of 2005, rating agency Standard & Poor's (S&P) lowered the long-term senior debt and counterparty ratings of AIG from 'AAA' to 'AA.' As discussed in Section B3, this proved disastrous for AIGFP.[6]

2. AIG's Structure and Regulatory Scheme

The scale of and linkages across AIG's operations posed unique managerial and regulatory challenges. Prior to the rescue, AIG was the world's largest insurance organization, with over $1 trillion in assets and 76 million customers in over 130 countries. Core insurance operations encompassed both general insurance, including property and casualty, commercial and industrial, and life insurance, including annuities and retirement services. In addition to insurance, AIG's primary business units included financial services and asset management.

Figure 5 below outlines the primary operations housed within AIG's four core business segments in 2008 as well as the relevant regulatory bodies—if any—that were responsible for oversight.

FIGURE 5: AIG CURRENT PRIMARY BUSINESS SEGMENTS

General Insurance	Life Insurance & Retirement Services	Financial Services	Asset Management [8]
Function			
Property/casualty insurance ..	Individual and group life insurance products.	Capital markets	Investment advisory
	Retirement services	Consumer finance	Brokerage
	Annuities	Insurance premium finance	Private banking
		Aircraft leasing	Clients include AIG subsidiaries, institutional and individual investors
Commercial/industrial insurance.			
Specialty insurance.			
Reinsurance.			
Key Regulators [7]			
50 state insurance regulators.	50 state insurance regulators.	Office of Thrift Supervision ..	Securities and Exchange Commission [8]
	Texas International Regulators.	Securities and Exchange Commission.	International Regulators
Arizona, Delaware, Missouri, New York, Pennsylvania, Tennessee, Texas International Regulators.		International Regulators	

[7] Only domestic regulators are named here. International subsidiaries are overseen by the relevant regulators in the country of operation. The Office of Thrift Supervision had regulatory responsibility over the holding company, AIG Inc. (and therefore all of AIG) prior to September 18, 2008. FRBNY and Treasury now act as AIG's *de facto* primary regulators.

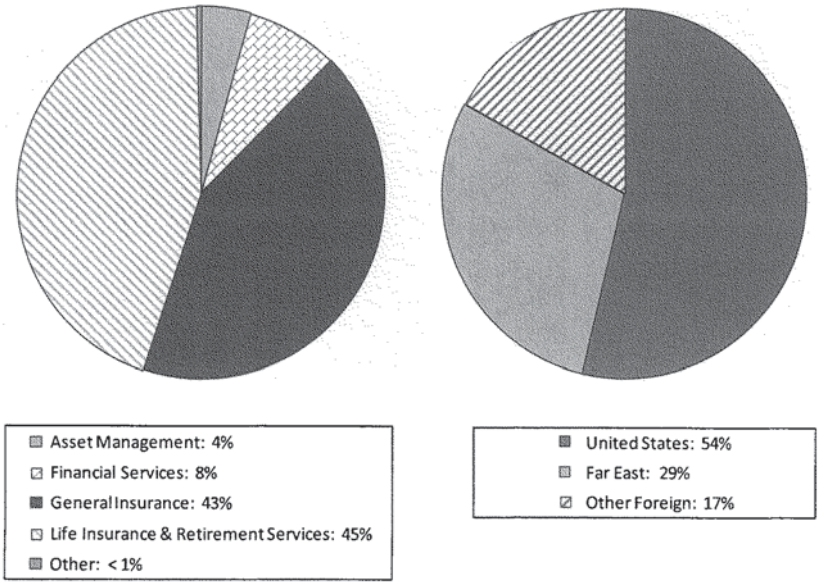
[8] The Securities and Exchange Commission has a regulatory relationship with several AIG subsidiaries, including AIG Asset Management LLC, AIG Financial Securities Corp, and SunAmerica Capital Services Inc. SEC does not regulate the AIG parent company or AIGFP.

Prior to the financial crisis, AIG generated annual revenue of more than $100 billion. During the 2004 to 2006 period, insurance operations accounted for nearly 90 percent of AIG's total net revenue, as shown in Figure 6. Approximately half of the company's

[6] American International Group, Inc., *Form 10–K for the Fiscal Year Ended December 31, 2005,* at 14 (Mar. 16, 2006) (online at www.sec.gov/Archives/edgar/data/5272/000095012306003276/y16349e10vk.htm) (hereinafter "AIG Form 10–K for FY05").

net revenue during this period came from outside of the United States, largely concentrated in Asia.

FIGURE 6: REVENUE BY SEGMENT (LEFT PIE) AND REVENUE BY GEOGRAPHIC REGION (RIGHT PIE), 2004–2006 (AGGREGATE) [9]



AIG's product and regional diversity was predicated on maintaining an exceptional credit rating, which helped bolster its insurance operations and allowed the company to use its low cost of funds as leverage to boost non-insurance business lines, including aircraft leasing and consumer finance. AIG's longtime AAA credit rating also increased its attractiveness as a counterparty in the capital markets, helping the company further expand its product base in the United States and around the world. The product and geographic breadth of AIG's operations, however, were not matched by a coherent regulatory structure to oversee its business. The Office of Thrift Supervision (OTS), a federal agency that regulates the U.S. thrift industry, was specifically charged with overseeing the parent and it failed to do so. Whether the OTS or a more coherent regulatory framework could have prevented the build-up in risks that the company's own management team failed to understand is unlikely, but this does not obscure the point that AIG's holding company regulator had the power and the duty to spot and require the company to curtail its risk.

[9] American International Group, Inc., *Form 10–K for the Fiscal Year Ended December 31, 2006, at 4*, 124 (Mar. 1, 2007) (online at www.sec.gov/Archives/edgar/data/5272/000095012307003026/y27490e10vk.htm) (hereinafter "Form 10–K for the Fiscal Year Ended December 31, 2006"); AIG Form 10–K for FY05, *supra* note 6, at 4, 94; American International Group, Inc., *Form 10–K for the Fiscal Year Ended December 31, 2004*, at 4, 147 (May 31, 2005) (online at www.sec.gov/Archives/edgar/data/5272/000095012305006884/y03319e10vk.htm) (hereinafter "AIG Form 10–K for FY04").

AIG insurance subsidiaries operate and are licensed in all 50 states, and the states regulate the firm's domestic insurance subsidiaries.[10] All of AIG's domestic insurance subsidiaries are domiciled in one of 14 states or Puerto Rico, and each of those jurisdictions has primary regulatory authority over its domiciled subsidiaries.[11]

The states, through the National Association of Insurance Commissioners (NAIC), coordinate so that AIG's insurance subsidiaries have four lead regulators. Texas is the lead regulator for life insurance companies, Pennsylvania for property & casualty, New York for personal lines, and Delaware for "surplus" or specialized lines. Domestic regulators, lead and otherwise, perform AIG's examinations concurrently, because of the commonality of systems between companies.[12] Each lead regulator's main role is to coordinate examinations and other regulatory functions among the various state regulators. The lead regulator has no special legal authority; its role is merely to coordinate the various state regulators. Each state still has responsibility for examining its domiciled subsidiaries.[13] This regulation entails regular financial examinations as well as scrutiny of major transactions, solvency issues, and other matters. The lead regulator and the individual state regulators each conduct regular examinations, but the lead regulator coordinates them. The state insurance regulators, including the lead regulators, only examine the AIG holding company to the extent that it relates to the insurance subsidiaries.[14]

Foreign insurance regulators, operating under their own countries' laws, have jurisdiction over AIG's overseas insurance subsidiaries.

The OTS was the regulator of AIG's holding company, AIG Group, Inc., after it granted a federal charter to AIG Federal Sav-

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[10] *See* McCarran-Ferguson Act, 15 U.S.C. §§ 1011–1015. The McCarran-Ferguson Act exempts insurance from federal regulation unless expressly stated by Congress. It does not mandate that states regulate insurance; it states that no "Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, . . . unless such Act specifically relates to the business of insurance." 15 U.S.C. § 1012(b).

The state insurance agencies work together through the National Association of Insurance Commissioners (NAIC) to coordinate regulation, set certain uniform standards, and determine accreditation standards for state insurance regulators. One of these accreditation standards requires state regulators to conduct quarterly financial analyses of the state's multi-state domiciliary insurance companies and full examinations every 5 years. Regulators of non-domiciliary companies may also choose to conduct examinations, or they may rely on the lead regulator's examination. The insurance regulators will also communicate with other regulators, such as OTS.

[11] Most of these states have more than one AIG subsidiary; Delaware, North Carolina, New York, and Pennsylvania all have six or more. This excludes more than 100 foreign governments that regulate AIG's foreign insurance subsidiaries. *See* House Committee on Oversight and Government Reform, Written Testimony of Timothy F. Geithner, secretary, U.S. Department of the Treasury, *The Federal Bailout of AIG*, at 3 (Jan. 27, 2010) (online at oversight.house.gov/images/stories/Hearings/Committee__on__Oversight/TESTIMONY-Geithner.pdf) (hereinafter "Testimony of Sec. Geithner"). An insurance company is domiciled in the state in which it is organized or which it has chosen as its state of domicile.

[12] Panel staff conversation with the National Association of Insurance Commissioners (Apr. 2, 2010).

[13] Panel staff conversation with New York State Insurance Department (June 3, 2010).

[14] Though examinations of the holding company are limited to how it relates to the subsidiaries, the regulators obtain additional information about the holding company through informal channels, such as regular communications with holding company management and review of public filings. Panel staff conversation with New York State Insurance Department (June 3, 2010).

ings Bank (AIG FSB) in May 2000.[15] OTS was responsible for monitoring AIG's operations, ensuring compliance with relevant laws, and preventing risks that could affect the safety and soundness of the firm.[16] The regulatory approach of OTS in regulating a thrift holding company such as AIG is predicated on evaluating the overall holding company to ensure that no harm is done to the thrift. As a result, OTS took a bottom-up approach to regulating AIG, from the thrift to the holding company, as opposed to a top-down, comprehensive approach to regulation.[17] Although AIG's insurance subsidiaries were subject to the oversight of state and foreign regulators, OTS was the firm's consolidated supervisor, responsible for coordinating overall supervision.[18]

The interlocking nature of AIG's businesses as well as the vast array of counterparties with which these businesses transacted posed an impediment to regulators constrained by functional and regional limitations on their oversight. In particular, AIGFP, the chief purveyor of AIG's credit default swaps (CDS) business, fell outside the scope of the state insurance regulators. Although OTS examined AIGFP in its regulation of the holding company, the CDS book of business fell outside of its regulatory authority.[19] In addition, because OTS was considered an "equivalent regulator" by European Union (EU) standards, AIGFP's activities were only regulated by European regulators when they coincided with the European business of Banque AIG, a French subsidiary of AIGFP. This regulatory arrangement excluded any comprehensive examination and regulation of CDS activity within AIGFP.[20] Certain other financial operations inside AIG—including capital markets, consumer finance and aircraft leasing—were regulated on a piecemeal basis or escaped regulation entirely.

3. The Causes of AIG's Problems

The trigger and primary cause of AIG's collapse came from inside AIGFP. This business unit, which included CDS on collateralized debt obligations (CDOs) backed by subprime mortgages, produced unrealized valuation losses and collateral calls that engulfed AIG in the fall of 2008. While the risk overhang in this business would have likely been sufficient to bring down the firm on its own, AIG's securities lending operations, which involved securities pooled from AIG's domestic life insurance subsidiaries, significantly raised the level of difficulty associated with executing a private sector solution

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[15] Office of Thrift Supervision, *OTS Approves AIG Acquisition of American General Bank* (Aug. 1, 2001) (online at files.ots.treas.gov/77152.html).

[16] *See* House Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Written Testimony of Scott M. Polakoff, acting director, Office of Thrift Supervision, *American International Group's Impact on the Global Economy: Before, During, and After Federal Intervention*, at 7 (Mar. 18, 2009) (online at www.house.gov/apps/list/hearing/financialsvcs__dem/ots__3.18.09.pdf) (hereinafter "Written Testimony of Scott Polakoff").

[17] Panel staff conversation with the Office of Thrift Supervision (May 21, 2010).

[18] U.S. Government Accountability Office, *Troubled Asset Relief Program: Status of Government Assistance Provided to AIG*, GAO–09–975 (Sept. 2009) (online at www.gao.gov/new.items/d09975.pdf) (hereinafter "GAO Report").

[19] Panel staff conversation with the Office of Thrift Supervision (May 21, 2010). Credit default swaps were also exempted from regulation by the Securities and Exchange Commission (SEC) and the Commodities Future Trading Commission (CFTC) as a result of the Commodities Futures Modernization Act of 2000.

[20] Panel staff conversation with the Office of Thrift Supervision (May 21, 2010).

or an orderly bankruptcy.[21] In the words of Marshall Huebner of Davis Polk & Wardwell, a law firm that represented FRBNY, the securities lending problems contributed to a "double death spiral." [22] The problems in AIGFP exacerbated the problems in securities lending, and vice versa, as collateral demands from both sets of counterparties quickly imperiled the company's liquidity position as it struggled to meet its cash demands. Meanwhile, the company's insurance operations were incapable of generating the requisite cash either through normal operations or asset sales to fund the parent company. In both cases, the threats within these businesses emanated from outsized exposure to the deteriorating mortgage markets, owing to grossly inadequate valuation and risk controls, including insufficient capital buffers as losses and collateral calls mounted.

AIG was taking risks with the assets of its life insurance subsidiaries through its securities lending program, creating a potential $15 billion-plus cash drain on their operations, a shortfall that may have threatened the solvency of these units in the absence of government assistance, as discussed in Section B3b.[23] Excluding the liquidity issues stemming from AIG's securities lending program, industry observers and regulators viewed the core operations on the life insurance side of the company as generally sound.[24] The same held true for AIG's property-casualty insurance business. As a result of the financial crisis, life insurance companies industry-wide felt pressure from declining asset values. At AIG, as asset valuations for CDS portfolios moved closer to levels at which collateral requirements were triggered, reserve requirements for embedded guarantees in certain insurance products were increased, but this pressure did not otherwise translate into immediate liquidity issues for the company.

a. Credit Default Swaps

AIG's downfall stemmed in large part from its CDS on multi-sector CDOs, which exposed the firm to the vaporization of value in the subprime mortgage market.[25] While many counterparties purchased these contracts to hedge or minimize credit risk, AIG essentially took the other side, a one-way, long-term bet on the U.S.

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[21] AIG's securities lending operations are discussed below in Section B.3.b (a detailed explanation of this business is provided in Annex V). Securities lending normally provides a low-risk mechanism for insurance companies and other long-term investors in the financial markets to earn modest sums of money on assets that would otherwise be sitting idle. However, rather than investing the cash collateral from borrowers in low-risk short-term securities in order to generate a modest yield, AIG invested in more speculative securities tied to the RMBS market. Consequently, these investments posed a duration mismatch (securities lending counterparties could demand a return of their collateral with very little notice), that was exacerbated by valuation losses and illiquidity in the mortgage markets that impaired AIG's ability to return cash to its securities lending counterparties.

[22] FRBNY and Treasury briefing with the Panel and Panel staff (Apr. 12, 2010).

[23] As of September 30, 2008, the fair value of the approximately $40 billion RMBS portfolio in AIG's securities lending program was approximately $23.5 billion. American International Group, *Form 10–Q for the Quarterly Period Ended September 30, 2008*, at 52 (Nov. 10, 2008) (online at www.sec.gov/Archives/edgar/data/5272/000095012308014821/y72212e10vq.htm) (hereinafter "AIG Form 10–Q for Third Quarter 2008").

[24] Panel staff conversation with the National Association of Insurance Commissioners (Apr. 2, 2010); Standard and Poor's conversation with Panel staff (May 13, 2010) (noting prior to September 2008 AIG primarily derived its high credit rating from its insurance subsidiaries).

[25] See Annex III for an explanation of AIG's CDS business and the CDS market more generally.

mortgage market.[26] This bet was premised on the presumed security of the 'AAA'-plus ratings on the underlying CDOs, aided by the subordination structures built into the underlying collateral pools, as well as AIG's once stellar 'AAA' credit rating. AIG relied on these factors to serve as a bulwark against market volatility that would undermine the value of the reference securities, and necessitate mark-to-market valuation losses and the posting of collateral to AIG's trading partners. AIGFP's model for CDOs was insufficiently robust to anticipate the impact of the significant declines in value associated with the market meltdown. This basic failure of comprehensive modeling and prudent risk/reward analysis on what was a relatively small slice of AIGFP's business ultimately brought down the entire firm and imperiled the U.S. financial system.

AIGFP's obligations were guaranteed by its highly-rated parent company ('AAA'-rated by Standard & Poor's since 1983), an arrangement that facilitated easy money via much lower interest rates from the public markets, but ultimately made it difficult to isolate AIGFP from its parent, with disastrous consequences.[27] The company's stellar earnings, business diversity, and sizable equity base allowed the firm to borrow at relatively cheaper levels in the capital markets. This allowed for the emergence of a "carry trade" mentality—i.e., borrowing at low rates, investing/lending at higher rates, and pocketing the difference, or spread—in pursuing investments that would maximize the value of AIG's balance sheet and low cost of funds.[28] It is rare for any financial institution, much less one with significant capital markets operations, to have a AAA-rating.[29] Major banks and other capital markets players could not compete with AIG's rating and its resulting access to lower-cost funding and more permissive collateral arrangements. Of course, AIG's rating would skew its internal risk/reward dynamics, as it could enter new markets more cheaply and deploy its balance sheet far more extensively than other competitors in the marketplace. As discussed in more detail below, the firm continued to underwrite multi-sector CDOs for almost a year after losing its AAA-rating in 2005.

In turn, the parent company benefited from the modest earnings diversity offered by AIGFP's capital markets business.[30] AIG's ster-

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[26] This was in contrast to other market participants, particularly dealers, which sought to balance the risk in their portfolios by accumulating both long and short positions to better net risk positions.

[27] House Committee on Oversight and Government Reform, Written Testimony of Elias Habayeb, former senior vice president and chief financial officer, AIG Financial Services, *The Federal Bailout of AIG*, at 3 (Jan. 27, 2010) (online at oversight.house.gov/images/ stories/Hearings/Committee__on__Oversight/ 2010/012710__AIG__Bailout/TESTIMONY-Habayeb.pdf) (hereinafter "Written Testimony of Elias Habayeb").

[28] *See* Congressional Oversight Panel, Testimony of Robert Benmosche, president and chief executive officer, American International Group, *COP Hearing on TARP and Other Assistance to AIG* (May 26, 2010) (hereinafter "Testimony of Robert Benmosche").

[29] In 2005, for example, the year AIG lost its AAA rating, only four other financial companies had a AAA-rating from Standard & Poor's—Berkshire Hathaway, GE Capital, Syncora Guarantee, and Toyota Motor Credit.

[30] AIGFP was viewed favorably by AIG investors and the ratings agencies. From their vantage point, AIGFP was a risk management tool for AIG's core insurance business because it diversified the company's earnings base. "The establishment of a separate entity by an insurance company to offer financial products could satisfy one or more of the following benefits: the creation of capital efficiencies, isolation of the risk related to a specific business line for risk-management purposes, and the creation of a noninsurance entity that is not encumbered by possible regulatory restrictions." Standard & Poor's Ratings Services, *Rating Financial Product Companies Higher Than Related Insurance Companies* (Apr. 29, 2004) (online at www.standardandpoors.com/prot/ratings/articles/en/us/?assetID=1245173065318).

ling credit rating was a differentiator in the market, and allowed the division to move aggressively into new business lines with lower levels of competition, expanding its scope as a counterparty to and underwriter of risk products, as institutional investors and financial institutions sought out more sophisticated instruments to hedge or speculate on credit, or other financial assets, through a variety of derivatives instruments.[31] AIGFP both enabled and participated in this market. Federal Reserve Chairman Bernanke later characterized AIGFP as a "hedge fund . . . attached to a large and stable insurance company."[32]

AIGFP entered the fledging credit derivatives market in 1998 when it underwrote its first credit default swap (CDS) with JP Morgan.[33] CDS contracts are privately negotiated contracts that obligate one party to pay another in the event that a third party cannot pay its obligation.[34] CDS contracts function in a similar manner to insurance contracts, although their payoff structure is closer to that of a put option.[35]

Over time AIGFP became a central player in the fast-growing CDS market, underwriting its first corporate arbitrage CDS in 2000 and its first multi-sector CDS in 2004.[36] AIGFP's corporate arbitrage CDS portfolio was comprised of CDS contracts written on corporate debt and collateralized loan obligations (CLOs) and its multi-sector CDS portfolio is comprised of CDS contracts written on CDOs. The collateral pools backing the corporate debt and CLO CDS portfolio included baskets of investment-grade corporate bonds and loans of commercial and industrial loans of large banks. The collateral pools backing the multi-sector CDOs included prime, Alt-A, and subprime residential mortgage-backed securities (RMBS); commercial mortgage-backed securities (CMBS); and other asset-backed securities (ABS).[37] CDS written on corporate debt, CLOs, and multi-sector CDOs serve as protection against "credit events" of the issuer of the reference obligation, including bankruptcy, failure to pay, acceleration of payments on the issuer's obligations, default on the issuer's obligations, restructuring of the issuer's debt, and similar events.[38]

Figure 7 shows the explosion in the CDS market from its infancy in 2001 to a market with over $60 trillion in notional contracts outstanding in 2007.

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[31] These included over-the-counter (OTC) derivatives and exchange-traded derivatives. OTC contracts, such as credit default swaps and forward contracts, are privately negotiated contracts between two parties. On the other hand, exchange-traded derivatives, including futures and option contracts, are traded on an exchange and settled through a clearing house.

[32] Senate Budget Committee, Testimony of Ben S. Bernanke, chairman, Board of Governors of the Federal Reserve System, *Economic and Budget Challenges for the Short and Long Term* (Mar. 3, 2009).

[33] Panel staff briefing with Weil Gotshal (May 12, 2010).

[34] BMO Capital Markets, *Credit Default Swaps* (online at www.bmocm.com/products/marketrisk/credit/swaps/default.aspx) (accessed June 8, 2010).

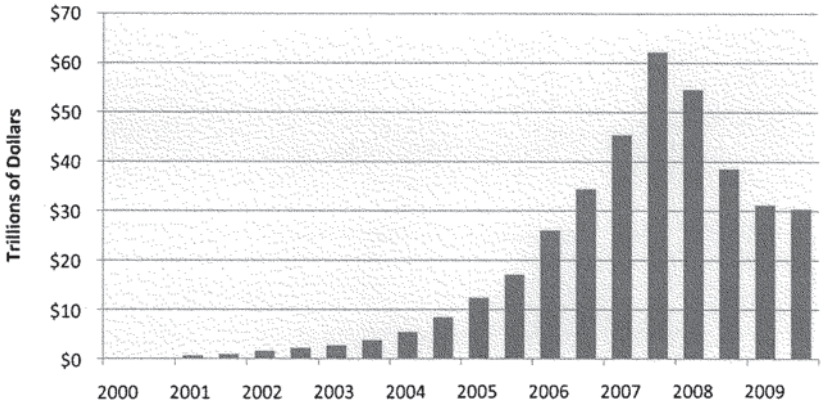
[35] See Annex III for a more detailed discussion of CDS contracts. Also, for a definition of CDS contracts in prior reports *see* Congressional Oversight Panel, *December Oversight Report: Taking Stock: What Has the Troubled Asset Relief Program Achieved?*, at 35 (Dec. 9, 2009) (online at cop.senate.gov/documents/cop–120909–report.pdf).

[36] Panel staff briefing with Weil Gotshal (May 12, 2010).

[37] AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 18, 116, 121–22.

[38] Senate Committee on Agriculture, Nutrition and Forestry, Written Testimony of Robert Pickel, chief executive officer, International Swaps and Derivatives Association, *Role of Financial Derivatives in Current Financial Crisis*, at 1 (Oct. 14, 2008) (online at www.isda.org/press/pdf/Testimony-of-Robert-Pickel.pdf) (hereinafter "Written Testimony of Robert Pickel").

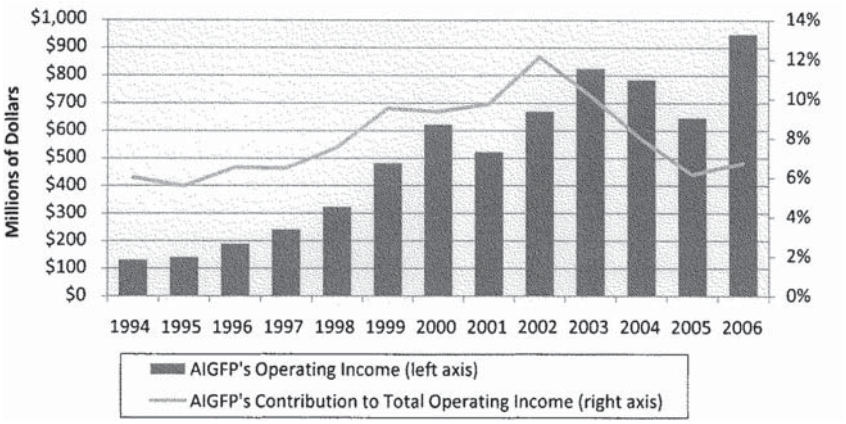
FIGURE 7: NOTIONAL AMOUNT OF CREDIT DEFAULT SWAPS OUTSTANDING [39]



AIGFP's operating income grew from $131 million in 1994 to $949 million in 2006, paralleling the boom in the overall derivatives market, as well as the CDS market. While the credit markets provided a source of steady profits for AIGFP, the division's operating income represented a relatively small percentage of AIG's total operating income, contributing just 7 percent to firmwide net income in 2006.[40] More importantly, as recent events make clear, the risk involved in this business was dramatically disproportionate to the revenue produced. For example, losses in 2007 totaled $11.5 billion, twice the aggregate net income produced by this division from 1994 to 2006.[41]

[39] International Swaps and Derivatives Association, *ISDA Market Survey: Historical Data* (online at www.isda.org/statistics/historical.html) (accessed June 8, 2010).
[40] AIG Form 10–K for FY04, *supra* note 9, at 24.
[41] American International Group, Inc., Form *10–K for the Fiscal Year Ended December 31, 2007, at 34* (Feb. 28, 2008) (online at www.sec.gov/Archives/edgar/data/5272/000095012308002280/y44393e10vk.htm) (hereinafter "AIG Form 10–K for FY07").

FIGURE 8: AIGFP'S OPERATING INCOME VS. CONTRIBUTION TO CONSOLIDATED AIG RESULTS [42]



This risk stemmed from a relatively small contributor to the firm's overall derivatives exposure. AIGFP grouped its CDS business into three separate categories, based on the underlying assets that were being insured: corporate debt/CLOs (corporate arbitrage), regulatory capital, and multi-sector CDOs. At its peak in 2007, these three groups represented an aggregate CDS portfolio of $527 billion,[43] constituting just 20 percent of the unit's overall derivatives exposure of $2.66 trillion.[44] In addition to its credit book, AIGFP also engaged in a wide variety of other derivative and financial transactions. These included standard and customized interest rate, currency, equity, commodity, and credit products; structured borrowings through notes, bonds, and guaranteed investment agreements (GIAs); and various commodity, foreign exchange trading, and market-making activities. These activities were responsible for the majority of AIG's derivatives activity.[45]

Only $149 billion, or 6 percent, of AIGFP's total derivatives portfolio in 2007 was classified as Arbitrage CDS, comprised of both the multi-sector CDO and corporate debt/CLO components (see Figure 9).[46] Ultimately, these two portfolios accounted for 99 percent of

[42] AIG Form 10–K for FY04, *supra* note 9, at 24; AIG Form 10–K for FY05, *supra* note 6, at 74; American International Group, Inc. *Form 10–K for the Fiscal Year Ended December 31, 2002*, at 63 (Mar. 31, 2003) (online at www.sec.gov/Archives/edgar/data/5272/000095012303003570/y65998e10vk.txt); American International Group, Inc., *Form 10–K for the Fiscal Year Ended December 31, 1999*, at 45 (Mar. 30, 2000) (www.sec.gov/Archives/edgar/data/5272/0000950123–00–002999.txt); American International Group, Inc., *Form 10–K for the Fiscal Year Ended December 31, 1996*, at 38 (Mar. 28, 1997) (online at www.sec.gov/Archives/edgar/data/5272/0000950123–97–002720.txt).

[43] In addition to its credit book, AIGFP also engaged in a wide variety of financial transactions through its Capital Markets division. These included standard and customized interest rate, currency, equity, commodity, and credit products; structured borrowings through notes, bonds, and guaranteed investment agreements; and various commodity, foreign exchange trading, and market-making activities. Capital Markets was responsible for the majority of AIG's derivatives activity. AIG Form 10–K for FY04, *supra* note 9, at 12, 75, 93.

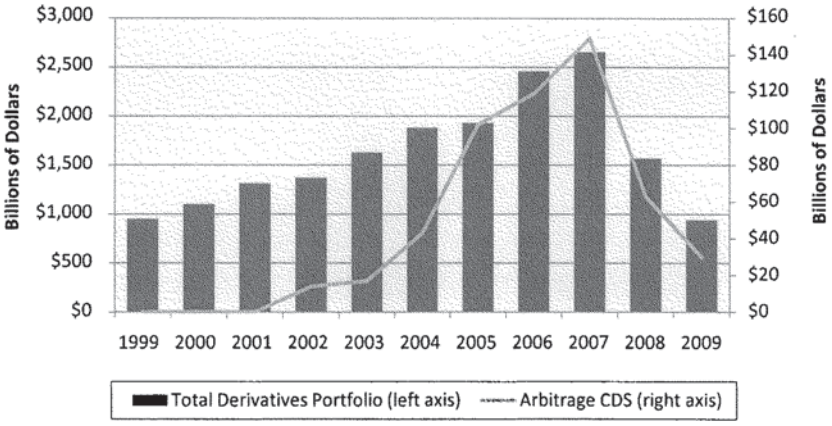
[44] Congressional Oversight Panel, Testimony of Jim Millstein, chief restructuring officer, U.S. Department of the Treasury, *COP Hearing on TARP and Other Assistance to AIG* (May 26, 2010) (hereinafter "Testimony of Jim Millstein").

[45] AIG Form 10–K for FY04, *supra* note 9, at 75, 93–4.

[46] AIG Form 10–K for FY07, *supra* note 41, at 122.

AIGFP's unrealized valuation losses in 2007 and 2008.[47] AIGFP's multi-sector CDO subset of the Arbitrage portfolio, which represented approximately 3 percent of the notional value of AIGFP's total credit and non-credit derivatives exposure, accounted for over 90 percent of these losses.[48] Ultimately, these losses were driven by just 125 of the roughly 44,000 contracts entered into by AIGFP.[49]

FIGURE 9: ARBITRAGE CDS PORTFOLIO VS. NET NOTIONAL AMOUNT OF AIGFP'S TOTAL DERIVATIVES PORTFOLIO[50]



Drilling down further, at the end of September 2008, the net notional amount of the multi-sector CDO book was $72 billion, or less than 20 percent, of AIGFP's total credit portfolio. Approximately $55 billion, or 77 percent, of the reference CDOs contained securities that included exposure to the U.S. subprime mortgage market.[51] Because AIGFP ceased underwriting new subprime multi-sector CDS in 2005 (after launching this product line in 2004), the majority of this portfolio was exposed to 2004 and 2005 subprime RMBS vintages.[52] However—and this is very important—the reference CDOs that AIG insured were not always static, and thus weaker, newer vintages infected older pools of securities as CDO managers adjusted portfolios.[53] Weil Gotshal, a law firm that rep-

[47] American International Group, Inc., *Form 10–K for the Fiscal Year Ended December 31, 2008*, at 116 (Mar. 2, 2009) (online at www.sec.gov/Archives/edgar/data/5272/000095012309003734/y74794e10vk.htm) (hereinafter "AIG Form 10–K for FY08").

[48] See Figure 36 in Section I.2(f) for an outline of the exposures and losses within AIGFP's credit portfolio, from 2008 to the first quarter of 2010.

[49] Testimony of Robert Benmosche, *supra* note 28.

[50] American International Group, Inc., *Form 10–K for the Fiscal Year Ended December 31, 2009*, at 130 (Feb. 26, 2010) (online at www.sec.gov/Archives/edgar/data/5272/000104746910001465/a2196553z10-k.htm) (hereinafter "AIG Form 10–K for FY09"); AIG Form 10–K for FY07, *supra* note 41, at 122.

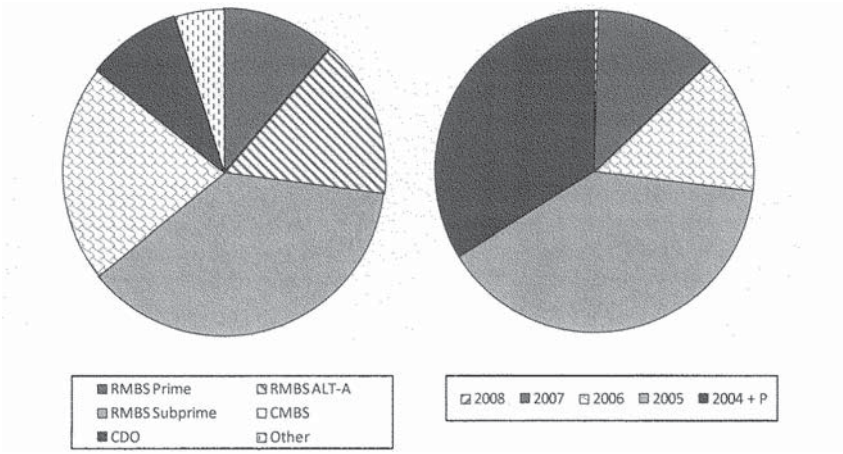
[51] AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 115–16.

[52] A handful of CDOs with subprime exposure, which were apparently committed to before AIG decided to exit this business, were underwritten in early 2006.

[53] AIG Form 10–K for FY07, *supra* note 41, at 122. Managed CDOs usually consist of a sponsor, collateral manager, and investors who buy tranches with various maturity and credit risk characteristics. The duration of a managed deal consists broadly of three phases in which managers: (1) invest proceeds from sale of CDO securities; (2) actively manage the collateral (as as-

resents AIG, states that AIG's Credit Risk Management was in fact aware that some of the 2004 to 2005 CDO portfolios were actively managed, but there is no further information to suggest that this featured prominently in the desk's understanding of this product's ongoing risk profile.[54] Ultimately, after considering these reinvestments (less than 10 percent of the portfolio) and non-subprime and CMBS deals closed in 2006 and 2007, approximately 26 percent of the overall multi-sector CDO book included the particularly toxic 2006 and 2007 vintages, of which 37 percent were exposed to subprime or Alt-A mortgages.

FIGURE 10: COMPOSITION AND VINTAGE OF AIGFP COLLATERAL SECURITIES IN THE MULTI-SECTOR CDO BOOK (SEPTEMBER 30, 2008)[55]



In exchange for regular payments, which functioned much like insurance premiums, AIGFP was obligated to provide credit protection on a designated portfolio of loans or debt securities. In general, protection on these assets—including residential mortgages, commercial real estate loans, corporate debt and European bank loan books—were structured so that AIGFP was in a second-loss position. This meant that losses on the reference securities would have to exceed a certain threshold (referred to as an "attachment point")[56] before triggering a credit event.[57] AIGFP offered protection on the "super senior" risk layer of these securities, a level that

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sets amortize) and reinvest the cash flows; (3) and hold the collateral until maturity as assets are sold off and investors are paid back. Managers tend to be financial institutions who specialize in "back office" transactions.

[54] Weil Gotshal conversation with Panel staff (May 24, 2010).

[55] AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 116.

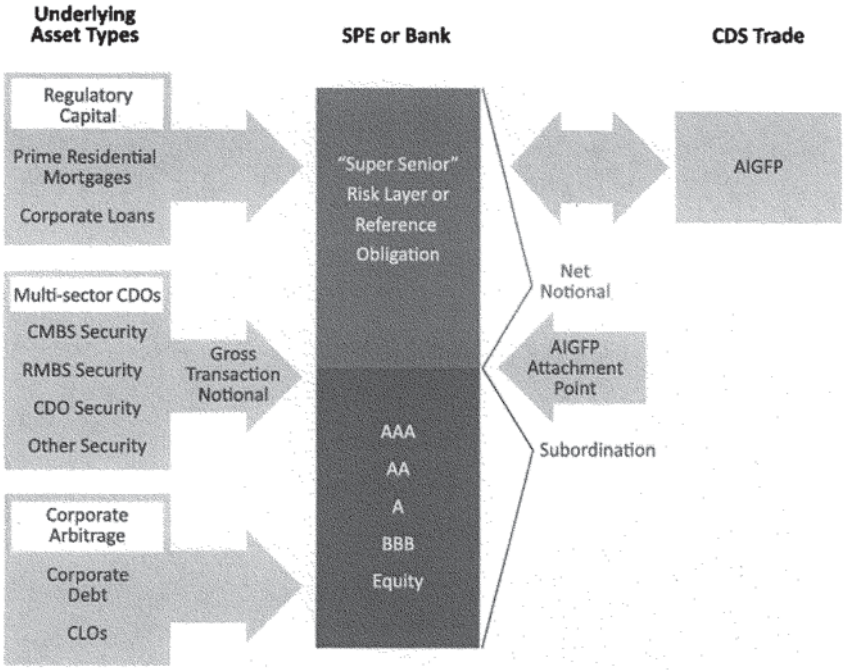
[56] Attachment points or subordination levels are described in more detail below, but in general, the higher the attachment point, the lower the level of credit risk (e.g., an attachment point of 20 percent indicates a cushion on the first 20 percent of bad debt exposure).

[57] *See* American International Group, Inc., *Form 10–Q for the Quarterly Period Ended September 30, 2009*, at 55 (Nov. 6, 2009) (online at www.sec.gov/Archives/edgar/data/5272/000104746909009659/a2195237z10-q.htm). AIGFP will incur credit losses only after a shortfall of principal and/or interest, or other credit events (in respect of the protected loans and debt securities) exceed a specified threshold amount or level of "first loss."

would absorb losses only after subordinate, including AAA-rated, tranches were impacted by a credit event.

Figure 11, below, illustrates how the super senior level of this protection was structured. (See Annex III for a more detailed discussion of the CDS market more generally and the nature of AIGFP's business.)

FIGURE 11: SUPER SENIOR RISK LAYER TRANSACTION EXAMPLE [58]



AIGFP's decision to cease underwriting new contracts on subprime multi-sector CDOs in December 2005 was not related to AIG's ratings downgrade from AAA that same year but rather reflected AIGFP's view that underwriting standards had deteriorated, according to Weil Gotshal, the counsel for AIGFP. This decision, though, which would otherwise appear to be a prudent reaction to changing market conditions, only impacted the intake mechanism, as no serious effort was made to reduce or hedge legacy exposures.[59] AIGFP and AIG continued to view the risk associated with these transactions as extraordinarily remote and did not take steps to reduce or significantly hedge legacy or new exposures.[60] In fact, as noted above, legacy positions on AIGFP's books would soon reflect the more problematic credit issues as older reference securi-

[58] AIG Form 10–K for FY09, *supra* note 50, at 132.

[59] Panel staff briefing with Weil Gotshal (May 12, 2010). According to Weil Gotshal, there was no evidence of any discussion about hedging or unwinding the CDS risk book at that time. Also according to Gotshal, at the time that AIGFP changed the criteria for CDS written on multi-sector CDOs, they did not hedge the portfolio. At some point in 2006 there were small hedges put in place, but never on a scale sufficient to hedge the $70 billion book.

[60] Panel staff briefing with Weil Gotshal (May 12, 2010).

ties were replaced with more suspect ones by CDO managers. Former AIG CEO Hank Greenberg has asserted publicly and in a conversation with Panel staff that the company should have exited the multi-sector CDO sector after AIG lost its AAA rating in March 2005, arguing that the economics and risks of this business changed with the ratings downgrade, since counterparties could contractually demand more collateral if the value of the CDOs began to deteriorate.[61] However, there does not appear to be any evidence that Mr. Greenberg advocated for such a position shortly after the downgrade, a period when he was no longer the CEO, but clearly a large shareholder with a unique perspective on the company.[62]

AIGFP continued to assume through the beginning of 2008 that the credit risk from its CDS portfolio was virtually non-existent given the super-senior credit ratings of the reference securities.[63] This stance was by no means unique to AIG, as other market participants, including Citigroup and Merrill Lynch, also placed undue faith in the credit ratings of these instruments. However, AIG's assertion is somewhat odd given that the company underwrote this risk on behalf of clients who clearly believed there was some risk in these instruments worth insuring.

The company, both in investor presentations and through its regulatory filings, continuously asserted that there was "no probable and reasonably estimable realized loss" in its CDS portfolio, based on its risk model's assessment of the credit profile and the ratings of the reference obligations.[64] Joseph Cassano, the head of AIGFP at the time, noted on the company's second quarter 2007 earnings call: "It is hard for us, without being flippant, to even see a scenario within any kind of realm or reason that would see us losing $1 in any of those transactions."[65] AIG's then-CEO, Martin Sullivan, asserted in an investor presentation in December of 2007 that because AIG's CDS business is "carefully underwritten and structured with very high attachment points to the multiples of expected losses, we believe the probability that it will sustain an economic loss is close to zero."[66] According to congressional testimony by the former chief financial officer of AIG Financial Services, Elias Habayeb, it was not until the summer of 2008 that AIG took action to reduce the size of its legacy exposures.[67]

While AIG's assessment of the underlying credit quality of the reference obligations may have been technically correct (as AIGFP did not experience a "credit loss" event until the end of 2008),[68]

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[61] Panel staff briefing with Maurice "Hank" Greenberg, former chief executive officer, AIG (May 13, 2010).

[62] Panel staff could find no evidence that Mr. Greenberg used his influence to push AIG to cease writing multi-sector CDS contracts in the period shortly after the firm lost its AAA-rating. *Fact Sheet on AIGFP,* E-mail from Boies, Schiller & Flexner LLP, counsel for former AIG CEO Maurice "Hank" Greenberg, to Panel staff (May 18, 2010).

[63] Panel staff briefing with Gerry Pasciucco, chief operating officer, AIGFP (Apr. 23, 2010).

[64] AIG Form 10–K for FY07, *supra* note 41, at 124.

[65] American International Group, Inc., *American International Group Q2 2007 Earnings Call Transcript* (Aug. 9, 2007) (online at seekingalpha.com/article/44048–american-international-group-q2-2007-earnings-call-transcript?source=bnet).

[66] American International Group, Inc., *American International Group Investor Meeting: Final Transcript*, at 5(Dec. 5, 2007).

[67] Written Testimony of Elias Habayeb, *supra* note 27, at 5.

[68] For CDS transactions requiring physical settlement, AIGFP's payment obligations were triggered by the occurrence of a "credit event" in respect to the reference obligation. All of

Continued

AIGFP's models failed to anticipate the consequences of declining market prices on the reference CDOs, as well as the attendant liquidity risks stemming from collateral calls from its CDS counterparties, and how these factors might impact the company's own credit rating (this dynamic is illustrated in greater detail below).[69] This of course became painfully evident as the subprime crisis deepened, decimating liquidity and valuations in the underlying reference mortgage markets. PricewaterhouseCoopers (PwC), AIG's external auditor, noted in 2007 that AIG did not maintain effective internal control over financial reporting due to a material weakness related to the valuation of the AIGFP super senior CDS portfolio.[70]

In the lead-up and during the initial phase of the subprime crisis, AIG was blinded by the limitations of its model, believing that valuations would ultimately align upwards with the underlying credit worthiness of the reference security. AIG's model overlooked the obligation and, therefore, the amount of collateral it could be required to post for its multi-sector CDS portfolio in the event of a meltdown of the markets for the underlying reference securities.

Accordingly, as the first collateral calls from trading counterparties began in the summer of 2007, the firm stood behind its models, arguing that valuations were temporarily distorted by the absence of liquidity in the market, which prevented the emergence of benchmark pricing. A battle of the models ensued between AIG and its counterparties, resulting in protracted discussions on valuations and corresponding collateral obligations.[71] Despite the uncertainty, AIGFP was generally able to resolve valuation differences and negotiate the collateral amounts with the counterparties.[72]

While one-off negotiations were manageable, increased demands by counterparties ultimately left AIG with little room to maneuver, given the risks of being perceived as unwilling or unable to honor its obligations in the market, which could conceivably impact the firm's ability to secure funding.[73] However, as the crisis deepened in 2007, rating agencies began to downgrade several of the referenced multi-sector CDOs,[74] and prominent market participants, particularly Citigroup and Merrill Lynch, began to report losses in their CDS portfolios.[75]

AIGFP's CDS transactions requiring physical settlement define a "credit event" as a "failure to pay," which is generally triggered by the failure of the issuer of the reference CDO to make a payment under the reference obligation. AIGFP experienced its first loss arising from a "credit event" in the fourth quarter of 2008 in the amount of $15 million. AIG Form 10–K for FY08, *supra* note 47, at 141, 168.

[69] AIG Form 10–K for FY07, *supra* note 41, at 124.

[70] AIG Form 10–K for FY07, *supra* note 41, at 202. See Section B(4)(a) (Risk Management) for a further discussion of PwC's audit findings.

[71] Panel staff briefing with Weil Gotshal (May 12, 2010).

[72] AIG Form 10–K for FY07, *supra* note 41, at 124.

[73] Panel staff briefing with Weil Gotshal (May 12, 2010).

[74] AIG Form 10–K for FY07, *supra* note 41, at 33.

[75] In 2007, Citigroup and Merrill Lynch reported unrealized losses on their subprime CDO portfolios in the amount of approximately $18 billion and $17 billion, respectively. *See* Citigroup, *Form 10–K for the Fiscal Year Ended December 31, 2007*, at 48 (Feb. 2, 2008) (online at www.sec.gov/Archives/edgar/data/831001/000119312508036445/d10k.htm); Merrill Lynch, *Form 10–K for the Fiscal Year Ended December 28, 2007*, at 37 (Feb. 25, 2008) (online at www.sec.gov/Archives/edgar/data/65100/000095012308002050/y46644e10vk.htm). The ratings agencies responded to the news of the large losses and substantial exposures to subprime-related assets (especially CDOs) by downgrading the ratings of both companies. Fitch Ratings, *Fitch Global Corporate Rating Activity: Credit Quality Takes Negative Turn in 2007*, at 4 (Mar. 6, 2008) (online at www.fitchratings.com/creditdesk/reports/report__frame.cfm?rpt__id=375822); Standard

These events changed the equation.[76] The amount of collateral AIG was required to post for CDS contracts was a function of AIG's credit ratings, the rating of the reference multi-sector CDO, and the market value of the reference obligations.[77] While market conditions remained similarly illiquid, ratings downgrades on the reference securities and valuation losses by market participants helped establish two of the three primary triggers for collateral payments, making it more difficult for AIG to continue to hide behind its models. As a result, in 2007 AIG recognized an unrealized market valuation loss totaling $11.25 billion, which primarily occurred in the fourth quarter of 2007.[78]

As the value of the underlying CDOs continued to decline thereafter, AIG—under mark-to-market accounting standards—recorded valuation allowances on its contracts. While these losses were in almost all cases unrealized non-cash valuation charges, they corresponded with collateral calls from AIG's counterparties, which contributed to a drain on AIG's cash resources.[79]

Predictably, valuation write-downs into the billions of dollars and collateral calls from CDS counterparties intensified pressure on AIG's own credit rating, the third key component in the collateral calculation cocktail. Subsequent downgrades of AIG's credit rating in turn precipitated additional collateral calls.[80] This negative feedback loop, illustrated below in Figure 12, eventually exposed the firm's reckless securities lending business, as AIG was unable to meet the cash calls from jittery trading partners worried about the company's CDO exposure. And finally, according to one AIG execu-

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and Poor's, *Research Update: Merrill Lynch & Co. Inc. Ratings Lowered To 'A/A–1' From A+/A–1'*, at 3 (June 2, 2008) (online at www2.standardandpoors.com/spf/pdf/events/fiart66308.pdf).

[76] In accordance with the adoption of FAS 155 as of January 1, 2006 ("Accounting for Certain Hybrid Financial Instruments—an amendment of FAS 140 and FAS 133"), AIGFP began to record its credit default swap portfolio according to its fair market value, which resulted in a write-down of $11.5 billion in 2007. AIGFP used a complex model, which relied on numerous assumptions, to estimate the fair value of its super senior credit default swap portfolio. "The most significant assumption utilized in developing the estimate is the pricing of the securities within the CDO collateral pools. If the actual pricing of the securities within the collateral pools differs from the pricing used in estimating the fair value of the super senior credit default swap portfolio, there is potential for significant variation in the fair value estimate." AIG Form 10–K for FY07, *supra* note 41, at 123, 145.

[77] AIG Form 10–K for FY09, *supra* note 50, at 148. See Annex III.B for an explanation of collateral calls.

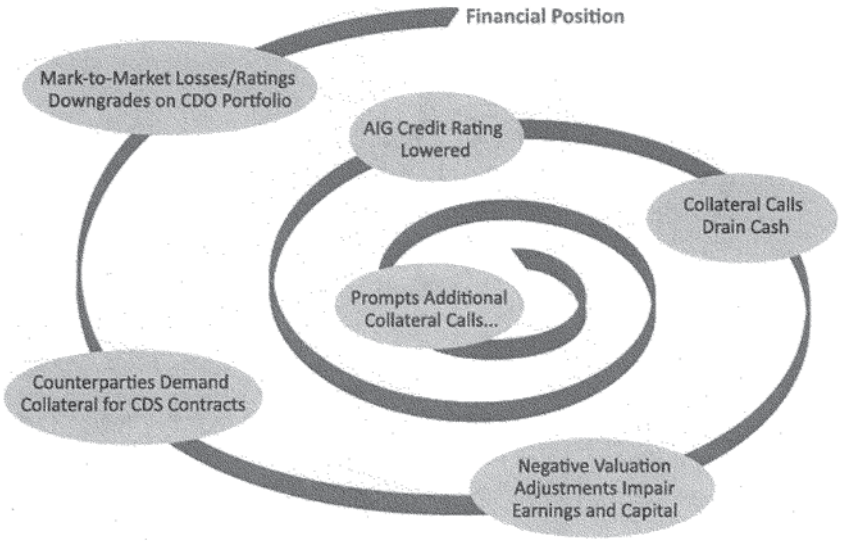
[78] AIG Form 10–K for FY07, *supra* note 41, at 34; American International Group, Inc., *Conference Call Credit Presentation: Financial Results for the Year Ended December 31, 2007*, at 8, 15 (Feb. 29, 2008) (online at media.corporate-ir.net/media_files/irol/76/76115/Conference_Call_Credit_Presentation_031408_revised.pdf) (hereinafter "AIG Financial Results Conference Call—2007"). The large loss was a consequence of the economic downturn and credit deterioration, particularly in U.S. sub-prime mortgages. The unrealized market valuation loss of $11.25 billion significantly exceeded AIG's estimates of the realizable portfolio loss under a "severe" scenario.

[79] See Annex III.B for a more detailed discussion of the nature of the collateral rights AIG issued under CDS contracts.

[80] On March 30, 2005 S&P downgraded AIG's rating from 'AAA' to 'AA+' because of its concern over AIG's internal controls, especially regarding its financial transactions. S&P again lowered the rating to 'AA' in June 2005 based on AIG's significant accounting adjustments. In February 2008, S&P placed a negative outlook on AIG's credit rating because of concerns as to how AIG valued it CDS portfolio. The credit rating was again downgraded in May 2008 to 'AA-' based in large part on the $5.9 billion loss on its CDS portfolio. As the crisis in the financial markets escalated in September 2008, S&P became more concerned with AIG's financial condition. The final nail in the coffin occurred on September 15, 2008 when S&P lowered AIG's rating to 'A-.' Congressional Oversight Panel, Written Testimony of Rodney Clark, managing director of ratings services, Standard & Poor's Financial Services, *COP Hearing on TARP and Other Assistance to AIG,* at 3–5 (May 26, 2010) (online at cop.senate.gov/documents/testimony-052610-clark.pdf) (hereinafter "Written Testimony of Rodney Clark").

tive, as the crisis peaked toward mid-September 2008, counterparties who owed AIG cash were "sitting on their hands."[81]

FIGURE 12: ILLUSTRATION OF NEGATIVE FEEDBACK LOOP



The demand for collateral calls accelerated in 2008 as a result of the rapid deterioration of its multi-sector CDS portfolio. In the first and second quarters of 2008, AIG scrambled to post $20.8 billion in cash to meet its collateral obligations for this portfolio.[82] In the third quarter of 2008 (ending September 30, 2008), AIG had posted approximately $31.5 billion in collateral as a result of the deterioration in value of its multi-sector CDO portfolio.[83]

Collateral calls stemming from AIGFP's other CDS portfolios were, in comparison, immaterial.[84] However, the liquidity drain from the multi-sector portfolio accelerated demands by the firm's securities lending counterparties for the return of their cash collateral (discussed in more detail in Section B.3(b) below). Unable to access private capital to meet collateral calls stemming from its CDS book and securities lending activities, AIG's liquidity crisis deepened against a deteriorating market backdrop that saw the firm report unrealized mark-to-market valuation losses on its multi-sector CDS book that totaled just under $40 billion as of the end of 2008.[85]

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[81] Panel staff conversation with former AIG executive.

[82] AIG Form 10–K for FY08, *supra* note 47, at 146. AIG posted approximately $7 billion in cash collateral as of March 2008 and approximately $13 billion in cash collateral as of June 2008.

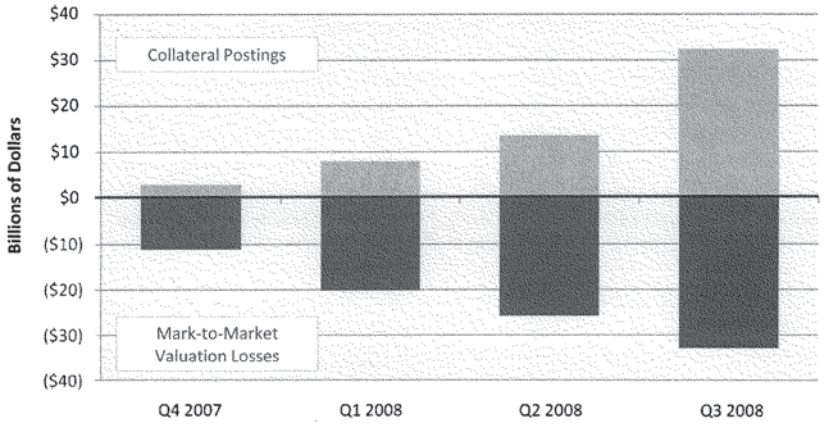
[83] AIG Form 10–K for FY08, *supra* note 47, at 68, 146. AIGFP surrendered $35 billion of collateral previously posted in connection with ML3, which terminated $62.1 billion net notional amount of multi-sector CDS. For an in-depth discussion of ML3, see Section D.3.

[84] By the end of 2008, collateral postings for the corporate arbitrage portfolio totaled $2.3 billion, whereas collateral postings for AIGFP's regulatory capital portfolio totaled $1.3 billion. AIG Form 10–K for FY08, *supra* note 47, at 146.

[85] Panel staff briefing with Weil Gotshal (May 12, 2010).

Figure 13, below, outlines the growing demand for additional cash collateral from AIGFP's multi-sector CDO counterparties as the value of the underlying contracts (and the market's perception of AIG as a reliable counterparty) deteriorated. By the end of September 2008 AIG recorded cumulative unrealized market valuation losses over the prior two years of $33 billion on this portfolio. This coincided with posted collateral of $32 billion, which represented 44 percent of the notional value of the multi-sector CDS portfolio at the time.[86]

FIGURE 13: COUNTERPARTY COLLATERAL DEMANDS VS. MARK-TO-MARKET LOSSES ON MULTI-SECTOR CDO PORTFOLIO



While the multi-sector CDS portfolio was the primary trigger for market concerns regarding AIGFP's exposure to the deteriorating mortgage market, the potential termination of AIG's largest credit book, the regulatory capital portfolio, from a bankruptcy filing had the potential to cause significant problems for numerous European banks.

The regulatory capital swaps allowed financial institutions that bought credit protection from AIGFP to hold less capital than they would otherwise have been required to hold by regulators against pools of residential mortgages and corporate loans. A hypothetical example helps illustrate how this worked. According to the international rules established under Basel I,[87] which generally applied

[86] AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 114; AIG Form 10–K for FY08, *supra* note 47, at 146. AIG's collateral on this portfolio ultimately reached $37 billion as of November 5, 2008. Congressional Oversight Panel, Testimony of Timothy F. Geithner, secretary, U.S. Department of the Treasury, *COP Hearing with Treasury Secretary Timothy F. Geithner*, at 79 (Dec. 10, 2009) (online at cop.senate.gov/documents/transcript-121009-geithner.pdf) (hereinafter "COP Hearing with Secretary Geithner").

[87] Basel I was introduced in July 1988 and was described as an attempt to "secure international convergence of supervisory regulations governing the capital adequacy of international banks." Bank for International Settlements, *International Convergence of Capital Measurement and Capital Standards,* at 1 (July 1988) (online at www.bis.org/publ/bcbsc111.pdf). The committee that constructed Basel II intended the majority of the framework which it set out to be accessible for implementation as of the completion of 2006, while the most complex approaches would be made available at the completion of 2007. Basel II sought to separate credit risk from operational risk and align economic and regulatory capital more directly. Bank for International

Continued

to European banks prior to AIG's collapse, a bank that held an unhedged pool of loans valued at $1 billion might be required to set aside $80 million, or 8 percent of the pool's value. But if the bank split the pool of loans, so that the first losses were absorbed by an $80 million junior tranche, and AIGFP provided credit protection on the $920 million senior tranche, the bank could significantly reduce the amount of capital it had to set aside.[88] Importantly, AIG's regulatory capital swaps were sold by an AIGFP subsidiary called Banque AIG, which was a French-regulated bank.[89] Under Basel I, claims on banks such as Banque AIG were assigned a lower risk weighting in the calculation of required capital reserves than the loans for which the counterparties were buying credit protection would have been assigned.[90] This formula worked to the advantage of the counterparties, which could then use some of their regulatory capital savings to pay for the credit protection from AIGFP, and could use the remaining amount to make more loans, increasing their own leverage and risk. Because these swaps allowed banks to take on greater risk by shifting their liabilities to AIGFP, former AIG CEO Edward Liddy has referred to the deals as a "balance sheet rental."[91]

This business grew to become the largest portion of AIGFP's CDS exposure, reflecting the demand for regulatory capital savings among European banks.[92] As of the end of 2007, AIGFP's notional exposure on these swaps was $379 billion, or about 72 percent of its notional exposure on its entire super senior CDS portfolio.[93] But these swaps were not one of the key reasons that AIG was on the verge of filing for bankruptcy on September 16, 2008; AIG's collateral payments to these counterparties totaled less than $500 million at the time,[94] an amount far lower than had been paid under AIG's multi-sector CDO swaps. This disparity may have been due in part to differences in the value of the underlying assets, as well as differences in the way the swap contracts were structured. Nonetheless, in September 2008, AIGFP's regulatory capital swaps were a source of concern at FRBNY because of the potential consequences that an AIG bankruptcy would have had on the capital

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Settlements, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework,* at 1–5 (Nov. 2005) (online at bis.org/publ/bcbs118.pdf).

[88] *See* Jeffrey Rosenberg, *Toward a Clear Understanding of the Systemic Risks of Large Institutions,* 5 Journal of Credit Risk, No. 2, at 77 (Summer 2009).

[89] Banque AIG entered into back-to-back contracts with AIGFP, which thus bore the ultimate risk of the transaction.

[90] *See* Houman B. Shadab, *Guilty By Association? Regulating Credit Default Swaps,* 4 Entrepreneurial Business Law Journal, No. 2, at 448, fn 199 (2010) (online at ssrn.com/abstract=1368026); U.S. Government Accountability Office, *Risk-Based Capital: Bank Regulators Need to Improve Transparency and Overcome Impediments to Implementing the Proposed Basel II Framework,* at 15 (Feb. 2007) (GAO–07–253) (online at www.gao.gov/new.items/d07253.pdf).

[91] House Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Testimony of Edward Liddy, chief executive officer, American International Group, Inc., *American International Group's Impact on the Global Economy: Before, During, and After Federal Intervention,* at 63–64 (Mar. 18, 2009) (online at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111__house__hearings&docid=f:48868.pdf) (hereinafter "Testimony of Edward Liddy").

[92] American International Group, Inc., *AIG: Is the Risk Systemic?*, at 18 (Mar. 6, 2009) (hereinafter "AIG Presentation on Systemic Risk").

[93] AIG Form 10–K for FY07, *supra* note 41, at 33.

[94] AIG Form 10–K for FY08, *supra* note 47, at 146.

structures of the European banks that had bought credit protection from AIG.[95]

b. Securities Lending

AIG's aggressive expansion of its securities lending business, which is generally a low-risk and mundane financing operation on Wall Street, ramped up the company's exposure to the subprime mortgage market in late 2005.[96] Ironically, this business's growth and investment strategy coincided with the time period that AIGFP stopped writing CDS on subprime-related CDOs. Subsequently, after the government bailout and the creation of ML2, AIG unwound this business.[97]

Apart from its risk profile, the mechanics of AIG's securities lending program functioned in a similar fashion to those used by custody firms and long-term asset managers. AIG lent out securities owned by participating insurance subsidiaries in exchange for cash collateral.[98] Several of AIG's life insurance subsidiaries participated in the securities lending program, which essentially aggregated the securities lending (and collateral investment) operations of these subsidiaries. These subsidiaries entered into securities lending agreements with an affiliated lending agent (AIG Securities Lending Corp.) that authorized the agent to lend their securities to a list of authorized borrowers (primarily major banks and brokerage firms) on their behalf or for their benefit. This effectively centralized investment decisions related to securities lending collateral within AIG's asset management operations group, and away from the individual life insurance subsidiaries.[99] By appointing an affiliated agent to manage the securities lending program, the subsidiaries provided AIG's asset management operations group with some measure of control of the securities lending program.

Securities lending normally provides a low-risk way for insurance companies to earn modest sums of money on assets that would otherwise be sitting idle.[100] AIG's program, however, was unusual in two ways.

The first difference, alluded to above, involves the degree of risk that AIG took when it invested the cash collateral it received. Because securities lending agreements allow the counterparties to require the lender to return their cash collateral at any time, the cash collateral is normally invested in liquid securities, such as short-term Treasury bonds, or kept in cash to meet laddered collateral demands that range from overnight to roughly three months

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[95] E-mail from Alejandro LaTorre to Timothy Geithner and other Federal Reserve Bank of New York officials (Sept, 14, 2008) (FRBNYAIG00496). See Section F(1)(b)(iv) for a more detailed discussion of the potential impact of AIG failure on European banks.

[96] Memorandum from Kevin B. McGinn to AIG Credit Risk Committee, AIGGIG Global Securities Lending (GSL) Cash Collateral Investment Policy (Dec. 20. 2005).

[97] AIG Form 10–K for FY08, *supra* note 47, at 251.

[98] See Annex V for a more detailed discussion of the mechanics of securities lending.

[99] *See, e.g.*, SunAmerica Annuity and Life Assurance Company, *Annual Statement for the Year 2009*, at 19.1, 19.18 (Dec. 31, 2009) (hereinafter "SunAmerica 2009 Annual Statement"). The program was managed by an affiliated lending agent (AIG Securities Lending Corp.) and an affiliated investment advisor (e.g., AIG Institutional Asset Management). AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 104, 143–44.

[100] See Annex V for a full discussion of securities lending.

in maturity.[101] Beginning in late 2005, however, AIG used some of this collateral to buy RMBS, with the intention of maximizing its returns.[102] At the height of AIG's securities lending program in 2007, the U.S. pool held $76 billion in invested liabilities, 60 percent of which were RMBS.[103]

Additionally, while AIG management has asserted that it began to reduce the size of the securities lending program in the fourth quarter of 2007, AIG CFO David Herzog, who was controller at the time of the rescue, noted that these efforts were primarily motivated by a goal of reducing the large relative size of this business to the firm's overall balance sheet. He believed that addressing the increasingly illiquid nature of the investments made with the collateral was a byproduct of those efforts, but not the sole focus.[104] This effort was either tentative or was unduly complicated by market conditions. In any case, there is little evidence that the effort was accompanied by any meaningful reduction in the proportion of securities lending collateral held in RMBS, which posed a graver risk to the firm than the program's absolute size relative to AIG's balance sheet.

In contrast to Herzog's statements, the state insurance regulators say that in mid-2007, when they discovered the RMBS securities in the securities lending program, they were concerned about the concentration of the investments, which ultimately experienced liquidity issues. The regulators began to work closely with AIG to address regulatory concerns. In order to respond to those concerns, AIG developed a plan to wind down the program and enact a plan to increase the liquidity of the pool.[105] This plan was for a gradual wind-down of the program, aimed at avoiding realized losses to the collateral pool from the sale of impaired securities.[106] It included guarantees by the AIG parent company against realized losses in the pool of up to $5 billion.[107]

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[101] Panel and staff briefing with AIG CFO David Herzog, chief financial officer, AIG (May 17, 2010).

[102] *See* AIG Form 10–K for FY08, *supra* note 47, at 40 ("Under AIG's securities lending program, cash collateral was received from borrowers in exchange for loans of securities owned by AIG's insurance company subsidiaries. The cash was invested by AIG in fixed income securities, primarily residential mortgage-backed securities (RMBS), to earn a spread").

[103] Congressional Oversight Panel, Written Testimony of Michael Moriarty, deputy superintendent for property and casualty markets, New York State Insurance Department, *COP Hearing on TARP and Other Assistance to AIG,* at 4 (May 26, 2010) (online at cop.senate.gov/documents/testimony-052610-moriarty.pdf) (hereinafter "Written Testimony of Michael Moriarty"). See Section B.6, *supra*, for a discussion of the insurance regulators' insistence on the dismantling of the securities lending pool.

[104] Panel and staff briefing with AIG CFO David Herzog (May 17, 2010). As of December 2007, Securities Lending assets and liabilities represented 7 percent and 8.5 percent, respectively, of AIG's total balance sheet. AIG Form 10–K for FY07, *supra* note 41, at 130–31.

[105] Panel staff conversation with Texas Department of Insurance (May 24, 2010).

[106] Panel call with Texas Department of Insurance (May 24, 2010). *See also* AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 43 ("During the second quarter of 2008, AIG made certain revisions to the American International Group, Inc. (as Guarantor) Condensed Statement of Cash Flows, primarily relating to the effect of reclassifying certain intercompany and securities lending balances"); *Id.* at 49 ("AIG parent also deposited amounts into the collateral pool to offset losses realized by the pool in connection with sales of impaired securities"); Senate Committee on Banking, Housing, and Urban Affairs, Written Testimony of Eric Dinallo, superintendent, New York State Insurance Department, *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation,* at 6 (Mar. 5, 2009) (online at banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=8ee655c8-2aed-4d4b-b36f-0ae0ae5e5863).

[107] The size of the guarantee grew over time. In fall of 2007, AIG had itself implemented a guarantee for up to $500 million of realized losses. In order to respond to regulatory concerns, AIG increased the guarantee to $1 billion on May 1, 2008 and then $5 billion on June 17, 2008. The insurance regulators were mindful of liquidity pressures at the parent. At the insurance regulators' quarterly meeting with AIG management in August 2008, they asked holding com-

While these RMBS were AAA-rated at the time AIG purchased them, as the mortgage crisis deepened, the ratings of the securities likewise deteriorated, along with liquidity in the underlying market. So while AIG's counterparties could request a return of their cash collateral with little notice, AIG had invested the money in securities that were increasingly illiquid after housing prices began to fall in 2006. This duration mismatch represented an overly aggressive foray into outright speculation, or a misreading of the risks associated with subprime RMBS, or both.[108]

The second reason that AIG's securities lending program was riskier than other such programs stemmed from payments the AIG parent company made to the insurance subsidiaries that owned the securities that had been lent out. In normal circumstances, securities lending counterparties would be required to post collateral of 100 to 102 percent of the market value of the securities they borrowed, as specified by state insurance regulators.[109] But when unregulated companies started to lend securities under terms that included lower collateral requirements, AIG determined that lower collateral amounts were necessary to compete in the market, with the AIG parent company making up the difference and posting the collateral deficit up to 100 percent.[110]

As the subprime crisis deepened, and investors grew worried about AIG's solvency (initially owing to its CDS portfolio), counterparties to securities lending transactions sought to ring-fence their duration exposure to AIG. They did this initially by shortening the length of their exposure to AIG—for example, from 90-day or 30-day liabilities to 3-day or overnight ones—before ultimately opting to close out their exposure, demanding the return of their cash collateral in exchange for the securities they had borrowed. Between September 12 and September 30, 2008 securities lending counterparties demanded that AIG return approximately $24 billion in cash.[111] This proved difficult for AIG to do, as losses on the RMBS in the context of an increasingly illiquid market required AIG to look elsewhere for the cash, creating yet another drain on the par-

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pany management to come to the next meeting prepared to discuss liquidity at the holding company level. Panel staff conversation with NAIC (Apr. 27, 2010).

[108] It is important to realize that, since AIG was both insuring RMBS through their sale of CDS and also purchasing RMBS through their investment of securities lending collateral, in order to assess the risk to the company, one would need to know how these products moved together, or co-varied. And, since AIG did not fully grasp the details of the securities underlying the CDS, it would be almost impossible to estimate the covariance, and therefore truly understand the risk they were facing in their aggregate exposures across AIGFP and the company's securities lending activities.

[109] *See* National Association of Insurance Commissioners Model Laws, 280–1, § 16(E).

[110] Panel call with Texas Department of Insurance (May 24, 2010); *see* AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 49 ("Historically, AIG had received cash collateral from borrowers of 100–102 percent of the value of the loaned securities. In light of more favorable terms offered by other lenders of securities, AIG accepted cash advanced by borrowers of less than the 102 percent historically required by insurance regulators. Under an agreement with its insurance company subsidiaries participating in the securities lending program, AIG parent deposited collateral in an amount sufficient to address the deficit"); *see also* SunAmerica 2009 Annual Statement, *supra* note 99, at 19.1 ("The Company's lending agent received primarily cash collateral in an amount in excess of the market value of the securities loaned. Such collateral was held by the lending agent for the benefit of the Company and [was] not available for the general use of the Company. Since the collateral was restricted, it was not reflected in the Company's balance sheet as an asset and offsetting liability"). This restricted collateral could be used to pay the securities lending counterparties or reinvested. Had the AIG parent filed for bankruptcy, the subsidiaries would have had access to the collateral in order to pay the counterparties.

[111] Written Testimony of Michael Moriarty, *supra* note 103, at 4.

ent company's liquidity.[112] The situation was further complicated by AIG's aforementioned subsidization of below-market terms to its securities borrowers, as the company, in desperate need for cash, began to accept collateral in some cases as low as 90 percent of the value of the securities borrowed.[113] By the end of August 2008, AIG had provided $3.3 billion, in the form of financing terms and investment sales, to its insurance subsidiaries to help plug the shortfall.[114]

The insurance regulators have asserted that the securities lending program alone would not have caused the insolvency of the insurance subsidiaries. This assumes, however, a situation in which the problems at AIGFP did not exist. New York Deputy Insurance Superintendent Michael Moriarty wrote in his testimony to the Panel: "Certainly, there would have been losses, with some companies hurt more than others. But we believe that there would have been sufficient assets in the companies and in the parent to maintain the solvency of all the companies."[115] The existence of "sufficient assets . . . in the parent" assumes that these assets were not needed for AIGFP—a big assumption.[116]

4. Other Problematic Aspects of AIG's Financial Position and Performance

While the primary causes of AIG's distress were the collateral calls relating to its CDSs and securities lending program, it appears that other aspects of the company—both conventional and unconventional—may have amplified its problems, and made it more difficult to assess AIG's true financial position. Accounting, risk management, technology, financial controls and—ultimately—company leadership contributed to the problems that would engulf AIG.

a. Risk Management

The accounting treatment for AIGFP's CDSs on CDOs did not necessarily encourage hard questions about their risk. Given the perceived credit strength of the super senior tranches of the CDOs, which put holders at the front of the line in terms of cash flows, AIG (and many others in the marketplace) viewed the risk as remote, similar to catastrophic risk, and did not incur any capital charges on its balance sheet when it booked the initial transactions. This encouraged both underpricing and a large appetite for these products. And, as discussed above in Section B.3(a), this adherence to a limited risk model led the firm to overlook the potential consequences of protracted liquidity risk, and the consequent mark-to-market valuation losses on CDS exposure, as well as the liquidity constraints from collateral calls.

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[112] While specific data for mid-September 2008 is not available, as of September 30, 2008, the fair value of the approximately $40 billion RMBS portfolio in AIG's securities lending program was approximately $23.5 billion. AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 52.

[113] Panel staff briefing with David Herzog, chief financial officer, AIG (May 17, 2010).

[114] AIG Form 10–K for FY08, *supra* note 47, at 3.

[115] Written Testimony of Michael Moriarty, *supra* note 103, at 5.

[116] The New York Insurance Department has subsequently stated that there would have been sufficient capital and assets within the subsidiaries to resolve the securities lending issue without assistance from the parent. Panel staff conversation with New York Insurance Department (June 3, 2010).

As noted earlier, in 2007 AIG reported a material weakness in its internal oversight and monitoring of the financial reporting related to the valuation of the AIGFP CDS portfolio. AIG did not have sufficient resources to design and carry out effective controls over the valuation model, which hindered its ability to adequately assess the relevance of third party information to the model inputs in a timely manner.[117] Changes to fair value accounting standards and the contraction in the CDS market driven by deteriorating credit conditions necessitated the development of a valuation model to estimate the fair value of the portfolio as actual market data was no longer readily available, and created a need for human resources and processes that AIG was ultimately unable to address quickly enough to ensure reliable valuation results.[118] Information sharing at appropriate levels, especially between AIG and AIGFP, was also not effective in regards to the CDS portfolio valuation, exacerbating the problems inherent with the model's lack of comprehensive data inputs and preventing them from being detected and escalated.[119] As a result of its lax oversight, AIG failed to detect inaccuracies in AIGFP's fair value estimates of its super senior CDS portfolio.[120]

This followed other accounting issues noted by AIG and PwC in the course of the 2004 audit[121] and uncovered by former New York Attorney General Eliot Spitzer and former New York State Insurance Superintendent Howard Mills, who filed a civil lawsuit on May 26, 2005 against AIG, AIG's former chairman Maurice Greenberg, and AIG's former chief financial officer Howard Smith, charging them with manipulating AIG's financial statements.[122] In January 2006, AIG entered into a settlement agreement with the New

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[117] AIG Form 10–K for FY07, *supra* note 41, at 202.

[118] This period also coincided with the elimination of EITF 02–03 and the implementation of FAS 157's market valuation requirements.

[119] AIG Form 10–K for FY07, *supra* note 41, at 202.

[120] AIG revealed weaknesses in its oversight and monitoring of AIGFP's valuation process for its super senior credit default swap portfolio, including the timely sharing of information with AIG and AIG's internal risk control groups. "As a result, controls over the AIGFP super senior credit default swap portfolio valuation process and oversight thereof were not adequate to prevent or detect misstatements in the accuracy of management's fair value estimates and disclosures on a timely basis, resulting in adjustments for purposes of AIG's December 31, 2007 consolidated financial statements. In addition, this deficiency could result in a misstatement in management's fair value estimates or disclosures that could be material to AIG's annual or interim consolidated financial statements that would not be prevented or detected on a timely basis." AIG Form 10–K for FY07, *supra* note 41, at 202. The revelations regarding AIG's lax oversight of AIGFP led S&P to place AIG on negative outlook in February 2008. Written Testimony of Rodney Clark, *supra* note 80, at 4.

[121] For the fiscal year 2004, AIG noted five material weaknesses in its financial statements related to the following: control environment, controls over balance sheet reconciliations, controls over accounting for certain derivative transactions/FAS 133 implementation, controls over the evaluation of risk transfer/reinsurance, and controls over income tax accounting. AIG Form 10–K for FY04, *supra* note 9, at 99.

[122] Plaintiffs' Complaint, 2–4, *People* v. *American International Group, Inc*., N.Y. App. Div. (May 26, 2005) (No. 401720–2005) (online at www.ag.ny.gov/media_center/2005/may/Summons%20and%20Complaint.pdf). In 2005 problems with AIG's reinsurance division led to an investigation by the Securities and Exchange Commission, the New York Attorney General, the New York State Insurance Department, and the Justice Department as to "whether reinsurance companies controlled by AIG were treated as separate entities in order to help hide AIG's exposure to risk; whether reinsurance transactions are tantamount to loans that should have been so listed; whether assets and liabilities were swapped to smooth earnings; and, finally, whether AIG used finite reinsurance to smooth earnings." The reinsurance revelations contributed to the rating agencies' downgrade of the credit rating of AIG in 2005, AIG's amendment of its 2005 10–K filing, and Mr. Greenberg's departure as chairman and CEO of AIG.

York Attorney General in which AIG made payments totaling $1.6 billion in restitution and penalties.[123]

While the problems at AIGFP can be viewed as a valuation and risk management failure, exacerbated by accounting issues, the life insurance subsidiaries' securities lending business was a blatant risk-management failure. The decision to invest cash collateral from the firm's securities lending customers in RMBS represented a misjudgment of the volatility and liquidity risks in the mortgage market. It was the duration mismatch on these investments—in the context of the collapse in the mortgage market—that created a liquidity crunch for the parent company. The situation was exacerbated by the cross-funding arrangements throughout the firm, which complicated the relationship between AIG's subsidiaries and the parent company. In addition, the life insurance subsidiaries were ramping up the purchases of RMBS at the same time that AIGFP had decided to stop writing swaps on subprime mortgage backed securities because of the riskiness of the underlying bonds, highlighting the failure of enterprise risk management at the company.

b. Technology

An additional factor which may have contributed to AIG's financial troubles was shortfalls in its technological infrastructure. AIGFP Chief Operating Officer Gerry Pasciucco, who joined the division in the aftermath of government assistance, asserts that the unit's technology and infrastructure—which he described as similar to that of a fast-growing hedge fund, but with few deficiencies that would rise above the "annoyance" level—did not contribute to the valuation and risk management challenges that engulfed AIG. Rather than the models or the technology, Mr. Pasciucco believes the inputs and the assumptions underlying those inputs were the source of the problem.[124]

That said, while the systems *within* the individual businesses may have been adequate, discussions with several market observers point to *systemic* technology issues that may have prevented AIG from adequately measuring its aggregate risk exposures and inter-connections. In this context, it may have been difficult for management and regulators to see the whole picture across AIG's vast, interconnected business operations.

c. Reserves

Insurance companies report reserve estimates for both GAAP and statutory reporting purposes, and due to inherent differences in reserve requirements for each, the two estimates often differ. Statutory reserves must be maintained at levels required by state insurance regulators, while GAAP reserves must meet the reserve estimate methodology required for financial statement reporting. Insurance reserve estimate methodology under GAAP employs assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the

[123] Attorney General of the State of New York, *Agreement Between the Attorney General of the State of New York and American International Group, Inc. and Its Subsidiaries,* at 12–19 (Jan. 18, 2006) (online at www.ag.ny.gov/media__center/2006/feb/signedSettlement.pdf).

[124] Panel staff conversation with Gerry Pasciucco (Apr. 23, 2010).

time of initial contract with adjustments to the assumptions made over time.[125] As with any assumptions, the degree of subjectivity and flexibility allows for a wide range of reserve results of which AIG has historically chosen the lower end. Some market observers believe that the company has had a deliberate and consistent policy of slightly underreserving in a manner that is not material to any one subsidiary, but is material on a consolidated basis at the parent.[126] The regulators review life reserves on a legal entity basis and P&C reserves on a pooled basis, but do not perform a group-wide consolidated review of life reserves.[127] Similarly, the ratings agencies that rate insurance subsidiaries do not look at all subsidiaries on a consolidated basis; but they do a consolidated evaluation of all subsidiaries of a particular group (life, property & casualty).[128] Fitch placed AIG on Ratings Watch Negative after it took a $1.8 billion after tax reserve charge in the P&C operations in 2003.[129] In addition, AIG is required to include in its annual report with the SEC a reestimate of its insurance reserves over a 10-year period.[130] The insurance reserves reestimate is calculated based on current information rather than past information.[131] The 2009 10–K shows consistent deficiencies in reserves over the past 10 years, with the highest deficiency amount in 2001 and 2002, when the net deficiency amount totaled $22.0 billion and $22.6 billion, respectively.[132]

d. Cross-holdings

Inter-company transactions and cross-holdings complicated AIG's financial position. Many of AIG's insurance subsidiaries held common stock in other AIG insurance subsidiaries.[133] This stock was counted towards regulatory capital of the insurance subsidiaries. In addition to common stock, some larger subsidiaries provided guarantees for smaller subsidiaries.

Beyond the insurance subsidiaries, AIGFP had liabilities across AIG, both to the parent and other subsidiaries. AIGFP had "inter-

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[125] Accounting Standards Codification (ASC) 944–40–30, Financial Services—Insurance, Claim Costs and Liabilities for Future Policy Benefits, Initial Measurement (online at asc.fasb.org/section&trid=4737918%26analyticsAssetName =subtopic__page__section%26nav__type=subtopic__page).

[126] Panel staff conversation with industry participants (May 7, 2010).

[127] Panel staff conversation with Texas Insurance Department (May 24, 2010). The regulators review statutory reserves, not GAAP reserves.

[128] Panel staff conversations with rating agency (May 18, 2010); Panel staff conversation with rating agency (May 19, 2010).

[129] Fitch Ratings, *Fitch Places AIG's Sr Debt on RW-Neg; Affirms ST Rtg and Financial Strength Rtgs* (Feb. 3, 2003).

[130] SEC's Industry Guide 6 (Disclosures Concerning Unpaid Claims and Claims Adjustment Expenses from Property—Casualty Insurance Underwriters) provides disclosure guidance for companies with material casualty insurance operations. Guide 6 calls for tabular information depicting the activity with respect to loss reserves and revisions to those estimates over time. *See* U.S. Securities and Exchange Commission, *Industry Guides,* at 32 (online at www.sec.gov/about/forms/industryguides.pdf).

[131] As noted in the 2009 Form 10–K, the increase from "the original estimate[d] [reserve] generally results from a combination of a number of factors, including claims being settled for larger amounts than originally estimated." AIG Form 10–K for FY09, *supra* note 50, at 5.

[132] This data shows "losses and loss expense reserves. . .excluding those with respect to asbestos and environmental claims." Including asbestos and environmental claims results in higher deficiencies. AIG Form 10–K for FY09, *supra* note 50, at 7.

[133] For example, as of September 30, 2009, Pacific Union owned 67,435 shares of the parent company. *See* Pacific Union Assurance Company, *Quarterly Statement as of September 30, 2009 of the Condition and Affairs of the Pacific Union Assurance Company,* at Q07.2 (Nov. 11, 2009).

company payables" of $54 billion owed to the parent.[134] FRBNY considered the systemic risk of these obligations to be high, as "the failure of FP to perform on obligations to other AIG entities may create an event of default for the company," and the "[f]ailure of FP may put at risk the financial condition of other AIG operating subsidiaries." The insurance and financing subsidiaries also had $1.85 billion in derivatives exposure to AIGFP. The subsidiaries with the largest exposures were ILFC ($695 million), AIG Matched Investment Program ($441.5 million), SunAmerica LIC ($240.3 million), and American General ($225.4 million). Lastly, as discussed in Section B.6, all of Banque AIG's risk was back-to-back with AIGFP, meaning that AIGFP was liable for all of Banque AIG's obligations. An FRBNY staff document describes that a default by AIGFP would have "a catastrophic impact on Banque AIG."[135]

Through 2008 and 2009, AIG provided capital contributions to its subsidiaries. In total, AIG provided $27.2 billion to its subsidiaries in 2008 and $5.7 billion in 2009.[136] Of the 2008 capital contributions, $22.7 billion went to the domestic life insurance subsidiaries, primarily to cover losses in the securities lending portfolio.[137] In 2008, the parent contributed $4.4 billion to the foreign life insurance subsidiaries after they experienced "significant capital needs following publicity of AIG parent's liquidity issues and related credit ratings downgrades and reflecting the decline in the equity markets."[138] In 2009, AIG contributed $2.4 billion to its domestic life insurance subsidiaries "to replace a portion of the capital lost as a result of net realized capital losses (primarily resulting from other-than-temporary impairment charges) and other investment-related items."[139] The parent provided $624 million in funding to foreign life insurance subsidiaries in 2009.[140] In some cases, the subsidiary paid the entire amount back later in the year as a dividend.[141]

e. Leadership

Some view AIG's leadership as another factor leading to its collapse. Though a controversial figure, Hank Greenberg is widely acknowledged to have been the only person who fully understood the company's vast web of inter-relationships.[142] Some believe that, had he remained with the company, he would have realized the im-

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[134] This $54 billion is the sum of maturing AIGFP liabilities plus collateral posted to third-parties—the parent had lent AIGFP funds to pay off counterparties and AIGFP debtholders.

[135] *AIGFP Systemic Risk Analysis—Draft,* Attachment to e-mail sent from Peter Juhas, advisor, Morgan Stanley, to Sarah Dahlgren, senior vice president, Federal Reserve Bank of New York, at 1, 2 (Oct. 25, 2008) (FRBNY-TOWNS-R1-116163); Systemic Risks of AIG, Attachment to e-mail sent from Michael Gibson to Rich Ashton, at 3 (Nov. 3, 2008) (FRBNY-TOWNS-R1-122347-352).

[136] Although much of these payments are post-rescue, they reflect issues that existed before the rescue, such as securities lending. These numbers exclude MIP and Series AIGFP debt. A significant portion of the 2008 capital contributions were to cover securities lending liabilities at the life insurance subsidiaries. AIG Form 10–K for FY09, *supra* note 50, at 48–49; AIG Form 10–K for FY08, *supra* note 47, at 48.

[137] AIG Form 10–K for FY08, *supra* note 47, at 50, 251. The insurance regulators have stated, however, that the subsidiaries could have managed these liquidity needs on their own, without outside assistance. See note 167 and accompanying text, *infra*.

[138] AIG Form 10–K for FY08, *supra* note 47, at 50.

[139] AIG Form 10–K for FY09, *supra* note 50, at 50.

[140] AIG Form 10–K for FY09, *supra* note 50, at 50.

[141] AIG Form 10–K for FY09, *supra* note 50, at 49 ("In 2009, AIG made a capital contribution of $641 million to a Chartis U.S. subsidiary, all of which was returned as a dividend to AIG later in the year").

[142] The charges brought against Mr. Greenberg, and forced him to resign, were largely related to reinsurance transactions and an off-shore entity. See Section B1, *supra*.

plications of the market shift in late 2005 and required AIGFP to hedge its CDS exposure and also would have provided stronger enterprise risk management.[143] Among other things, he might have noted the inconsistencies when the securities lending program began purchasing RMBS at the same time that AIGFP stopped writing CDS on subprime mortgage products. Others believe that many of the company's bad practices were developed under his watch. Lack of adequate succession planning also played a role. Had AIG had a strong succession plan in 2005 when Mr. Greenberg was forced to resign, the new CEO could have had a more thorough understanding of the complexity of the company, and thus could have prevented or mitigated the damage. This complexity and lack of transparency was not only a cause of the company's troubles, it also impeded the rescue and recovery by obscuring the nature and size of the problem.[144]

5. The Role of Credit Rating Agencies [145]

Credit rating agencies played an exceptionally important role in AIG's collapse and rescue. Credit rating downgrades were a factor in AIG's problems, and the need to maintain ratings significantly constrained the government agencies' options in the rescue. Large insurance companies in general are dependent on a sound credit rating that permits them to access the bond markets cheaply. Many insurance customers are highly ratings sensitive, and will not do business with insurers with less than an investment grade credit rating. A low cost of borrowing enables these companies to make a profit from the spread between their cost of capital and the return on their investments. AIG appears to have been more dependent on this business model than most other insurance firms, as can be seen in the frequent guarantee of the obligations of AIG subsidiaries. Although AIG profited for many years from its AAA credit rating, it also became particularly vulnerable to the negative consequences of ratings downgrades.

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[143] Panel staff call with industry analysts (Apr. 23, 2010).

[144] Former AIG General Counsel Anastasia Kelly stated: "There wasn't focus on the fact that now that Hank's gone, what do we need, what kind of succession planning should we have in place. . .A lot of companies have very robust human resource-driven succession plans, have people identified. AIG didn't have that. Maybe they would have had Hank stay as long as he wanted to and had done it himself." She continued, saying that when the crisis hit, AIG did not have the "infrastructure to call upon to respond" and that "there was no one in charge." Ian Katz and Hugh Son, *AIG Was Unprepared for Financial Crisis, Former Top Lawyer Says,* Bloomberg News (Mar. 13, 2010) (online at www.bloomberg.com/apps/news?pid=20601087&sid=aYq7MDFtelkc).

[145] Credit rating agencies, known formally as Nationally Recognized Statistical Rating Organizations (NRSROs), are private, SEC-registered firms that assign credit ratings to issuers, such as companies, measuring their "willingness and ability" to repay their financial obligations. In general, higher credit ratings lower an issuer's borrowing costs, enhance its ability to raise capital, and heighten its appeal as a business partner or counterparty. Credit ratings can also be assigned to individual debt issues, such as mortgage-backed securities, measuring their likelihood of default. Rating agencies use letter-based rating scales to express credit quality; for example, a 'AAA' rating indicates the least amount of credit risk, while a 'D' rating indicates the most. Changes in credit quality can trigger upgrades or downgrades along this rating scale. Three rating agencies (S&P, Moody's, and Fitch) account for 98 percent of all ratings generated by NRSROs. Although credit ratings technically constitute only an opinion of credit quality, because ratings are used to make investment decisions, and to satisfy certain regulatory and investment requirements, credit ratings play a critical role in the broader markets. *See* Standard and Poor's, *Credit Ratings Definitions & FAQs* (online at www.standardandpoors.com/ratings/definitions-and-faqs/en/us) (accessed June 9, 2010); Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective,* at 4 (Apr. 2009) (online at www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf).

AIG was a AAA company as recently as late 2004. In early 2005, all three major ratings agencies began downgrading AIG. Although the agencies downgraded AIG again as its vulnerabilities became more apparent in 2008, it still entered September 2008 with relatively decent, investment-grade ratings.[146] On Monday, September 15, the day Lehman Brothers failed, after the extent of AIG's liquidity problems became known, AIG was again downgraded by all three major rating agencies and by A.M. Best, a specialty insurance rating agency. These downgrades prompted collateral calls that brought AIG to the brink of bankruptcy, and ultimately resulted in FRBNY's rescue. Less than two months later, ratings agencies again warned of downgrades, concerned that FRBNY credit facility was making AIG overleveraged. As discussed below, this event was a factor in Treasury's intervention with TARP funds.

6. Were Regulators Aware of AIG's Position?

In retrospect, it is clear that AIG's regulators failed to assess the firm's risk adequately. OTS operated under "a statutory mandate to regulate federal savings associations in a manner that preserves safety and soundness, protects the federal deposit insurance funds, and promotes the provision of credit for homes and other goods and services in accordance with the best practices of thrift institutions in the United States."[147] As discussed earlier, OTS was the only regulator that had explicit authority to look at the entire company, and the only regulator with any authority over AIGFP.[148] But under federal law, OTS' regulatory authority was predicated on the chief objective of protecting the thrift subsidiary, with holding company regulation conducted in light of that objective. As such, OTS generally did not interpret its mandate broadly, focusing primarily on the company's regulated thrift, which represented a small fraction of AIG's overall business, and accounted for well under 1 percent of the holding company's total assets.[149]

Federal law regarding savings and loan holding companies is generally aimed at protecting the safety and soundness of the thrift subsidiary by preventing capital drains or overreaching by affiliates within the holding company structure. OTS is provided with the authority to examine the holding company and its subsidiaries, as well as to restrict activities of the holding company when there is reasonable cause to believe that the activities constitute "a serious risk to the financial safety, soundness, or stability" of the hold-

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[146] For example, as of September 14, 2008, AIG's senior unsecured debt ratings were AA- from S&P, and Aa3 from Moody's.

[147] Office of Thrift Supervision, *Legal Opinions: Operating Subsidiaries and Federal Preemption* (Oct. 17, 1994) (online at www.ots.treas.gov/__files/56423.pdf); 12 U.S.C. 1464(a).

[148] Testimony of Edward Liddy, *supra* note 91, at 39 (stating that "while credit default swaps may be an unregulated product, they absolutely, positively fell within a company that OTS regulated and we indeed very much understood the risks of the profile of the credit default portfolio as we were looking at it").

[149] Although OTS had oversight over the entire company, AIG FSB's assets of $1.27 billion as of December 2008 constituted a mere 0.14 percent of AIG's total assets. *See* American International Group, Inc., *2008 Annual Report,* at 192 (Mar. 27, 2009) (online at phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MTQ4OHxDaGlsZElEPS0xfFR5cGU9Mw==&t=1); *see also* Federal Financial Institutions Examination Council, AIG Federal Savings Bank, *Consolidated Statement of Condition* (online at www2.fdic.gov/Call__TFR__Rpts/toccallreport1.asp?pInstitution=&pSQL=pcmbQtrEnd=12/31/2008&pas__city=&pcmbState=ANY&pCert=35267&prdbNameSearch=&pDocket) (accessed June 9, 2010).

ing company's subsidiary savings association.[150] The Gramm-Leach-Bliley Act of 1999 provided for coordination between the primary regulator (in this case, OTS) and various functional regulators of the holding company's subsidiaries (in this case, state insurance regulators) and emphasized the safety and soundness of the subsidiary depository institution as the primary objective of regulation.[151]

OTS supervises and examines holding company enterprises, such as AIG, within regulated holding companies, but it generally relies on specific functional regulators for findings and issues related to the various holding company subsidiaries examined by other functional regulators to reduce duplication of work. In its role as supervisory regulator, OTS must consult with the functional regulator of a holding company subsidiary before further examining or making authoritative decisions regarding that entity and must prove that it needs information that might indicate an adverse impact on the holding company.[152] According to OTS staff, to their knowledge, the determination to prove the need to further examine a subsidiary regulated by another functional regulator and obtain more information was never made or exercised during its regulation of AIG.[153] Since no other functional regulator was overseeing AIGFP, the potential for missed clues about future liquidity or credit risks was high.

After becoming the regulator of AIG's holding company in 2000, OTS began conducting targeted, risk-focused reviews of AIG's businesses, including AIGFP, in 2004 and made recommendations regarding risk management oversight, financial reporting transparency, and corporate governance to AIG's senior management and Board of Directors.[154] OTS began holding annual "supervisory college" meetings with the firm's key foreign and U.S. insurance regulators in 2006 to share information and coordinate actions, with certain meetings including AIG personnel and others limited to only supervisors. OTS rolled out a formal, risk-focused continuous supervision plan for large holding companies such as AIG that same year, well after the ramp-up in CDS contracts within AIGFP.[155] In January 2007, French bank regulator Commission Bancaire, coordinating supervisor of AIG's European operations, deemed the supervision of AIG by OTS as having equivalency status in accordance with the EU's Financial Conglomerates Directive.[156] This decision exempted London-based AIGFP from oversight by UK and European regulators, except in instances of

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[150] *See* 12 U.S.C. 1467a (2009) for regulation of holding companies.

[151] Gramm-Leach-Bliley Act, Pub. L. 106–102, Sec. 401 (1999) (online at www.gpo.gov/fdsys/pkg/PLAW-106publ102/pdf/PLAW-106publ102.pdf); Congressional Oversight Panel, Written Testimony of Michael E. Finn, Northeast regional director, Office of Thrift Supervision, *COP Hearing on TARP and Other Assistance to AIG,* at 3 (May 26, 2010) (online at cop.senate.gov/documents/testimony-052610-finn.pdf) (hereinafter "Written Testimony of Michael E. Finn").

[152] Pub. L. 106–102, Sec. 401 (online at www.gpo.gov/fdsys/pkg/PLAW-106publ102/pdf/PLAW-106publ102.pdf); Panel staff conversation with OTS (May 21, 2010).

[153] Panel staff conversation with OTS (May 21, 2010).

[154] Written Testimony of Michael E. Finn, *supra* note 151, at 13.

[155] Testimony of Edward Liddy, *supra* note 91, at 217.

[156] *OJ C 28 E of 11.2.2003, Directive 2002/87/EC of the European Parliament and of the Council* (Dec. 16, 2002) (online at eur-lex.europa.eu/pri/en/oj/dat/2003/l_035/l_03520030211en00010027.pdf); Office of Thrift Supervision, *Press Release: OTS 07–011—OTS Receives EU Equivalency Designation for Supervision of AIG* (Feb. 22, 2007) (online at www.ots.treas.gov/%5C?p=PressReleases&ContentRecord_id=df05bfa2-8364-45a7-bf4c-18437165c11f).

AIGFP activity affecting Banque AIG's European activity and transactions,[157] but it did not provide OTS with any additional regulatory authority or powers in its supervision of AIG.[158]

In 2007, as the housing market deteriorated, OTS increased its surveillance of AIGFP and its portfolio of mortgage-related CDSs. Among other things, OTS recommended that AIGFP review its CDS modeling assumptions in light of worsening market conditions and that it increase risk monitoring and controls. Beginning in February 2008, in response to a material weakness finding in AIG's CDS valuation process, OTS again stepped up its efforts to force AIG to manage the risks associated with its CDS portfolio. OTS downgraded the firm's CORE rating[159] in March 2008 and wrote a formal letter to AIG's General Counsel regarding AIG's risk management failure.[160] In August 2008, OTS began to review AIG's remediation plan to improve practices and processes earlier criticized by OTS.[161] During this same month, the OTS field examiner to AIG met with personnel from FRBNY at the request of the bank, largely for FRBNY to obtain information and data about AIG's current state from the field examiner. The most forceful protective action taken by OTS occurred in September 16, 2008, when, in light of mounting problems at the holding company level, OTS precluded AIG FSB from engaging in transactions with affiliates without its knowledge and lack of objection, restricted capital distributions, required minimum liquidity be maintained, and required retention of counsel to advise the board about pending corporate issues and risks.[162]

All of these steps were too little, too late to address the company's vast exposure to a rapidly deteriorating housing market and economy. As former Acting OTS Director Scott M. Polakoff later acknowledged: "OTS did not foresee the extent of risk concentration and profound systemic impact CDS caused within AIG." Polakoff also stated that OTS should have directed AIG to stop originating CDSs and begin reducing its CDS portfolio before December 2005.[163] Former senior personnel at OTS have admitted that they should have stopped AIGFP's CDSbook of business in 2004 and that they "did not foresee the extent that the mortgage market would deteriorate and the impact on the liquidity of AIGFP."[164] While OTS claims to have reviewed the valuation models that AIG used and worked with the external auditors in understanding the valuation process, they readily admit to not grasping the inherent complexities of the CDS business, the degree of risk taken on by AIG through its most troublesome subsidiaries, and the comprehensive impact of collateral triggers on AIG's liquidity and ability to operate as a going concern in a worst case scenario. Some

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[157] Panel staff conversation with OTS (May 21, 2010).
[158] Written Testimony of Michael E. Finn, *supra* note 151, at 12.
[159] The OTS evaluates a supervised company's managerial resources, financial resources, and future prospects through the CORE holding company examination components: Capital, Organizational Structure, Risk Management, and Earnings. The examination reviews a company's capital adequacy in light of inherent risk, ability to absorb unanticipated losses, ability to support debt maturities, and overall strategy. A CORE rating is assigned based on the results of the OTS examination.
[160] Written Testimony of Scott Polakoff, *supra* note 16, at 15–16.
[161] Panel staff conversation with OTS (May 21, 2010).
[162] Written Testimony of Michael E. Finn, *supra* note 151, at 14.
[163] Written Testimony of Scott Polakoff, *supra* note 16, at 18.
[164] Written Testimony of Scott Polakoff, *supra* note 16, at 17.

have speculated that AIG founded its thrift in 2000 primarily to secure supervision from the supposedly lax OTS.[165]

Prior to AIG's collapse, OTS deemed the capital at the thrift level to be adequate, and as that was its starting point for regulation, it did not take more forceful actions against the holding company. As OTS monitored actions by management and encouraged corrective action in 2008, OTS put a protective hedge around the thrift to ensure it remained well capitalized and that its capital could not be drained by the holding company. Furthermore, OTS personnel note that after the fall of Bear Stearns in early 2008, all OTS field regulators were conducting heightened evaluations of the major banks with a focus on CDS practices, mortgage lines, and off-balance sheet transactions.[166]

AIG's insurance regulators had more success in taking action regarding the company's securities lending program. In mid-2007, as part of its examination process, Texas, the lead regulator for the firm's life insurance subsidiaries, discovered that AIG was purchasing RMBS with its securities lending collateral (a practice that began in late 2005).[167] When Texas discovered this, various state insurance regulators began working closely with management to develop both short (guarantees) and long (wind-down) term plans to address the regulators' concerns with the program.[168] AIG's goal was to wind down the program gradually, so as not to force the subsidiaries to sell assets at a loss.[169] During this period they required detailed monthly reporting on the securities lending portfolio. They also closely monitored realized and unrealized losses from the program and capital levels at the subsidiaries.

At the November 2007 AIG Supervisory College, the Texas Department of Insurance informed OTS and the other regulators of the securities lending issue.[170] The Texas regulators discussed the securities lending issue as part of its presentation to the other regulators, and also held a private conversation with OTS about the issue afterwards.[171] This presentation included a summary of what they had found in the examination, as well as a mention of the $1 billion in unrealized losses the program had incurred to date. OTS did not follow up on this issue with the Texas regulators after this meeting.

Texas had a plan in place if the program had to be wound down quickly, but it was not implemented because of FRBNY's rescue. From its height of $76 billion, the securities lending portfolio had

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[165] *See, e.g.* Paul Kiel, *Banks' Favorite (Toothless) Regulator*, ProPublica (Nov. 25, 2008) (online at www.propublica.org/article/banks-favorite-toothless-regulator-1125).

[166] Panel staff conversation with OTS (May 21, 2010).

[167] NAIC has stated that AIG should have disclosed to the regulators this material change in the composition of the assets purchased.

[168] Panel staff conversation with Texas Department of Insurance (May 24, 2010). The New York Insurance Department learned of the RMBS purchases in mid-2006; they discovered them when reviewing AIG's risk-based capital reporting. Because the RMBS were AAA-rated liquid assets at the time, New York did not raise the RMBS purchases as an issue. Panel staff conversation with New York Insurance Department (June 3, 2010).

[169] Through the wind down of the program, the insurance subsidiaries had $5 billion in realized losses and $7.873 billion in unrealized losses, as of July 2008, from the securities lending program. Panel staff conversation with Texas Department of Insurance (May 24, 2010).

[170] Texas also informed the other insurance regulators with domiciled subsidiaries that participated in the program.

[171] Panel staff conversation with Texas Department of Insurance (May 24, 2010).

been wound down to $58 billion by September 2008 [172]—a significant decrease, though not enough to avoid enormous liquidity strains at the height of AIG's troubles. The regulators have stated that, had it not been for the "run" by securities lending counterparties, caused by the public liquidity crunch at AIGFP, the insurance subsidiaries would have been able to gradually wind down the program without significant assistance from the parent.[173]

Though supervision of each of the four main insurance groups was coordinated, it is not clear that the regulators coordinated further to analyze all of the insurance subsidiaries on a consolidated basis. Lead regulators evaluated the subsidiaries individually as well as each group as a whole. While all of AIG's insurance regulators talk regularly about issues related to the company, they do not engage in any consolidated review of all of the subsidiaries across groups.

C. The Rescue

1. Key Events Leading up to the Rescue

AIG's problems did not arrive out of the blue in mid-September 2008. More than six months earlier, in February, the firm announced that AIGFP had recognized $11.1 billion in unrealized market valuation losses on its CDS contracts for the fourth quarter of 2007, and that the head of the business would resign.[174] On May 21, AIG raised $20 billion in capital through sales of common stock, mandatory convertible stock, and hybrid fixed maturity securities.[175] On June 15, the company announced that CEO Martin Sullivan was leaving his post and being replaced by Chairman Robert Willumstad.[176] In late June, the company recognized $13.5 billion in unrealized losses against its RMBS and other structured securities investments.[177] In July, Mr. Willumstad discussed AIG's condition with rating agencies, which said they would wait to review the firm's ratings until after AIG announced its strategic plans, which was then scheduled for September 25.[178] On July 29, Mr. Willumstad spoke to then-President Timothy Geithner about the possibility of getting access to the Federal Reserve's Discount Win-

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[172] Written Testimony of Michael Moriarty, *supra* note 103, at 4.

[173] *See* Panel staff conversation with Texas Department of Insurance (May 24, 2010); Written Testimony of Michael Moriarty, *supra* note 103, at 4–5 ("At that point, the crisis caused by Financial Products caused the equivalent of a run on AIG securities lending. Borrowers that had reliably rolled over their positions from period to period for months began returning the borrowed securities and demanding their cash collateral. From September 12 to September 30, borrowers demanded the return of about $24 billion in cash.").

[174] AIG Form 10–K for FY07, *supra* note 41, at 197; AIG Financial Results Conference Call—2007, *supra* note 78; Allstair Barr and Greg Morcroft, *AIG Shares Plunge After Company Posts $5.29 Billion Loss,* MarketWatch (Feb. 29, 2008) (online at www.marketwatch.com/story/aig-shares-fall-after-loss-troubled-unit-chief-resigns).

[175] American International Group, Inc., *Credit Exposure to AIG* (Sept. 16, 2008), Attachment to e-mail from Antonio Moreano of FRBNY to others at FRBNY (Sept. 16, 2008) (FRBNYAIG00444).

[176] American International Group, Inc., *AIG Names Robert B. Willumstad Chief Executive Officer* (Sept. 15, 2008) (online at web.aig.com/2008/mem7755/mem7755NewCEO.pdf).

[177] American International Group, Inc., *Form 10–Q for the Quarterly Period Ended June 30, 2008,* at 112 (Aug. 6, 2008) (online at www.sec.gov/Archives/edgar/data/5272/000095012308008949/y59464e10vq.htm) (hereinafter "AIG Form 10–Q for the Second Quarter 2008"). This figure includes gross unrealized losses on RMBS ($10 billion), CMBS ($2 billion) and CDO/ABS ($1.5 billion).

[178] Congressional Oversight Panel, Written Testimony of Robert Willumstad, former chairman and chief executive officer, American International Group, Inc., *COP Hearing on TARP and Other Assistance to AIG,* at 3 (May 26, 2010) (online at cop.senate.gov/documents/testimony-052610-willumstad.pdf) (hereinafter "Written Testimony of Robert Willumstad").

dow; according to Mr. Willumstad, President Geithner expressed the view that if the Federal Reserve were to provide liquidity to AIG, it would only exacerbate the potential of a run on AIG by its creditors.[179] From mid-July through August 2008, AIG management reviewed measures to address the liquidity problems of its securities lending portfolio and the collateral calls on AIGFP's CDSs.[180] On August 18, AIG raised $3.25 billion through a 10-year debt issuance that paid 8.25 percent,[181] but the company felt that it needed more capital. In late August, AIG contacted triple-A-rated insurer Berkshire Hathaway about the possibility of providing a $5 billion backstop to AIG's guaranteed investment contracts.[182] Around the same time, AIG hired JP Morgan Chase to help develop alternatives as the market and the company's condition deteriorated rapidly.[183] But those efforts proved insufficient.

AIG's growing problems were unfolding within the broader context of the financial crisis. JPMorgan Chase's government-supported acquisition of Bear Stearns happened on March 24, 2008, and Bank of America purchased Countrywide Financial Corp. on June 5. The financial market deterioration accelerated in September. Between September 7–15, the markets reflected a level of turmoil unseen for decades. On September 7, the U.S. government took control of Fannie Mae and Freddie Mac,[184] a decision that cemented the market's view, already widely held, that taxpayers would assume their liabilities if the two mortgage giants became imperiled. Three major events shook the financial system in the two days prior to FRBNY's bailout of AIG. Bank of America announced that it was buying Merrill Lynch amid concerns about Merrill's exposure to securities based on residential mortgages.[185] In addition, at midday on September 16, the assets of a money-market mutual fund that had exposure to Lehman fell below $1 per share, a rare occurrence known as "breaking the buck," which further stoked investors' fears;[186] that week, money-market mutual funds were subjected to enormous withdrawals, especially by institutional investors.[187] And finally, as described in more detail

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[179] Congressional Oversight Panel, Testimony of Robert Willumstad, former chairman and chief executive officer, American International Group, Inc., *COP Hearing on TARP and Other Assistance to AIG* (May 26, 2010) (hereinafter "Testimony of Robert Willumstad").

[180] AIG Form 10–K for FY08, *supra* note 47, at 3.

[181] AIG Form 10–K for FY08, *supra* note 47, at 56.

[182] Warren Buffett conversation with Panel staff (May 25, 2010).

[183] American International Group, Inc. *Form 10–K for the Fiscal Year Ended December 31, 2008,* at 3 (Mar. 2, 2009) (online at sec.gov/Archives/edgar/data/5272/000095012309003734/y74794e10vk.htm).

[184] *See* U.S. Department of the Treasury, *Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers* (Sept. 7, 2008) (online at www.ustreas.gov/press/releases/hp1129.htm).

[185] *See* Bank of America Corporation, *Bank of America Buys Merrill Lynch Creating Unique Financial Services Firm* (Sept. 15, 2008) (online at newsroom.bankofamerica.com/index.php?s=43&item=8255).

[186] *See* The Reserve, *Important Notice Regarding Reserve Primary Fund's Net Asset Value* (Nov. 26, 2008) (online at www.reservefunds.com/pdfs/Press Release Prim NAV 2008__FINAL__112608.pdf).

[187] *See* Bank for International Settlements, *International Banking and Financial Developments,* BIS Quarterly Review, at 72 (Mar. 2009) (online at www.bis.org/publ/qtrpdf/r__qt0903.pdf) (hereinafter "International Banking and Financial Developments").

below, Lehman Brothers filed for bankruptcy,[188] in what became the largest bankruptcy case in U.S. history.[189]

Various data illustrate the turmoil that racked the financial markets in the fall of 2008. The Dow Jones Industrial Average fell by about 25 percent between September 9 and October 9, from 11,231 to 8,579.[190] Arguably more important, the cost of interbank borrowing soared to historic levels, a situation that held the potential to choke off the supply of credit in the U.S. economy. The spread between the three-month rate at which banks typically lend to each other and the three-month Treasury bill rate rose from 1.16 percent on September 9 to 3.02 percent on September 17.[191] The spread between the interest rate for 30-day commercial paper loans, which many businesses use to finance their day-to-day operations, and the rate for Treasury bonds also skyrocketed.[192] Figure 14 includes data that quantify the problems experienced between August-November 2008 both by AIG and in the financial markets more generally.

FIGURE 14: INDICATORS OF FINANCIAL MARKET UPHEAVAL[193]

	TED Spread (bps)	3-Month LIBOR-OIS Spread (bps)	3-Month Treasury Bond Yield (%)	AIG Stock Price ($)	Dow Jones Industrial Average	AIG CDS Spread (bps)
August 15, 2008	96	77	1.85	459.8	11,659.9	300.7
September 15, 2008	180	105	1.02	95.2	10,917.5	1,527.6
October 15, 2008	433	345	0.22	48.6	8,577.9	1,816.9
November 7, 2008	198	176	0.31	42.2	8,943.8	2,923.9

[193] SNL Financial.

In early September, AIG met with the major rating agencies about the company's liquidity problems.[194] On Tuesday, September 9, Mr. Willumstad again spoke with President Geithner. Mr. Willumstad noted AIG's widening credit spreads and multi-billion-dollar losses in recent quarters, and stated that he expected further losses.[195] Then on Friday, September 12, the company's deterioration accelerated. S&P placed AIG on a watch status with negative implications, and noted that its review of the company could lead to a lower rating of up to three notches. Two financial services subsidiaries of AIG were unable to replace all of their maturing commercial paper, and AIG's parent company advanced loans to them

[188] *See* U.S. Securities and Exchange Commission, *Statement Regarding Recent Market Events and Lehman Brothers* (Sept. 14, 2008) (online at www.sec.gov/news/press/2008/2008-197.htm).

[189] House Committee on Financial Services, Written Testimony of Anton R. Valukas, court-appointed bankruptcy examiner, *Lehman Brothers Bankruptcy: Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner,* at 2 (Apr. 20, 2010) (online at www.house.gov/apps/list/hearing/financialsvcs_dem/valuks_4.20.10.pdf).

[190] Bloomberg, *Dow Jones Industrial Average Chart* (online at www.bloomberg.com/apps/cbuilder?ticker1=INDU%3AIND) (accessed June 8, 2010).

[191] Bloomberg, *TED Spread Chart* (online at www.bloomberg.com/apps/cbuilder?ticker1=.TEDSP%3AIND) (accessed June 8, 2010).

[192] *See* Board of Governors of the Federal Reserve System, *Commercial Paper Rates and Outstanding* (online at www.federalreserve.gov/releases/cp/) (accessed June 8, 2010); Board of Governors of the Federal Reserve System, *Market Yield on U.S. Treasury Securities at 1-month Constant Maturity, Quoted on Investment Basis* (online at www.federalreserve.gov/releases/h15/data/Business_day/H15_TCMNOM_M1.txt) (accessed June 8, 2010).

[194] House Committee on Oversight and Government Reform, Written Testimony of Robert B. Willumstad, former chief executive officer, American International Group, Inc., *The Causes and Effects of the AIG Bailout,* at 3–4 (Oct. 7, 2008) (online at oversight.house.gov/images/stories/documents/20081007101054.pdf); AIG Form 10–K for FY08, *supra* note 47, at 3–4. AIG's meeting with Standard & Poor's happened on Sept. 11, 2008.

[195] Testimony of Robert Willumstad, *supra* note 179.

so that they could meet their obligations.[196] Also on Friday, Mr. Willumstad called Warren Buffett, CEO of Berkshire Hathaway, to discuss a possible investment in AIG. Later in the day, Mr. Buffett received a packet of materials about AIG's property & casualty insurance business, which AIG was interested in selling to Berkshire Hathaway. But Mr. Buffett quickly concluded that the assets for sale were not attractive enough, and he would have had trouble raising the $25 billion that AIG would have needed to receive for its property & casualty business.[197]

After the markets closed on Friday, an e-mail by an FRBNY employee stated that hedge funds were panicking about AIG. "Every bank and dealer has exposure to them," read the e-mail, which was sent to William Dudley, then executive vice president of FRBNY's Markets Group and currently FRBNY's president, among others. "People I heard from worry they can't roll over their funding. . . . Estimate I hear is 2 trillion balance sheet."[198] That same evening, officials from FRBNY and the Federal Reserve Board of Governors met with AIG senior executives. At this meeting, AIG stated that it had $8 billion cash in its holding company and enough liquidity to last for the next two weeks. AIG estimated that it might have to pay out $18.6 billion over the next week if, as expected, its ratings were downgraded the following week.[199] Also Friday, AIG informed Treasury and the New York state insurance regulators of its severe liquidity problems, principally due to increasing demands to return cash collateral under its securities lending program and collateral calls on AIGFP's CDS portfolio.[200] AIG found itself unable to obtain short-term or long-term financing in the public debt markets. This, coupled with its inability to roll over commercial paper coming due, posed the most significant immediate threat to the company's solvency.[201]

At the same time as AIG's collapse, Lehman Brothers was also on the verge of bankruptcy. On Friday, President Geithner called together representatives of 12 major financial institutions to participate in discussions regarding a private-sector consortium rescue for Lehman. The financial institutions committed to financing $40 billion of Lehman's real estate assets in order to facilitate Lehman's acquisition by Barclays; those efforts would soon unravel, though.[202]

While top government officials were continuing to deal with the problems facing Lehman Brothers and Merrill Lynch, teams from FRBNY and the New York State Insurance Department worked Saturday to determine how a failure of AIG would affect the financial system and the broader economy, and examined their options

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[196] The two subsidiaries were International Lease Finance Corporation (ILFC) and American General Finance (AGF). AIG Form 10–K for FY08, *supra* note 47, at 4.

[197] Warren Buffett conversation with Panel staff (May 25, 2010).

[198] E-mail from Hayley Boesky, vice president, Federal Reserve Bank of New York, to William Dudley, executive vice president, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept, 12, 2008) (FRBNYAIG00511).

[199] E-mail from Alejandro LaTorre, vice president, Federal Reserve Bank of New York, to Timothy F. Geithner, president, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept. 12, 2008) (FRBNYAIG00509).

[200] *See* GAO Report, *supra* note 18, at 11–15; Testimony of Sec. Geithner, *supra* note 11, at 3; AIG Form 10–K for FY08, *supra* note 47, at 40.

[201] AIG Form 10–K for FY08, *supra* note 47, at 201.

[202] FRBNY conversation with the Panel (May 11, 2010).

for containing the damage from an AIG failure.[203] The Governor of New York, David Paterson, and the State Insurance Department considered allowing AIG to tap $20 billion from its insurance subsidiaries, as part of an emergency plan devised by AIG. (The following Monday, Governor Paterson announced publicly that the authorities would allow this transaction, though it did not actually happen in the end.)[204]

At 11 a.m. Saturday, Federal Reserve officials held a call with AIG CEO Willumstad and CFO Steven Bensinger, among others, during which AIG said it had a plan over the next six to 12 months to sell approximately $40 billion in assets, including domestic and foreign life insurance subsidiaries; these assets equaled 35–40 percent of the company. AIG said that in addition to the aforementioned assistance from the New York State Insurance Department, it needed bridge financing, and was interested in tapping Federal Reserve lending facilities. Federal Reserve officials got the impression that AIG had not approached private financial institutions about obtaining this financing, likely because AIG believed that it would be turned down. This phone call also included a discussion of the Federal Reserve's emergency lending authority under Section 13(3) of the Federal Reserve Act. The Federal Reserve officials stated that 13(3) lending to AIG would send a negative signal to the market, and told AIG that they "should not be particularly optimistic," given the history and hurdles of 13(3) lending.[205]

During that weekend, a small number of private equity firms submitted bids to acquire a controlling interest in AIG.[206] JC Flowers & Co. LLC, a private equity firm in New York, made two different efforts. Its first overture involved a plan to combine private equity with asset sales, along with the upstreaming of assets, as contemplated by the New York State Insurance Department, from AIG's insurance subsidiaries to the parent company. This plan also relied on a backstop of AIG guaranteed investment contracts by Berkshire Hathaway; AIG contacted Mr. Buffett about the idea, but it never came to fruition.[207] The second attempt jointly offered private equity from JC Flowers and German insurance firm Allianz SE. The latter plan, which was regarded by some senior officials at the FRBNY as a "takeover offer," called for AIG to more than double its outstanding shares and was contingent on AIG gaining access to the Federal Reserve's lending facilities.[208] A later account provided in former Treasury Secretary Henry M Paulson Jr.'s book, "On The Brink," characterized the offers as an attempt by Flowers

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[203] Testimony of Sec. Geithner, *supra* note 11, at 4–5.

[204] David A. Paterson, governor, State of New York, *Governor Paterson Announces New York Will Facilitate Financing Plan for World's Largest Insurance Provider* (Sept. 15, 2008) (online at www.state.ny.us/governor/press/press__0915082.html). *See also* e-mail from Patricia Mosser, senior vice president, Federal Reserve Bank of New York, to Scott Alvarez of Federal Reserve Board of Governors, among others (Sept. 13, 2008) (FRBNYAIG00508).

[205] E-mail from Patricia Mosser, senior vice president, Federal Reserve Bank of New York, to Scott Alvarez of Federal Reserve Board of Governors, among others (Sept. 13, 2008) (FRBNYAIG00508). For a discussion of the Federal Reserve authority under 13(3), see Section C.4.

[206] AIG got assistance during this process from investment banking advisors JPMorgan Chase and Citigroup. Testimony of Robert Willumstad, *supra* note 179.

[207] E-mail from Patricia Mosser, senior vice president, FRBNY, to others at FRBNY and the Federal Reserve Board (Sept. 14, 2008) (FRBNYAIG00495); Warren Buffett conversation with Panel staff (May 25, 2010).

[208] E-mail from Patricia Mosser, senior vice president, FRBNY, to others at FRBNY and the Federal Reserve Board (Sept. 14, 2008) (FRBNYAIG00495).

to "buy pieces of AIG on the cheap. . ."[209] The buyout firms Kohlberg Kravis Roberts & Co. and TPG Capital also expressed interest in acquiring at least some portion of AIG, according to news reports at the time.[210] For its own part, AIG was also still trying to renegotiate the terms of its most burdensome financial instruments. In addition to its talks with private equity firms, AIG's efforts to raise capital and otherwise improve its liquidity position included conversations with sovereign wealth funds, and the retention of Blackstone Advisory Services LP to assist in these efforts.[211]

Between Friday, September 12 and the evening of Saturday, September 13, AIG's own estimate of the size of the hole in its balance sheet rose from $20 billion to $40 billion.[212] Saturday evening, Mr. Willumstad told Secretary Paulson and President Geithner that he believed AIG could probably raise $30 billion that weekend,[213] but only if the potential investors and the New York State Insurance Department received assurances that the company would survive after it got the $30 billion. Mr. Willumstad believed that the Federal Reserve was the only entity that could provide such an assurance. But Mr. Willumstad says he was told that there would be no government solution for AIG.[214]

Throughout the weekend of September 13–14, representatives of large financial institutions were meeting at FRBNY regarding the potential rescue of Lehman Brothers. Two of the CEOs on hand provided assurances to FRBNY officials that there would be a private-sector solution for AIG, according to recent testimony before the Panel by a senior FRBNY official.[215] And right up until FRBNY stepped in to rescue AIG, senior government officials remained hopeful that the private sector would produce an alternative solution resembling the bailout of Long-Term Capital Management ten years earlier.[216] The LTCM bailout was seen as a model because the government did not provide assistance, and the firms that did provide emergency credit were repaid with interest.[217]

By Sunday morning, FRBNY staffers were preparing to brief President Geithner on the pros and cons of providing AIG access

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[209] Henry M. Paulson, Jr., *On The Brink*, at 200, 217 (2010) (hereinafter "On The Brink"). Of course, given AIG's precarious condition at the time, it is neither surprising nor unusual that some market participants sought to take advantage by offering to buy assets at a discount.

[210] Andrew Ross Sorkin et al., *AIG Seeks $40 billion in Fed Aid to Survive,* New York Times Dealbook Blog (Sept. 14, 2008) (online at dealbook.blogs.nytimes.com/2008/09/14/aig-seeks-fed-aid-to-survive/).

[211] AIG Form 10–K for FY08, *supra* note 47, at 4.

[212] Testimony of Robert Willumstad, *supra* note 179.

[213] Testimony of Robert Willumstad, *supra* note 179.

[214] Testimony of Robert Willumstad, *supra* note 179. For a discussion of whether a hybrid public-private solution would have been feasible, see Section F.1, *infra.*

[215] Congressional Oversight Panel, Testimony of Thomas C. Baxter, Jr., general counsel and executive vice president of the legal group, Federal Reserve Bank of New York, *COP Hearing on TARP and Other Assistance to AIG* (May 26, 2010) (hereinafter "Testimony of Thomas C. Baxter").

[216] FRBNY conversation with the Panel (May 11, 2010).

[217] House Committee on Banking and Financial Services, Written Testimony of Alan Greenspan, chairman, Board of Governors of the Federal Reserve System, *Private-Sector Refinancing of the Large Hedge Fund: Long-Term Capital Management,* 105th Cong. (Oct. 1, 1998) (online at www.federalreserve.gov/boarddocs/testimony/19981001.htm) (hereinafter "Written Testimony of Alan Greenspan"); FRBNY conversation with the Panel (May 11, 2010).

to the Federal Reserve's Discount Window.[218] Later that afternoon, President Geithner received from his staff a spreadsheet showing which banks had the largest estimated exposure to AIG, as well as an FRBNY presentation about the strength of AIG's subsidiaries, and a two-page memo laying out the pros and cons of lending to AIG.[219] At 5 p.m. Sunday, Mr. Willumstad, after having been summoned to FRBNY notified Secretary Paulson and President Geithner that AIG had failed to raise any capital, and that the hole in the firm's balance sheet had grown again.[220] Mr. Willumstad's latest plan was for the Federal Reserve to provide a $40 billion bridge loan, to be accompanied by $10 billion that AIG thought it could generate from unencumbered securities. President Geithner again said that the government was not going to lend, and that Mr. Willumstad should seek a bridge loan from a consortium of private lenders.[221]

In a recent interview with the Panel, Secretary Geithner said that on Sunday night, he got government officials to start thinking about the implications of an AIG failure both on U.S. insurance subsidiaries and around the world.[222] Nonetheless, Secretary Geithner has stated that as late as that night, "it still seemed inconceivable that the Federal Reserve could or should play any role in preventing AIG's collapse."[223] Also Sunday evening, government officials contacted Morgan Stanley about serving as an adviser to the government in another effort to effect a private-sector rescue of AIG.[224] Government officials also summoned JPMorgan Chase for a meeting; AIG asked to be included in the talks, but the firm received word that it was not invited.[225]

Shortly after midnight on the morning of Monday, September 15, Lehman Brothers announced that it was filing for bankruptcy.[226] Only at this point did the focus of top government officials turn to AIG. President Geithner called Lloyd Blankfein, Goldman Sachs' CEO, and asked him to convene a team to work on a private-sector rescue.[227] Around 11 a.m., representatives from JPMorgan Chase and Goldman Sachs—along with representatives from AIG, the New York State Insurance Department, Treasury, and Morgan Stanley, which was acting in its new capacity as an adviser to the

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[218] E-mail from Paul Whynott, Federal Reserve Bank of New York, to Sarah Dahlgren, Brian Peters, Jim Mahoney, Catherine Voigts, and Christopher Calabria (Sept. 14, 2008) (FRBNYAIG00459–460).

[219] *Pros and Cons on AIG Lending,* E-mail and attachments from Alejandro LaTorre, assistant vice president, Federal Reserve Bank of New York (Sept. 14, 2008) (FRBNYAIG00496–505).

[220] Mr. Willumstad testified that the balance sheet hole was $60 billion by Sunday night. Secretary Paulson, in his book, put the figure at $50 billion. *See* Testimony of Robert Willumstad, *supra* note 179; On The Brink, *supra* note 209.

[221] On The Brink, *supra* note 209, at 217–218.

[222] Panel conversation with Secretary Geithner (June 2, 2010).

[223] Testimony of Sec. Geithner, *supra* note 11, at 4; Panel conversation with Secretary Geithner (June 2, 2010).

[224] Rescue Effort Participant conversation with Panel staff (May 24, 2010).

[225] Testimony of Robert Willumstad, *supra* note 179. Mr. Geithner says that on Sunday night he wanted a more organized effort by AIG's advisors to approach potential investors, including institutions that had an interest in AIG's survival, even though the probability of success in such an effort was low. Panel conversation with Secretary Geithner (June 2, 2010).

[226] *See* Lehman Brothers, *Press Release: Lehman Brothers Announces it Intends to File Chapter 11 Bankruptcy Petition* (Sept. 15, 2008) (online at www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf). *See also* Lehman Brothers Holdings Inc., *Voluntary Petition, United States Bankruptcy Court, Southern District of New York* (Sept. 14, 2008) (online at www.bankruptcylitigationblog.com/uploads/file/voluntary petition.pdf).

[227] Rescue Effort Participant conversation with Panel staff (June 2, 2010); Panel conversation with Secretary Geithner (June 2, 2010).

government—convened for a meeting at FRBNY.[228] Government officials hoped that these banks, by syndicating a multi-billion dollar loan with other large financial institutions, would be able to provide the private-sector bailout that AIG had been unable to organize over the weekend.[229] President Geithner spoke at the beginning of the meeting, and according to the accounts of several people who were there, he either strongly downplayed or ruled out the possibility of a government rescue of AIG.[230] Then he left. Secretary Paulson, after spending the weekend in New York dealing with Merrill Lynch and Lehman Brothers, had returned to Washington by Monday morning and was not in attendance.[231] According to one person who was in the room, the meeting that ensued was largely run by JPMorgan Chase and Goldman Sachs, though representatives of FRBNY and Treasury were also present.[232]

The assembled bankers later proceeded to AIG's headquarters, where they received additional information about the firm's liquidity position and the value of its businesses.[233] Later in the day, the group returned to FRBNY. The atmosphere throughout the day was described by one banker in attendance as highly frenetic, with various participants taking part in numerous side meetings and conversations.[234] It is not clear exactly when, but at some point, the private-sector banks developed a $75 billion term sheet for an AIG rescue. The idea was that the private-sector lending would serve as a bridge loan until AIG could sell enough assets to stabilize itself.[235] Although AIG has stated that Goldman Sachs and JPMorgan Chase made efforts on Monday to syndicate the loan,[236] it is not clear what other firms they contacted, or whether their efforts met with any success.

At a press conference Monday afternoon at the White House, Secretary Paulson was asked if the Federal Reserve was going to provide a bridge loan to AIG, and he responded by saying that "what is going on right now in New York has nothing to do with any bridge loan from the government. What's going on in New York is

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[228] *See* Federal Reserve Bank of New York, Visitors List (Sept. 15, 2008) (FRBNYAIG00488).

[229] In an e-mail circulated sent to FRBNY staff that morning, Brian Peters of FRBNY noted that FRBNY had no supervisory authority over AIG and stated: "As a result, we need to be clear that we are NOT holding ourselves out as responsible when we deal with firms and other supervisors. . . . We also believe that the private sector is and should be actively working on a resolution, and that based on our earlier dimensioning work that AIG has options (albeit unpleasant) to solve this themselves." *AIG: Important,* E-mail from Brian Peters, senior vice president, risk management function, Federal Reserve Bank of New York (Sept. 15, 2008) (FRBNYAIG 00491–492).

[230] One participant recalls Geithner saying that the banks should not assume that the Federal Reserve would bail out AIG, so the private sector needed to find the solution; others remember Geithner saying that he wanted the banks to explore a private solution given that government money was not going to be available. Morgan Stanley conversation with Panel staff (May 24, 2010); GS conversation with Panel staff (June 2, 2010).

[231] On The Brink, *supra* note 209.

[232] Morgan Stanley conversation with Panel staff (May 24, 2010). Mr. Willumstad testified that the meeting ended around 12:30 or 1 p.m., and that he did not believe at that time that a loan syndicate to rescue AIG was being put together. Testimony of Robert Willumstad, *supra* note 179.

[233] Rescue Effort Participant conversation with Panel staff (May 24, 2010).

[234] Rescue Effort Participant conversation with Panel staff (May 24, 2010).

[235] *See* AIG Form 10–K for FY08, *supra* note 47, at 4. FRBNY's visitors list from Sept. 15, 2008, also shows that representatives of Morgan Stanley, the law firm Sullivan & Cromwell, the New York Insurance Department, and Treasury were at FRBNY that morning. Federal Reserve Bank of New York Visitors List, September 15, 2008, Attachment to e-mail sent by Campbell Cole of FRBNY (Sept. 15, 2008) (FRBNYAIG00487–488).

[236] AIG Form 10–K for FY08, *supra* note 47, at 4.

a private-sector effort . . . "[237] AIG's problems were compounded further Monday afternoon, when three major rating agencies, Fitch Ratings, Moody's Investors Service, and Standard & Poor's, all downgraded AIG's credit ratings, triggering $20 billion in collateral calls and transaction termination payments.[238] Moody's attributed its decision to the impact on AIG's "liquidity and capital position" of the "continuing deterioration in the U.S. housing market." It also signaled that "further downgrades . . . are likely if the immediate liquidity and capital concerns are not fully addressed."[239] At this point, AIG's ability to meet collateral demands, already severely strained by the sharp decline in mortgage-linked asset values, was being exhausted in the wake of the Lehman bankruptcy and the subsequent rating downgrades of AIG. On Monday alone, AIG made payments of $5.2 billion to its securities lending counterparties.[240]

Just after 7 p.m. Monday, bankers from Goldman Sachs, JPMorgan Chase and Morgan Stanley, along with representatives from AIG, Treasury, and the New York State Insurance Department, reconvened for another meeting at FRBNY.[241] There was a sense among the bankers assembled that AIG's problems were too big for the private-sector banks, especially within a limited timeframe created by AIG's swift descent and the prevailing economic conditions.[242] Secretary Geithner says that by late Monday, he knew that the private-sector talks had failed, even though FRBNY did not get formal notification until early Tuesday morning;[243] Secretary Geithner says that he never thought the private-sector talks had a high probability of success.[244]

Government officials have given two reasons as to why the private-sector rescue effort collapsed.[245] One was that the banks could not establish with any precision what AIG's liquidity needs were.[246] The other reason was that after the Lehman bankruptcy,

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[237] The White House, *Press Briefing by Dana Perino and Secretary of the Treasury Henry Paulson* (Sept. 15, 2008) (online at georgewbush-whitehouse.archives.gov/news/releases/2008/09/20080915-8.html).

[238] Testimony of Sec. Geithner, *supra* note 11, at 6; AIG Form 10–K for FY08, *supra* note 47, at 4.

[239] Standard & Poor's Ratings Services, *Research Update: American International Group Inc. Ratings Placed on CreditWatch with Negative Implications* (Sept. 12, 2008); Standard & Poor's Ratings Services, *Research Update: American International Group Ratings Lowered and Kept on CreditWatch Negative* (Sept. 15, 2008); Moody's Investors Service, *Rating Action: Moody's Downgrades AIG (senior to A2); LT and ST Ratings Under Review* (Sept. 15, 2008) (online at www.wgains.com/assets/attachments/MoodysPressRelease.pdf).

[240] AIG Form 10–K for FY08, *supra* note 47, at 4.

[241] Federal Reserve Bank of New York, Visitors List, September 15, 2008, 7:05 pm EST.

[242] Rescue Effort Participant conversation with Panel staff (May 24, 2010).

[243] Testimony of Thomas C. Baxter, *supra* note 215.

[244] Panel conversation with Secretary Geithner (June 2, 2010).

[245] Donald L. Kohn, vice chairman of the Board of Governors of the Federal Reserve System, offered the following testimony in 2009: "The private sector worked through the weekend of September 13–14 to find a way for private firms to address AIG's mounting liquidity strains. But that effort was unsuccessful in a deteriorating economic and financial environment in which firms were not willing to expose themselves to risks. . . ." Senate Committee on Banking, Housing, and Urban Affairs, Written Testimony of Donald L. Kohn, vice chairman, Board of Governors of the Federal Reserve System, *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation*, at 4 (Mar. 5, 2009) (online at banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=aa8bcdf2-f42b-4a60-b6f6-cdb045ce8141) (hereinafter "Testimony of Donald Kohn").

[246] Panel conversation with FRBNY staff (Apr. 12, 2010). One bank that participated in the private-sector rescue effort told the Panel that the banks also concluded that AIG did not have adequate collateral to support the necessary loan. Panel conversation with Rescue Effort Participants. In connection with the September 15 private-sector rescue effort, SIGTARP states that "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."

the combination of AIG's rising liquidity needs and increased concern about capital preservation by large financial institutions caused them to pull back on their willingness to participate.[247]

Whatever the reasons, the private sector rescue effort fell apart. Instead, the term sheet that the banks had developed became the template for the AIG rescue package that FRBNY proceeded to put together later on Tuesday.

2. The Rescue Itself

On Tuesday, September 16, AIG was poised to fail. That morning, the two AIG subsidiaries that the previous week had lost access to the commercial paper market drew down a combined $11.1 billion from their revolving credit facilities with the parent company.[248] Between September 2 and 15, AIG's stock price had fallen by 79 percent.[249] The cost of a CDS that provided $1 million of protection against an AIG default within five years had risen by more than 900 percent, from around $37,000 on September 1 to around $350,000 on September 16.[250]

Early that morning, FRBNY staff e-mailed a staff proposal to President Geithner that would have allowed AIG's parent company to fail while having the government reinsure approximately $38 billion in AIG stable value wrap contracts, which provide a layer of security around the value of workers' pension funds. The staff proposal stated that an act of Congress would be necessary to implement the idea.[251] Also in the early morning hours of Tuesday, President Geithner received an FRBNY memo stating that an AIG failure could be more systemic than Lehman's failure, in part because of AIG's retail businesses. The memo went on to discuss how an AIG bankruptcy might unfold; it reflected FRBNY's uncertainty about the health of AIG's insurance subsidiaries, and noted various potential negative consequences that an AIG bankruptcy could have on the financial system.[252]

Later Tuesday morning, representatives from Goldman Sachs and JPMorgan Chase took part in a final meeting at FRBNY regarding AIG. FRBNY officials' recollection is that JPMorgan Chase

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SIGTARP goes on to state: "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." Office of the Special Inspector General for the Troubled Asset Relief Program, *Factors Affecting Efforts to Limit Payments to AIG Counterparties,* at 8 (Nov. 17, 2009) (online at sigtarp.gov/reports/audit/2009/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf) (hereinafter "SIGTARP Report on AIG Counterparties").

[247] FRBNY and Treasury briefing with Panel and Panel staff (May 11, 2010). More specifically, FRBNY states that in the wake of Lehman Brothers' bankruptcy, JPMorgan Chase was lending $40 billion–$60 billion per night to keep Lehman's broker-dealer afloat. Panel conversation with FRBNY staff (Apr. 12, 2010).

[248] AIG Form 10–K for FY08, *supra* note 47, at 4.

[249] Bloomberg, *American International Group Inc. Stock Price Chart* (online at www.bloomberg.com/apps/cbuilder?ticker1=AIG%3AUS) (accessed June 8, 2010).

[250] Bloomberg data.

[251] *Proposal to Insulate Retail Impact of AIGFP Failure,* e-mail from Alejandro LaTorre, vice president, Federal Reserve Bank of New York, to Timothy F. Geithner, president, Federal Reserve Bank of New York (Sept. 16, 2008) (FRBNYAIG00474–478) (hereinafter "Proposal to Insulate Retail Impact of AIGFP Failure").

[252] *Systemic Impact of AIG Bankruptcy,* Attachment to e-mail from Alejandro LaTorre of FRBNY to FRBNY President Geithner (Sept. 16, 2008) (FRBNYAIG00483–486). The memo, sent to Mr. Geithner at 3:16 a.m., states that AIG's derivatives book was more complex than Lehman Brothers'; that an AIG bankruptcy would be a bigger surprise than Lehman's; and that it would occur on the back of the Lehman bankruptcy, among other negative aspects of an AIG failure.

said they were bowing out of the rescue talks and were not going to listen to any further discussion.[253] FRBNY officials have said they concluded that continuing to seek a private-sector solution was futile.[254] The Panel found no evidence that FRBNY officials, following the previous night's failure, made any further effort with respect to the private-sector rescue effort.

Also on Tuesday morning, President Geithner participated in a conference call about AIG with Secretary Paulson and Chairman Bernanke. According to Thomas Baxter Jr., FRBNY's general counsel, who also participated in the call, the government officials faced "a binary choice to either let AIG file for bankruptcy or to provide it with liquidity."[255] A similar situation had occurred with Lehman just one day before, and in that case the government officials had chosen bankruptcy. During this call, according to Mr. Baxter, the decision was made that the consequences of a bankruptcy were far worse than those that would come from providing liquidity to AIG.[256] The decision would not be finalized, though, until the Federal Reserve Board authorized the loan under its emergency authority in Section 13(3) of the Federal Reserve Act.

In order for the Federal Reserve to use its 13(3) authority, AIG needed to come up with sufficient collateral to allow the Federal Reserve to lend on a secured basis. (The law required that the Federal Reserve be secured to its satisfaction.) That afternoon, FRBNY security personnel went to AIG's headquarters at 80 Pine Street in lower Manhattan, and, after collecting stock certificates representing billions of dollars worth of AIG's equity stakes in its insurance subsidiaries, walked back to FRBNY.[257] It is not clear exactly when the Federal Reserve Board voted to authorize lending to AIG, but it appears to have happened before 3:30 p.m., when FRBNY sent AIG the terms of a secured lending agreement that it was prepared to provide. In Washington, meanwhile, Secretary Paulson and Chairman Bernanke briefed the President and the President's Working Group on Financial Markets, as well as con-

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[253] FRBNY conversation with the Panel (May 11, 2010). Thomas Baxter, FRBNY's executive vice president and general counsel, told the Panel that he believes Marshall Huebner, the Davis Polk & Wardwell lawyer who was then representing the private-sector banking consortium, delivered the news. Testimony of Thomas C. Baxter, *supra* note 215.

[254] FRBNY conversation with the Panel (May 11, 2010).

[255] Congressional Oversight Panel, Joint Written Testimony of Thomas C. Baxter, Jr., general counsel and executive vice president of the legal group, and Sarah Dahlgren, executive vice president of special investments management and AIG monitoring, Federal Reserve Bank of New York, *COP Hearing on TARP and Other Assistance to AIG,* at 3 (May 26, 2010) (online at cop.senate.gov/documents/testimony–052610–baxter.pdf) (hereinafter "Joint Written Testimony of Thomas C. Baxter and Sarah Dahlgren"). For the Panel's analysis of this assertion, see Section F.1, *supra.*

[256] FRBNY conversation with the Panel (May 11, 2010).

[257] FRBNY conversation with the Panel (May 11, 2010). As part of the final Guarantee and Pledge Agreement associated with the creation of the Revolving Credit Facility (RCF) and executed on September 22, 2008, AIG pledged a portion of its equity interest in the following subsidiary companies: AIG BG Holdings, Inc. (1,000 shares), AIG Capital Corporation (10,000 shares), AIG Federal Savings Banks (1,000 shares), AIG Retirement Services (100 shares), AIG Trading Group (4,000 shares and 1,192 shares of non-cumulative preferred stock), American International Underwriters Overseas, Ltd. (20,000,000 shares), American Life Insurance Company (300,000 shares), Transatlantic Holdings, Inc. (17,073,690 shares), and an uncertified number of shares in AIG Life Holdings (International) LLC, AIG Castle Holdings LLC, and AIG Castle Holdings II LLC. Furthermore, AIG pledged $1.16 billion in financial instruments as collateral. Finally, AIG pledged 64 financial agreements held by the parent and certain subsidiaries: International Lease Finance Company ($35.6 billion), American General Finance, Inc. ($2.6 billion), American General Finance Corporation ($4.1 billion), and American International Group, Inc. ($63.6 billion). American International Group, Inc., *Form 8–K, Agreement Executed September 22, 2008,* at 193 (Sept. 26, 2008) (online at www.sec.gov/Archives/edgar/data/5272/000095012308011496/y71452e8vk.htm).

gressional leadership, about the rescue plan that FRBNY was developing. Also that afternoon, the head of bank supervision at FRBNY held a conference call with foreign banking and insurance supervisors to send a message that FRBNY was providing liquidity to AIG.[258]

The FRBNY offer was for an $85 billion credit facility, on the same terms put together the previous day by the private-sector banks;[259] FRBNY simply took the private-sector's $75 billion term sheet and added $10 billion as a cushion.[260] In mere days, the estimated cost of saving AIG had risen from $20 billion to $85 billion. Mr. Willumstad learned of the government's offer Tuesday afternoon, and was told that it was non-negotiable. Secretary Paulson told Mr. Willumstad that as part of the agreement, he would have to resign as AIG's CEO. AIG's Board of Directors met over the next few hours and agreed to the government's proposal that evening.[261]

At 9 p.m. Tuesday, the Federal Reserve Board of Governors, with the full support of Treasury, announced that, using its authority under Section 13(3) of the Federal Reserve Act, it had authorized FRBNY to establish an $85 billion RCF for AIG.[262] (That same evening, FRBNY advanced $14 billion in credit to AIG.)[263] The $85 billion facility would be secured by AIG's assets and would "assist AIG in meeting its obligations as they come due and facilitate a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy."[264] In exchange for the provision of the credit facility from the federal government, AIG provided to the United States Treasury preferred shares and warrants that, if the warrants were exercised, would give the government a 79.9 percent ownership stake in AIG.[265]

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[258] FRBNY officials say that prior to the Federal Reserve's exercise of authority under Section 13(3), they did not have any conversation with European banking supervisors about the consequences an AIG bankruptcy could have on European banks. FRBNY conversation with the Panel (May 11, 2010).

[259] Initially, the facility had a two-year term, and interest accrued on the outstanding balance at a rate of the 3–month London Interbank Offer Rate (LIBOR) plus 850 basis points. The loan is collateralized by all the assets of AIG and of its primary non-regulated subsidiaries (including the stock of substantially all of the regulated subsidiaries).

[260] FRBNY says this cushion was added in anticipation of looming liquidity concerns, and because the Federal Reserve did not want to have to increase the line of credit at a later date. FRBNY conversation with the Panel (May 11, 2010).

[261] Written Testimony of Robert Willumstad, *supra* note 178, at 5.

[262] The Board's vote was 5–0, with Chairman Ben Bernanke, Vice Chairman Donald Kohn, and Governors Kevin Warsh, Elizabeth Duke and Randall Kroszner all casting votes. Board of Governors of the Federal Reserve System, *Notice of a Meeting Under Expedited Procedures* (Sept. 17, 2008) (online at www.federalreserve.gov/boarddocs/meetings/2008/20080916/expedited.htm). *See also* On The Brink, *supra* note 209.

[263] Joint Written Testimony of Thomas C. Baxter and Sarah Dahlgren, *supra* note 255, at 4.

[264] Board of Governors of the Federal Reserve System, *Report Pursuant to Section 129 of the Emergency Economic Stabilization Act of 2008: Securities Borrowing Facility for American International Group,* at 2 (Oct. 14, 2008) (online at www.federalreserve.gov/monetarypolicy/files/129aigsecborrowfacility.pdf) (hereinafter "Securities Borrowing Facility for AIG").

[265] Because neither Treasury nor the Federal Reserve had the authority to own these shares, the terms were written so that the shares would be held by the U.S. Treasury. FRBNY conversation with the Panel (May 11, 2010). The government's AIG bailout plan involving its obtaining a 79.9 percent equity stake in the company was closely modeled on the approach taken with GSEs Fannie Mae and Freddie Mac. Treasury conversation with Panel staff (May 13, 2009). The ownership percentage of directly under 80 percent was chosen due to the consequences of "push down" accounting. When a purchase transaction results in one company becoming substantially owned by another, the financial statements of the purchased company should reflect the new basis of accounting for the purchased assets and liabilities shown in the financial statements of the parent company, which would be based on the purchase price. Thus, the new basis of the assets and liabilities per the parent company are "pushed down" to the

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At the time, the Federal Reserve stated that its goal was to provide AIG with sufficient liquidity to meet its obligations, and to allow for the orderly disposition of certain AIG businesses.[266] In more recent comments, FRBNY officials have maintained that they decided on a bailout because AIG needed liquidity, and stated that the Federal Reserve believed that AIG was solvent on the basis of its balance sheet.[267] FRBNY does not dispute that AIG's massive liquidity problem pre-dated Lehman's bankruptcy, but notes that there was a general pull-back in private sector liquidity after Lehman filed for bankruptcy. FRBNY officials say that the government took a 79.9 percent equity interest in AIG because it believed the taxpayer should receive the same terms and conditions that the private sector wanted,[268] and the 79.9 percent equity interest was in the private sector consortium's term sheet.

3. The Key Players in the Rescue

The rescue of AIG was ultimately led by FRBNY, acting on behalf of the Board of Governors of the Federal Reserve System and in close consultation with Treasury. The other key players in the story include the OTS, the New York State Superintendent of Insurance, other state insurance regulators, and numerous Wall Street lawyers, advisors, counterparties and investors. As discussed in section K.5, many of these actors, particularly advisors and attorneys, played more than one role in the rescue. Notwithstanding these parties' internal conflicts rules, these entanglements create an overwhelming perception by the public that Wall Street was helping Wall Street, using taxpayer funds.

Federal Reserve Bank of New York. The rescue of AIG was led by FRBNY and the Federal Reserve System, which began to focus on AIG's conditions toward the end of the week of September 7–13, 2008. Treasury was directly involved in discussions of AIG's conditions and the consequences for the financial system of an AIG failure, but it had little if any authority to provide funds to AIG at the time; EESA was not enacted until October 3, 2008. Similarly, other AIG regulatory bodies, such as state insurance regu-

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purchased company, causing either a net positive or a net negative adjustment to balance sheet valuation depending on the discrepancy between the purchase price and the balance sheet carrying values. This can have significant ramifications for the company's equity, key ratios, and overall valuation. Push down basis of accounting is required in "purchase transactions that result in an entity becoming substantially wholly owned," which in practice, means 95 percent or more. Push down accounting is permitted if ownership in an entity is between 80 and 95 percent, and it is prohibited with less than 80 percent ownership. Accounting Standards Codification (ASC) 805–50–S99, Business Combinations (formerly Emerging Issues Task Force, Topic D–97, Push-Down Accounting) (online at asc.fasb.org/subtopic&nav__type=topic__page%26analyticsAssetName=topic__page__subtopic%26trid=2899256). Thus, the government's maintenance of its ownership in AIG below the 80 percent threshold ensures that push down accounting is disallowed and not an issue. Securities and Exchange Commission, *SEC Staff Accounting Bulletin: Codification of Staff Accounting Bulletins, Topic 5(J)* (June 16, 2009) (online at www.sec.gov/interps/account/sabcodet5.htm#5j).

[266] Board of Governors of the Federal Reserve System, *Press Release* (Sept. 16, 2008) (online at www.federalreserve.gov/newsevents/press/other/20080916a.htm) (hereinafter "Federal Reserve Press Release").

[267] FRBNY conversation with Panel (Apr. 12, 2010).

[268] The Panel notes that in contrast to the position that the government took with regard to AIG, the government has in other instances during the financial crisis not taken advantage of the terms the private sector would have gotten. *See* Congressional Oversight Panel, *February Oversight Report: Valuing Treasury's Acquisitions,* at 7–9 (Feb. 6, 2009) (online at cop.senate.gov/documents/cop-020609-report.pdf) (discussion of a report by the international valuation firm Duff & Phelps that compares Treasury's investments with those made by private investors).

lators and OTS, possessed oversight authority but lacked any legal authority to step in and provide funds and aid to the company.

On September 16, the Federal Reserve authorized FRBNY to provide assistance to AIG in the form of an $85 billion lending facility under the authority of Section 13(3) of the Federal Reserve Act.[269] As indicated, Treasury had been involved in discussions of the rescue package and the Board and FRBNY acted in cooperation with Treasury and the Administration.[270] At the time of the initial aid to AIG, now-Secretary Geithner was the President of FRBNY, a position whose incumbent is appointed by the bank's board of directors (themselves primarily bankers or investment bankers) with the approval of the Federal Reserve.[271]

Treasury. Treasury's participation in the initial rescue of AIG was limited, as discussed above, to an advisory role. It is clear, however, that all actions taken by FRBNY were in close consultation with Treasury. In October 2008, that authority was provided through the passage of EESA, and Treasury took on a greater role in the AIG rescue as the government expanded and restructured its aid. See Sections D.2 and F.3 for a fuller discussion and analysis of Treasury's later role.

Office of Thrift Supervision. OTS was involved in conversations with Treasury and other officials during the weekend of the Lehman bankruptcy, as Treasury was concerned about AIG as well. Through these conversations and its own monitoring around this time, OTS became more aware of liquidity concerns at the holding company level, putting protections around the thrift to ensure that it remained well capitalized. OTS was not involved in any consultative manner with Treasury or the Federal Reserve concerning actions taken towards AIG, however. The calls between OTS and Treasury or the Federal Reserve were ultimately to provide OTS with an update of actions being taken, as opposed to seeking OTS officials' knowledge or opinions.

OTS continued to act as AIG's consolidated supervisor until FRBNY's loan to the company on September 16, 2008. At the close of the transaction, AIG was no longer defined as a savings and loan holding company under federal statute, and thus the holding com-

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[269] Federal Reserve Press Release, *supra* note 266. In general, Section 13(3) allows the Board of Governors of the Federal Reserve System to authorize a Federal Reserve bank (such as FRBNY) to provide emergency assistance to corporations, with certain limitations, if they determine that unusual and exigent circumstances exist (by the affirmative vote of at least five members). This lending authority has been rarely invoked and had not been used until the onset of the financial crisis (with the assistance in March 2008 to Bear Sterns) since the Great Depression. For additional discussion of Section 13(3), see Section C.4.b and Annex IV.

[270] Testimony of Sec. Geithner, *supra* note 11, at 1.

[271] Board of Governors of the Federal Reserve System, *Federal Reserve Bank Presidents* (Nov. 6, 2009) (online at www.federalreserve.gov/aboutthefed/bios/banks/default.htm). Steve Friedman, former chairman of the Board of Directors of the Federal Reserve Bank of New York at the time of the AIG bailout and a director at Goldman Sachs since April 2005 and Stone Point Capital, a private equity firm, stated in testimony before the House Committee on Oversight and Government Reform that he had no involvement in the decisions regarding AIG and that "the directors of the 12 Federal Reserve banks have no role in the regulation, supervision, or oversight of banks, bank-holding companies, or other financial institutions." Friedman stated that the Board of Governors in Washington effectively acts as the board of directors in the traditional sense, with the actual board of directors for each Federal Reserve bank serving more of an advisory capacity. House Committee on Oversight and Government Reform, Written Testimony of Steve Friedman, former chairman, Federal Reserve Bank of New York, *The Federal Bailout of AIG* (Jan. 27, 2010) (online at oversight.house.gov/images/stories/Hearings/Committee__on__Oversight/2010/012710__AIG__Bailout/TESTIMONY-Friedman-revised.pdf).

pany was no longer an entity subject to regulation by OTS.[272] As its role of equivalent regulator for EU and international purposes was based on its regulation of the holding company, OTS was no longer considered the equivalent regulator once its role as holding company regulator ended. OTS regulates only AIG FSB currently.[273]

State Insurance Regulators. Each of AIG's domestic insurance companies is a stand-alone legal entity with its own primary insurance regulator from the state in which it is domiciled.[274] During the government's rescue, the state insurance regulators were heavily involved in the protection of the insurance subsidiaries but were not called upon to provide any capital infusions from outside the AIG group. See Section F.1 for further analysis of the role played by the state insurance regulators.

Private Sector Actors. Numerous private entities also played important roles in the government's rescue of AIG. In some cases these private-sector actors played more than one role. The following list is not exhaustive, but it provides an overview of the roles that key private-sector actors played at various stages before and during the rescue:

- JPMorgan Chase became an advisor to AIG in late August 2008; it provided AIG advice on raising capital in the private markets. In the last two days before the government's rescue of AIG, FRBNY asked JPMorgan Chase to play a different role, as one of the financial institutions that would invest in the insurer in order to save it from bankruptcy. JPMorgan Chase was also the lead agent on a $15 billion, multi-bank line of credit to AIG that the insurer sought but was unable to tap in the hours before the government's initial bailout.[275]
- Goldman Sachs was one of AIG's largest counterparties until November 2008, when the government took steps to close out the exposure that Goldman and other large financial institutions had to AIG. On September 15, 2008, at the invitation of FRBNY, Goldman Sachs also took part in the failed private-sector rescue talks.[276]
- Morgan Stanley was also one of AIG's counterparties until November 2008, though its exposure to AIG was significantly smaller than Goldman's. Morgan Stanley was hired by the government as an advisor in the private-sector rescue talks from September 14–16, 2008. More recently, Morgan Stanley has served as FRBNY's banker in connection with its investment in AIG.[277]
- The law firm Davis Polk & Wardwell advised JPMorgan Chase in the failed attempt to organize a private-sector rescue of AIG. It was Davis Polk & Wardwell that informed FRBNY on the morning of September 16, 2008, that the private-sector effort had unraveled.

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[272] Testimony of Edward Liddy, *supra* note 91, at 17.

[273] Panel staff conversation with OTS (May 21, 2010).

[274] American International Group, Inc., *AIG and AIG Commercial Insurance Overview and Financial Update* (Nov. 13, 2008) (online at www.aig.com/aigweb/internet/en/files/RSSPres111308b_tcm20-132858.pdf).

[275] See Sections C1 and C2, *supra*; *AIG Drawing on Its Credit Line*, E-mail from Edgar Moreano, Federal Reserve Bank of New York, to other Federal Reserve Bank of New York officials (Sept. 16, 2008) (FRBNYAIG00470-472); E-mail from Jacqueline Lovisa, FRBNY to others at FRBNY re: AIG Update—Important (Sept. 16, 2008) (FRBNYAIG00439-440).

[276] See Section C2, *supra*, and Sections D3 and D4, *infra*.

[277] See Section C1, *supra*, and Sections D3 and F7, *infra*.

In a matter of minutes, Davis Polk & Wardwell transitioned to become an advisor to FRBNY and Treasury in the government's own rescue. Davis Polk & Wardwell's contract with FRBNY does not prevent it from also representing AIG's counterparties.[278]

• BlackRock Solutions acted as an advisor to AIG regarding the mortgage-related exposure at AIGFP in the months prior to the government rescue.[279] Since the bailout, FRBNY has retained BlackRock to manage and sell the mortgage-related instruments that two FRBNY-established SPVs purchased from AIG in late 2008.[280]

• Blackstone Advisory Services LP was retained by AIG in September 2008 to assist with its efforts to raise capital. Following the rescue, Blackstone continued to help AIG to restructure and sell its business units. Blackstone has hired away at least one AIG employee who had been charged with the same basic task within AIG.[281]

For a fuller discussion of the multiple roles private-sector institutions played in the government's rescue of AIG, and the problems raised by those roles, see Section K.5.

4. The Legal Options for Addressing AIG's Problems in September 2008

This section discusses the legal options and legal constraints that the Federal Reserve, FRBNY, and Treasury were facing in September 2008 when the Federal Reserve decided to authorize FRBNY to provide funds to AIG to meet its liquidity needs and avoid bankruptcy. A detailed analysis of the decisions made by the Federal Reserve, FRBNY, and Treasury is provided in Section F. The Federal Reserve, FRBNY, and Treasury have described their choice as "binary," either allowing AIG to file for bankruptcy or providing it with liquidity,[282] but as discussed more below and in Section F, more options were available than providing continuing capital so that all of AIG's creditors would be paid in full.

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[278] Testimony of Thomas C. Baxter, *supra* note 215; Columbia Law School, *It Really Was Too Big to Fail: Government's Lead Outside Counsel in AIG Rescue Takes a Look Back* (Mar. 3, 2010) (online at www.law.columbia.edu/media_inquiries/news_events/2010/march2010/aig-huebner); Engagement agreement between Davis Polk & Wardwell and the Federal Reserve Bank of New York, at § 10 (Sept. 16, 2008) (online at www.newyorkfed.org/aboutthefed/DavisPolk.pdf).

[279] BlackRock is one of the world's largest asset management firms. As of March 31, 2010, BlackRock's assets under management were $3.36 trillion. The firm manages these funds using a wide range of investment categories including equity, debt, cash management, real estate, and alternative investments (hedge funds). BlackRock employs over 8,500 individuals in 24 countries. The firm is publicly traded on the New York Stock Exchange and does not have a majority shareholder. Merrill Lynch, currently a subsidiary of Bank of America, PNC Financial Services Group and Barclays PLC own approximately 34.1 percent, 24.6 percent and 19.9 percent of BlackRock respectively.

Through its subsidiary, BlackRock Solutions, the firm provides advisory services, risk management analysis, and investment platforms. BlackRock Solutions is walled off from the rest of BlackRock. BlackRock conversation with Panel staff (May 18, 2010). As of March 31, 2010, BlackRock Solutions was utilized by clients with portfolios totaling approximately $9 trillion. The Financial Markets Advisory practice of BlackRock Solutions provides valuations and risk analysis on securities such as credit derivatives, securitized products and bonds. This practice also specializes in asset disposition for distressed portfolios.

[280] Joint Written Testimony of Thomas C. Baxter and Sarah Dahlgren, *supra* note 255, at 11; see Sections F.4, F.5, and J.1, *infra*.

[281] See Section C.1, *supra*; The Blackstone Group, *Advisory and Restructuring Selected Transactions* (Mar. 2, 2009) (online at www.blackstone.com/cps/rde/xchg/bxcom/hs/5694.htm); The Blackstone Group, *Our People* (online at www.blackstone.com/cps/rde/xchg/bxcom/hs/firm_ourpeople_6244.htm) (accessed June 8, 2010).

[282] Joint Written Testimony of Thomas C. Baxter and Sarah Dahlgren, *supra* note 255, at 4.

a. The Bankruptcy Regime That Would Have Applied

Bankruptcy was one option for AIG in mid-September 2008. It would have provided a mechanism to gather, value, and protect AIG's assets (within the limitations discussed below) by imposing an automatic stay on creditors while they negotiated a payment plan.[283] A bankruptcy filing would have constituted an event of default for AIG's various derivative contracts, and it would have stopped collateral calls by and termination payments to the counterparties to those derivative contracts.[284] Those counterparties, however, would not have been subject to the automatic stay, and would have been able to close out their agreements,[285] seize collateral that had been posted prior to the bankruptcy filing, mitigate their losses, and offset or net out other obligations.[286] They would have been subject to the substantial discount negotiated for unsecured creditors as part of the bankruptcy plan for any deficiency claims they asserted.[287]

Even though bankruptcy would have assisted the reorganization or liquidation of the AIG parent company and the derivatives portfolio, bankruptcy would not have covered all parts of AIG because the bankruptcy court would not have had jurisdiction over AIG's domestic or foreign insurance subsidiaries or other foreign subsidiaries without a sufficient connection to the United States.[288] This removes a substantial number of AIG's businesses from the pur-

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[283] For a more detailed discussion of the general protections provided by bankruptcy law, see Annex IV. Generally, creditors are subject to an automatic stay to protect the debtor's assets while they negotiate a payment plan, cannot get an unfair advantage from payments or collateral transfers made while the debtor was insolvent, and cannot terminate or modify contracts based on the debtor's financial condition or bankruptcy filing. *See* 11 U.S.C. 362(a), 365(e)(1), 544, 545, 547, 548. The decision of which subsidiaries would seek bankruptcy protection would be made on an entity-by-entity basis, weighing a variety of factors such as financial condition, the likely outcome of the bankruptcy, and the potential consequences on consumers, suppliers, creditors, and investors and taking into account that several of AIG's subsidiaries would not be able to file for bankruptcy in the U.S., as discussed below.

[284] It should be noted that AIG was not forced to post collateral. AIG could have refused to do so, also resulting in an event of default that would allow the counterparty requesting collateral to cancel the contract. However, such a refusal would have had negative business consequences for AIG, resulting in a loss of trust by its various counterparties that would hinder its ability to operate as a financial company.

[285] For an explanation of what it means to "close out" a derivative contract, see Annex III (What are Credit Default Swaps?).

[286] For a more detailed discussion of the specific provisions in the bankruptcy code providing additional protection or favorable treatment to counterparties to various financial instruments, see Annex IV. Generally, counterparties to various "financial instruments"—defined broadly to include credit default swaps issued by AIG and AIG's repurchase agreements—are exempt from the automatic stay, the prohibition on modifying or terminating contracts based on a bankruptcy filing, and various avoidance actions related to pre-bankruptcy collateral transfers. *See* 11 U.S.C. 101, 362(b)(6)–(7), 362(b)(17), 362(b)(27), 362(o), 546(e)–(g), 546(j), 553, 555, 556, 559, 560, 561. These statutory provisions, including those added to or amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("2005 amendments"), provide a "safe harbor" to the counterparties to various financial contracts and are thus often referred to as the "safe harbor" provisions. The Federal Reserve, FRBNY, and Treasury (as well as the SEC, CFTC, FDIC, and OCC) were proponents of the safe harbor provisions. *See, e.g.*, House Committee on the Judiciary, *Committee Report on the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 109th Cong., at 20 (Feb. 2005) (H. Rept. 109–31) (online at frwebgate.access.gpo.gov/cgi-bin/
getdoc.cgi?dbname=109__cong__reports&docid=f:hr031p1.109.pdf).

[287] Counterparties do not receive special priority for their deficiency claims, if any; these deficiency claims are unsecured claims subject to the discount negotiated for unsecured creditors as part of the bankruptcy plan.

[288] *See* 11 U.S.C. § 109(a) (requiring U.S. connection), 109(b)(2) (excluding domestic insurance companies and certain banks from Chapter 7 bankruptcy), 109(b)(3) (excluding foreign insurance companies from Chapter 7), 109(d) (making these Chapter 7 exclusions applicable to Chapter 11).

view of the bankruptcy court.[289] It is unclear how a bankruptcy filing would have affected the business or solvency of the insurance subsidiaries, the actions of the various insurance regulators, or the decisions of current and prospective insurance customers regarding insurance coverage.[290] The cross-border implications for the foreign subsidiaries—and the potential problems arising from the interplay between different regulatory and insolvency regimes—are also unclear. Moreover, once AIG had entered bankruptcy, it would have likely lost the confidence of market counterparties necessary to operate as a financial company, although normal considerations may not have applied if the government was the debtor-in-possession (DIP) lender.[291]

Finally, it is unclear how an AIG bankruptcy filing would have impacted the company's many counterparties or the financial system as a whole. Despite concerns about AIG's financial condition and its ability to pay, many of its CDS counterparties had not decided to close out their derivative contracts by mid-September 2008. If AIG had filed for bankruptcy, however, they probably would have done so, resulting in some level of disorder in the capital markets and causing liquidity pressure on some of the counterparties.[292] The severity of the market impact and how quickly the markets would have been able to recover are unclear. If the Lehman Brothers bankruptcy is any guide, the impact of an AIG bankruptcy on the financial system would have been severe. As discussed more below, when Lehman filed for bankruptcy, the LIBOR–OIS spread (a measure of illiquidity in financial markets) spiked significantly, providing one measure of the extent of the impact of Lehman's filing on the markets.[293] AIG was a much larger company with a more complicated corporate structure, more subsidiaries, more counterparties to its various derivative contracts and securities lending agreements, and an insurance component

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[289] For example, AIG "owns the largest commercial and industrial insurance company in the U.S. and one of our country's and the world's largest life insurance companies." House Committee on Oversight and Government Reform, Written Testimony of Eric Dinallo, superintendent, New York State Insurance Department, *The Causes and Effects of the AIG Bailout*, at 2 (Oct. 7, 2008) (online at oversight.house.gov/images/stories/documents/20081007100906.pdf) (hereinafter "Written Testimony of Eric Dinallo").

[290] For additional discussion of the potential impact on the insurance subsidiaries, see Section E2 and Annex VIII. For example, some of AIG's insurance regulators (New York, Texas, and Pennsylvania) have provided that they would not necessarily have seized AIG's insurance subsidiaries if the AIG parent company had filed for bankruptcy (providing Conseco Inc. as an example of an insurance holding company bankruptcy (Chapter 11) that did not require the insurance regulators to seize the insurance subsidiaries (who remained solvent before and after the holding company filed)). However, they indicated that they would have seized the subsidiaries if they believed formal action was necessary to protect the insurance subsidiaries or their policyholders. Panel staff conversation with Texas Department of Insurance (May 24, 2010); Panel staff conversation with NAIC (Apr. 23, 2010).

[291] For additional explanation of DIP financing, see Section E. The government may have provided an additional level of comfort, reliability, financial stability, or negotiating leverage to an AIG bankruptcy. However, it should be noted that the timing of an AIG bankruptcy would determine the government DIP lender. For example, if AIG had filed for bankruptcy before the enactment of EESA, Treasury would not have had the authority to be the DIP lender, leaving only the Federal Reserve banks to serve as the lender of last resort under Section 13(3) of the Federal Reserve Act.

[292] As discussed above, the bankruptcy filing would have constituted an event of default giving the counterparties the option to terminate or close out their derivative contracts. It should be noted that this discussion relates to CDS contracts issued by AIG.

[293] On September 15, 2008, the LIBOR–OIS spread jumped 22 percent from its level on the previous trading day to 105 basis points. By September 30, 2008, the metric had reached 232 basis points, a 168 percent increase from the trading day prior to Lehman Brother's bankruptcy. This metric, which averaged 74 basis points for the first three quarters of 2008, spiked to an average of 294 basis points during October 2008. For additional discussion of the importance of the LIBOR–OIS spread and Lehman's impact on the markets, see Section F.1(b)(iv).

that reached many individuals and businesses. The potential impact of an AIG bankruptcy filing is discussed in more detail in Sections E.2 and F.1 below.

There was no legal structure or resolution authority that had the capacity to address the resolution of AIG, the impact of an AIG bankruptcy filing on its insurance subsidiaries, the cross-border implications for the foreign subsidiaries, *and* the potential systemic consequences for the financial system as a whole. Treasury did not have the authority to act because Congress had not yet passed EESA.[294] As a result, the only alternative to bankruptcy that the government saw was intervention by the Federal Reserve using its emergency powers under Section 13(3) of the Federal Reserve Act. As indicated below, however, when it came to 13(3), more options were available to the Federal Reserve and FRBNY than the specific actions they took, beginning with the $85 billion RCF to make funds immediately available to AIG to fund its liquidity needs.

b. The Federal Reserve's Section 13(3) Authority

Section 13(3) of the Federal Reserve Act provides the Federal Reserve with the authority to authorize Federal Reserve banks to provide emergency assistance to individuals, partnerships, and corporations in limited circumstances as the lender of last resort.[295] It provides that the Federal Reserve Board "may authorize any Federal Reserve bank . . . to discount . . . notes, drafts, and bills of exchange" for "any individual, partnership, or corporation" if three conditions are met. First, the Board of Governors must determine that "unusual and exigent" circumstances exist by the affirmative vote of at least five members. Second, the notes, drafts, and bills of exchange must be secured to the satisfaction of the Federal Reserve bank. Third, the Federal Reserve bank must determine that the person or institution involved cannot secure adequate credit from other banking institutions.[296] In addition to Section 13(3), the Federal Reserve banks have the authority to exercise "incidental powers as shall be necessary to carry on the business of banking within the limitations prescribed by this Act."[297] Thus,

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[294] EESA was enacted on October 3, 2008. Treasury provided part of AIG's government assistance thereafter, such as the $40 billion preferred stock investment on November 10, 2008, as part of its SSFI under the TARP. *See, e.g.*, U.S. Department of the Treasury, *Treasury to Invest in AIG Restructuring Under the Emergency Economic Stabilization Act* (Nov. 10, 2008) (online at www.treas.gov/press/releases/hp1261.htm). As discussed in Section C.2 above, however, it should be noted that even though Treasury's formal participation in the AIG rescue began after the passage of EESA, it was in close consultation with the Federal Reserve and FRBNY regarding the forms of assistance provided to AIG.

[295] *See* 12 U.S.C. 343. Section 13(13) of the Federal Reserve Act, 12 U.S.C. 347c, allows the Federal Reserve to make advances to individuals, partnerships, and corporations, but these advances cannot exceed 90 days and must be secured by U.S. Treasury, U.S. agency, or U.S. agency-guaranteed obligations.

[296] 12 U.S.C. 343; *see also* David H. Small and James A. Clouse, *The Scope of Monetary Policy Actions Authorized Under the Federal Reserve Act*, at 14–16 (July 19, 2004) (online at www.federalreserve.gov/pubs/feds/2004/200440/200440pap.pdf). Section 13(3) also provides that the discounted instruments must bear interest "at rates determined under section 14(d)," and Section 14(d) provides that discount rates are to be set at least every 14 days, "with a view of accommodating commerce and business." Regulation A provides one set of authorizations for Federal Reserve lending under Section 13(3)—clarifying that credit must not be available from "other sources" (not just other "banking institutions"), adding the gloss that the institution's "failure to obtain such credit would adversely affect the economy," and providing that the discount rate will be "above the highest rate in effect for advances to depository institutions"—but this does not preclude the Federal Reserve Board from authorizing lending pursuant to Section 13(3) under other authorities. Panel staff conversation with Federal Reserve Board staff (May 27, 2010); 12 CFR § 201.4(d) (Regulation A).

[297] 12 U.S.C. § 341(4).

the incidental powers provision could supplement the authority granted in Section 13(3), but it would not give the Federal Reserve banks authority to take actions that were specifically prohibited by the Federal Reserve Act (Section 13(3) or otherwise).

There is very little historical precedent to shape the interpretation of Section 13(3).[298] The provision was enacted during the Great Depression and was used to extend 123 loans totaling around $1.5 million to a variety of businesses from 1932 to 1936.[299] The Federal Reserve's authority was broadened significantly in 1991, allowing the Federal Reserve to authorize any Federal Reserve bank to discount notes, drafts, or bills of exchange that "are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank"—removing the restriction that it could only discount the types of paper that could be discounted for member banks. The change both provided the Federal Reserve with additional flexibility and potentially made borrowing under the section more attractive.[300] However, loans were not actually made pursuant to the Federal Reserve's Section 13(3) authority again from 1936 until 2008.[301] Since March 2008, the Federal Reserve has relied on Section 13(3) several times, three times in providing assistance to AIG: the original $85 billion RCF in September 2008, a $37.8 billion Securities Borrowing Facility (SBF) in October 2008, and the Maiden Lane facilities (ML2 and ML3) in November 2008.[302]

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[298] It should be noted that the Federal Reserve Board not only had broad discretion under the statute but it is also generally relatively insulated from legal challenge. It is unclear whether anyone would have standing to sue the Federal Reserve related to its actions involving AIG, and in any event, the standard of review is very deferential (requiring clear evidence of arbitrariness or capriciousness). *See Huntington Towers, Ltd. v. Franklin National Bank*, 559 F.2d 863, 868 (2d Cir. 1978) ("Absent clear evidence of grossly arbitrary or capricious action on the part of [the Federal Reserve Bank] . . . it is not for the courts to say whether or not the actions taken were justified in the public interest, particularly where it vitally concerned the operation and stability of the nation's banking system."); *Raichle v. Federal Reserve Bank*, 34 F.2d 910 (2d Cir. 1929) ("It would be an unthinkable burden upon any banking system if its open market sales and discount rates were to be subject to judicial review. . . . The remedy sought would make the courts, rather than the Federal Reserve Board, the supervisors of the Federal Reserve System, and would involve a cure worse than the malady."). These cases do not involve actions taken by the Federal Reserve pursuant to Section 13(3), but their reasoning is arguably equally applicable.

[299] *See* Howard H. Hackley, *Lending Functions of the Federal Reserve Banks: A History*, at 130 (May 1973). According to the Bureau of Labor Statistic's CPI inflation calculator, $1.5 million in 1936 "has the same buying power" as $23.5 million in 2010. The largest single loan was for $300,000 (roughly the same buying power as $4.7 million in 2010).

[300] *See* James A. Clouse, *Recent Developments in Discount Window Policy*, Federal Reserve Bulletin No. 975 (Nov. 1994). Section 13(3) was also modified in 1935 by changing the requirement that notes, drafts, and bills of exchange be "indorsed and secured" to "indorsed or secured." In 2008, Congress added a requirement that the Federal Reserve Board must report to the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs on its justifications for exercising its Section 13(3) authority, the specific terms of the actions taken, and periodic updates on the status of the loan. EESA § 129(a)–(b). Copies of the reports must be sent to the Congressional Oversight Panel. EESA § 129(e). The Federal Reserve has also made the reports public by releasing them on its website (www.federalreserve.gov).

[301] It should be noted that the Federal Reserve invoked Section 13(3) to authorize the Federal Reserve banks to make loans to thrifts under certain terms and conditions from July 1, 1966 to March 1, 1967 and again from December 24, 1969 to April 1, 1970, but no thrift institutions took advantage of the lending facility. *See* Board of Governors, 56th Annual Report, at 92–93 (1969); Board of Governors, 53rd Annual Report, at 91–92 (1966). The Federal Reserve banks have also relied on Section 13(b), which was enacted in 1934 and repealed in 1958, to provide up to $280 million in working capital to any established business with maturities up to five years and no loan limits. *See* David Fettig, *Lender of More than Last Resort: Recalling Section 13(b) and the Years When the Federal Reserve Opened Its Discount Window to Businesses*, Banking and Policy Issues Magazine, at 45–46 (Dec. 2002) (online at www.minneapolisfed.org/pubs/region/02-12/lender.pdf).

[302] *See* Federal Reserve Bank of St. Louis, *Clarifying the Roles and the Spending: The Separate Functions of the Fed, Treasury and FDIC* (Fall 2009) (online at www.stlouisfed.org/publica-

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In addition to the facilities ultimately authorized by the Federal Reserve and entered into by FRBNY, other options would have been allowed (or available to the Federal Reserve) under Section 13(3) to deal with AIG's liquidity problems.[303] For example, in September 2008, the Federal Reserve could have authorized FRBNY to provide, under certain terms and conditions, short-term funding to give the parties more time to prepare a solution for AIG's liquidity problems, conditional lending that more equitably distributed the "pain" that would have resulted from an AIG failure, or a guarantee of a private loan or a portion of AIG's outstanding obligations.[304]

The Federal Reserve could have agreed to provide a short-term loan or bridge loan to AIG, secured by the same assets posted as collateral for the $85 billion RCF under Section 13(3). It could have made clear to AIG and its subsidiaries, their creditors, their regulators, and the markets that this funding was being extended to allow the parties more time to negotiate a prepackaged bankruptcy, to prepare for a regular bankruptcy, or to otherwise restructure or reorganize AIG's businesses or contractual obligations going forward. It should be noted, however, that any such short-term arrangement would have produced its own complications. Because contractual and safe harbor provisions provided favorable treatment to certain of AIG's creditors,[305] the Federal Reserve and FRBNY would have had to use their authority under Section 13(3) to impose restrictions on the use of the funds to prevent an unfair advantage for these creditors in the event of a later bankruptcy.[306] For example, to the extent that AIG had the ability to use the funds to provide additional collateral to its CDS counterparties, those funds could not have been used in a way that would help AIG effectively reorganize or survive. Instead, the public funds would have simply increased the level of security of the counterparties, providing additional protection to these counterparties in the event of an AIG bankruptcy filing (as discussed above, the CDS counterparties would not be subject to the automatic stay, could keep previously posted collateral, and would not be subject to various avoidance actions).

The Federal Reserve could also have imposed additional terms or conditions on its extension of credit so that the pain of an AIG rescue could be shared more equitably. For example, Martin Bienenstock, partner and chair of business solutions and government department, Dewey & LeBoeuf, testified before the Panel that

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tions/cb/articles/?id=1659) (providing information on recent Federal Reserve programs authorized under Section 13(3): collateralized funding provided to Bear Sterns, collateralized funding provided to AIG, Money Market Investment Funding Facility, Term Asset-Backed Securities Loan Facility, Term Securities Loan Facility, and Primary Dealer Credit Facility. For an analysis of the Federal Reserve's legal authority to provide these particular facilities, see Annex IV.

[303] Thus, although the Federal Reserve's decision was binary in the sense that it could have allowed AIG to enter bankruptcy in September 2008, or it could have provided assistance to prevent such a bankruptcy filing, the Federal Reserve's options of the types of assistance it could have provided under Section 13(3) included more than the full payment of all of AIG's creditors.

[304] For additional discussion and evaluation of these three alternatives, see Section F.

[305] For example, CDS counterparties and parties to AIG repo funding would receive favorable treatment under the bankruptcy code, and securities lending counterparties would enjoy similar contractual protections, if the regulators did not seize the life insurance subsidiaries participating in the securities lending program.

[306] Section 13(3) specifically provides that the assistance provided by the Federal Reserve "shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe." 12 U.S.C. § 343.

"all lenders are justified in requiring shared sacrifice" and that FRBNY could have used its lender status "to demand concessions" from the material creditors of AIG's business that were insolvent or not profitable.[307]

Finally, Section 13(3) is sufficiently broad that the Federal Reserve could have authorized FRBNY to provide a guarantee for a private loan to AIG or for a portion of AIG's outstanding obligations under certain terms and conditions.[308] A guarantee is simply an obligation to provide funds if needed; this is little different than the credit facilities made available to AIG. FRBNY could lend up to a stated amount, under certain terms and conditions, as needed, to a corporation that was unable to otherwise obtain adequate credit; the facility guaranteed AIG creditors by making up to $85 billion available to AIG to satisfy claims on the company.

In general, the Federal Reserve would be able to authorize a guarantee pursuant to Section 13(3) only if the guarantee were fully secured.[309] Thus, the amount of the guarantee would be "capped" by the value of available or unencumbered assets that could be posted as collateral.[310] The Federal Reserve System (and the taxpayers) would still have been liable (or at risk) for the full amount of the guaranteed private loan[311] or the guaranteed AIG obligations,[312] but it would not have had to provide funds to AIG initially and could have created a period in which markets could have stabilized, and the possibility of a private-sector solution could have increased.[313] On the other hand, the Federal Reserve would not have been able to authorize an open-ended guarantee or blanket assurance to AIG's creditors that AIG or its insurance subsidiaries would continue to be viable or to operate as going concerns in the near or medium term because AIG would not have had sufficient collateral for such an open-ended guarantee.[314] In addi-

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[307] Congressional Oversight Panel, Written Testimony of Martin Bienenstock, partner and chair of business solutions and government department, Dewey & LeBoeuf, *COP Hearing on TARP and Other Assistance to AIG,* at 1, 4 (May 26, 2010) (online at cop.senate.gov/documents/testimony-052610-bienenstock.pdf) (hereinafter "Written Testimony of Martin Bienenstock").

[308] Panel staff conversation with Federal Reserve Board staff (May 28, 2010). Without the proposed terms and conditions, it is difficult to say whether the Federal Reserve could authorize or FRBNY could provide a certain type of guarantee under Section 13(3). However, this paragraph will provide a general discussion of possibilities and limitations.

[309] Section 13(3) requires that assistance provided must be "indorsed or otherwise secured to the satisfaction of the Federal Reserve bank." 12 U.S.C. § 343.

[310] As part of a hybrid public-private solution, AIG may have pledged the same assets as collateral for both the private loan and the public guarantee. In that case, the private creditors would have had to agree to release collateral to FRBNY in the amount of any claims that they asserted in relation to the public guarantee. In the alternative, the private consortium or syndicate may not have required AIG to provide collateral for the loan because the protection offered by the Federal Reserve's guarantee provided sufficient security.

[311] Because the Federal Reserve would have been liable for the entire $85 billion under either the $85 billion Revolving Credit Facility or a guarantee of an $85 billion private loan, its risk profile would have been the same under either option. If FRBNY had issued a guarantee for such a loan, the transaction could be viewed as "for" AIG, under the authorizing statute.

[312] If the Federal Reserve guaranteed a portion of AIG's obligations, AIG would still have been required to raise capital to address its liquidity needs from other sources.

[313] The Federal Reserve would have to provide funds only when AIG defaulted on its obligations.

[314] In an open-ended guarantee, the Federal Reserve would not be able to quantify the extent of its potential exposure, making it difficult for the Federal Reserve to obtain adequate collateral or security. The Federal Reserve could estimate liabilities on a certain date based on current business or market conditions. However, the numbers and assumptions underlying the estimate will change (e.g., as the company generates additional liabilities or market conditions change), resulting in a significant level of uncertainty or risk for a guarantor. It is questionable whether any company would have sufficient assets to secure such an open-ended guarantee or compensate a guarantor for taking on so much risk.

tion, any Section 13(3) transaction must involve a "discount" or a fee structured as the economic equivalent of previously computed interest.[315] A guarantee of a private loan would allow the creditors to rely on the full faith and credit of the United States, and there is no reason to think that the strength of such a credit would not reduce, or modify, the otherwise required interest rate, but that would have to be shown.[316]

D. Subsequent Government Actions

1. Securities Borrowing Facility: October 2008

By September 30, 2008, just 14 days after the Federal Reserve Board approved the $85 billion RCF, AIG had already drawn down approximately $61 billion of that money.[317] It became apparent that the facility would be inadequate to meet all of AIG's obligations.[318] The Federal Reserve Board and FRBNY worried about further ratings downgrades, which would—among other adverse effects—trigger more collateral calls on AIGFP.[319]

On October 6, 2008, the Federal Reserve Board approved an additional SBF to allow FRBNY to lend up to $37.8 billion to AIG.[320] The lending would occur on an overnight basis, with FRBNY borrowing investment-grade fixed income securities from AIG's life insurance subsidiaries in return for cash collateral.[321] The facility allowed AIG to replenish liquidity to its securities lending program—by extending its then-outstanding lending obligations where those obligations were not rolled over or replaced by transactions with other private market participants—while giving FRBNY possession and control of the securities.

In its report to Congress shortly after establishing this facility, the Board wrote that the facility "addresses liquidity strains placed on AIG due to the ongoing withdrawal of counterparties from secu-

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[315] As discussed in Annex IV, the term "discount" has been interpreted broadly to refer to any purchase of paper (or essentially any advance of funds in return for a note) with previously-computed interest. *See* Board of Governors of the Federal Reserve System, Federal Reserve Bulletin, at 269 (Mar. 1958).

[316] Another path to satisfaction of the "discount" condition would be to argue that the guarantee, like the loan, was "for" the benefit of AIG, although not made to AIG directly.

[317] AIG used these funds for the following: $35.3 billion to cover loans to AIGFP for collateral postings, GIA, and other maturities; $13.3 billion in capital contributions for insurance subsidiaries; $3.1 billion to repay securities lending obligations; $2.7 billion for AIG funding commercial paper maturities; $1.5 billion for intercompany loan repayment; $1.0 billion each in contributions for AIG Consumer Finance Group's (AIGCFG) subsidiaries and debt repayments; and $2.7 billion in additional borrowing. Including paid in kind interest and fees on the amount borrowed, AIG's total balance outstanding on the facility was $62.96 billion at the end of September. AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 43; Board of Governors of the Federal Reserve System, *Data Download Program* (online at www.federalreserve.gov/datadownload/) (hereinafter "Federal Reserve Data Download Program") (accessed May 28, 2010).

[318] Securities Borrowing Facility for AIG, *supra* note 264, at 2.

[319] House Committee on Oversight and Government Reform, Written Testimony of Thomas C. Baxter, executive vice president and general counsel, Federal Reserve Bank of New York, *The Federal Bailout of AIG*, at 5–6 (Jan. 27, 2010) (online at oversight.house.gov/images/stories/Hearings/Committee__on__Oversight/2010/012710__AIG__Bailout/TESTIMONY-Baxter.pdf) (hereinafter "Testimony of Thomas C. Baxter").

[320] Financial Stability Oversight Board, *Minutes of the Financial Stability Oversight Board Meeting,* at 2 (Nov. 9, 2008) (online at www.financialstability.gov/docs/FSOB/FINSOB-Minutes-November-9-2008.pdf). The Federal Reserve Board publicly announced the Securities Borrowing Facility on October 8, 2008, the day that FRBNY established it. *See* Board of Governors of the Federal Reserve System, *Press Release* (Oct. 8, 2008) (online at www.federalreserve.gov/newsevents/press/other/20081008a.htm) (hereinafter "Federal Reserve Press Release").

[321] These securities were previously lent by AIG's insurance subsidiaries to third parties. The maximum amount of credit that FRBNY could extend at any one time was $37.8 billion. The Board made this authorization under Section 13(3) of the Federal Reserve Act.

rities borrowing transactions" and "reduce[s] the pressure on AIG to liquidate immediately the portfolio of RMBS that were purchased with the proceeds of the securities lending transactions." [322] Furthermore, the Board wrote, "The size of the Secured Borrowing Facility will permit the Reserve Bank, if necessary, to replace all remaining securities borrowing counterparties of AIG." [323]

During this period, AIG made extensive use of the Commercial Paper Funding Facility (CPFF), one of several liquidity programs that the Federal Reserve created during the financial crisis to deal with market stress. The CPFF purchased three-month unsecured and asset-backed commercial paper directly from qualified borrowers.[324] Three AIG subsidiaries—AIG Funding, Curzon Funding, and Nightingale Finance—were authorized to sell commercial paper to this facility in maximum amounts of $6.9 billion, $7.2 billion and $1.1 billion, respectively, while a fourth, ILFC, lost its access to this facility in January 2009 after S&P downgraded its short term credit rating.[325] Access to this Federal Reserve facility effectively supplemented the RCF and allowed AIG to maintain short-term borrowing on the same favorable terms that other major financial institutions were enjoying at the peak of the financial crisis.

2. The TARP Investment and First Restructuring: November 2008

Throughout the fall of 2008, it became clear that the rating agencies took an increasingly dim view of AIG's underlying creditworthiness. This growing skepticism intensified throughout the Lehman weekend amidst mounting concerns connected to its CDS positions. AIG and its subsidiaries were placed on credit watch with negative implications by S&P. On Monday, September 15, S&P lowered AIG's rating to A− due to mounting derivatives losses and diminished capacity to meet collateral obligations.

The only factor preventing AIG's creditworthiness from deteriorating immediately after September 16, 2008 was FRBNY's $85 billion RCF, said Rodney Clark, a managing director in S&P's rating services.[326] On October 3, Moody's downgraded AIG's senior unsecured debt rating to A3 from A2, and maintained a continuing watch review for possible further downgrades potentially triggered

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[322] Securities Borrowing Facility for AIG, *supra* note 264, at 2.

[323] Securities Borrowing Facility for AIG, *supra* note 264.

[324] The CPFF incurred no losses, and earned approximately $5 billion in earnings from credit enhancement fees, registration fees, and interest income. At its height in January 2009, it held $350 billion in commercial paper. It ceased purchasing new commercial paper on February 1, 2010, and its balance of commercial paper holdings was zero as of April 26, 2010. Board of Governors of the Federal Reserve System, *Credit and Liquidity Programs and the Balance Sheet,* at 10 (May 2010) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport201005.pdf) (hereinafter "Credit and Liquidity Programs and the Balance Sheet"); Board of Governors of the Federal Reserve System, *Data Download Program* (Factors Affecting Reserve Balances (H.4.1)—Net portfolio holdings of Commercial Paper Funding Facility LLC: Wednesday level) (online at www.federalreserve.gov/datadownload/) (accessed June 2, 2010).

[325] "AIG Funding use[d] the proceeds to refinance AIG's outstanding commercial paper as it mature[d], meet other working capital needs and make prepayments under the Fed Facility while the two other programs use[d] the proceeds to refinance maturing commercial paper. On January 21, 2009, S&P downgraded ILFC's short-term credit rating and, as a result, ILFC [could] no longer participate in the CPFF." At the end of December 2009, AIG had $4.7 billion outstanding under CPFF. American International Group, Inc., *What AIG Owes the U.S. Government* (Mar. 31, 2010); AIG Form 10–K for FY09, *supra* note 50, at 18.

[326] Written Testimony of Rodney Clark, *supra* note 80, at 5.

by activities related to AIG's global divestiture plan.[327] AIG was also expected to report an approximately $25 billion loss on November 10, 2008.

The credit rating agencies advised AIG that the company's upcoming November 10 report of third quarter results would likely trigger a ratings downgrade in the absence of a "parallel announcement of solutions to its liquidity problems."[328] AIG was having difficulty selling assets to pay down debt from the RCF and meet anticipated liquidity needs, particularly in light of continuing collateral calls under its CDS contracts.[329] Consequently, in the days leading up to AIG's earnings announcement, the Federal Reserve and Treasury hurried to put together additional financial assistance from the federal government that would address AIG's growing debt burden.

On November 10, 2008, FRBNY and Treasury announced a comprehensive multi-pronged plan to address AIG's liquidity issues, create a "more durable capital structure," and provide AIG with more time and increased flexibility to sell assets and repay the government.[330] This restructuring was intended to stabilize AIG's businesses and address rating agency concerns in order to allow an orderly restructuring.[331] As Secretary Geithner later stated, "[a]voiding any downgrade of AIG's credit rating was absolutely essential to sustaining the firm's viability and protecting the taxpayers' investment."[332]

As part of the November 10 restructuring announcement, Treasury said it planned to use $40 billion of TARP money to purchase newly issued AIG perpetual preferred shares and warrants to purchase AIG common stock;[333] this initiative was known as the Systemically Significant Failing Institutions program (SSFI), and AIG was its only beneficiary. At the same time, FRBNY reduced AIG's line of credit under the RCF to $60 billion. FRBNY also announced that it was restructuring the facility by extending the loan from two to five years and lowering the interest rate and fees charged.

On November 10, AIG reported a third-quarter 2008 loss of $24.5 billion, of which $19 billion was due to the securities lending program and AIGFP's CDSs.[334] Also on that day, Treasury and the Federal Reserve Board announced two major initiatives to increase and restructure federal assistance to AIG; FRBNY would be authorized to create two limited liability companies or SPVs—ML2

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[327] Moody's Investor Service, *Global Research* (Nov 10, 2008).

[328] Testimony of Thomas C. Baxter, *supra* note 319, at 9.

[329] Board of Governors of the Federal Reserve System, *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,* at 4 (online at federalreserve.gov/monetarypolicy/files/129aigrestructure.pdf) (hereinafter "Federal Reserve Report on Restructuring"); Testimony of Thomas C. Baxter, *supra* note 319, at 9.

[330] Board of Governors of the Federal Reserve System, *Federal Reserve Board and Treasury Department Announce Restructuring of Financial Support to AIG* (Nov. 10, 2008) (online at www.federalreserve.gov/newsevents/press/other/20081110a.htm) (hereinafter "Federal Reserve Press Release Announcing Restructuring").

[331] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010).

[332] Testimony of Sec. Geithner, *supra* note 11, at 8.

[333] The perpetual preferred shares were later known as the Series D Preferred Stock Purchase Agreement. American International Group, Inc., *U.S. Treasury, Federal Reserve and AIG Establish Comprehensive Solution for AIG,* at 1 (Nov. 10, 2008) (online at media.corporate-ir.net/media_files/irol/76/76115/reports/Restructuring10Nov08LTR.PDF).

[334] Federal Reserve Report on Restructuring, *supra* note 329, at 4.

and ML3—to purchase troubled assets from AIG and its subsidiaries.

3. Maiden Lane II

Maiden Lane II (ML2) was set up by FRBNY to address the liquidity problems AIG was encountering in early November 2008 in its securities lending program, which was the same objective for which FRBNY had established the SBF just a few weeks earlier. But the SBF was only intended as a temporary solution to the ongoing liquidity pressure on AIG stemming from the unwinding of AIG's securities lending program. On November 10, FRBNY, in close consultation with the Board, announced the creation of ML2, which would purchase RMBS assets from AIG's securities lending collateral portfolio. The motivating force was to get contingent liabilities off AIG's balance sheet.[335] The Federal Reserve authorized FRBNY to lend up to $22.5 billion to ML2; AIG also acquired a subordinated $1 billion interest in the facility, which would absorb the first $1 billion of losses.[336] On December 12, FRBNY extended a $19.5 billion loan to ML2 to fund its RMBS purchases from AIG's life insurance subsidiaries (which had $39.3 billion face value) in connection with the termination of the outstanding $37.8 billion of securities loans and related agreements with AIG.

The differences between ML2 and ML3 must be emphasized. ML2 purchased deeply discounted securities from AIG, which was then able to use the proceeds of those sales to close out related obligations. In contrast, in ML3, discussed in the following section, the SPV purchased securities from AIG's counterparties in transactions, the net effect of which was to give those counterparties the full notional value of their securities.

AIG used the proceeds to repay all of its outstanding debt under the SBF, thereby terminating that short-lived arrangement, as well as ending the securities lending program under which AIG had acquired the RMBS.[337] As discussed above, the SBF established in October 2008 was designed to be a temporary solution to the liquidity pressures facing AIG. AIG's counterparties in the securities lending program, whose claims were finally closed out by the ML2 transaction, are set out in the table below and discussed further in Section F below.[338]

FIGURE 15: PAYMENTS TO COUNTERPARTIES FOR U.S. SECURITIES LENDING

[Dollars in billions]

Counterparty	Amount
Barclays	$7.0
Deutsche Bank	6.4
BNP Paribas	4.9

[335] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010).

[336] As a result of this transaction, AIG's remaining exposure to losses from its U.S. securities lending program were limited to declines in market value prior to closing and its $1 billion of funding.

[337] AIG Form 10–K for FY08, *supra* note 47, at 251 ("The life insurance companies applied the initial consideration from the RMBS sale, along with available cash and $5.1 billion provided by AIG in the form of capital contributions, to settle outstanding securities lending transactions under the U.S. Securities Lending Program, including those with the NY Fed, which totaled approximately $20.5 billion at December 12, 2008, and the U.S. Securities Lending Program and the Securities Lending Agreement with the NY Fed have been terminated.").

[338] See Section F.2 for further discussion of the Securities Borrowing Facility.

FIGURE 15: PAYMENTS TO COUNTERPARTIES FOR U.S. SECURITIES LENDING—Continued

[Dollars in billions]

Counterparty	Amount
Goldman Sachs	4.8
Bank of America	4.5
HSBC	3.3
Citigroup	2.3
Dresdner Kleinwort	2.2
Merrill Lynch	1.9
UBS	1.7
ING	1.5
Morgan Stanley	1.0
Societe Generale	0.9
AIG International Inc.	0.6
Credit Suisse	0.4
Paloma Securities	0.2
Citadel	0.2
Total	$43.8

Cash flows generated by assets of ML2, i.e., principal and interest from amortization of mortgages and other loans underlying the securities, are now being used to pay down the loans to this SPV owned by FRBNY.[339] As of March 31, 2010 (see Figure 16), the principal balance of the FRBNY loan to ML2 had decreased by 28 percent from its original level of $19.5 billion to $15.3 billion. Since the inception of this SPV, FRBNY has earned $309 million in accrued and capitalized interest from its investments in ML2. Additionally, as of December 31, 2009, FRBNY received $55.3 million in proceeds from the sales of assets in ML2.[340] The Federal Reserve estimates the market value of ML2 as of March 31, 2010 at $16.2 billion, slightly above the outstanding FRBNY loan balance of $15.3 billion and slightly below the total outstanding principal balance, including the $1 billion AIG contribution to ML2, meaning that as of the date of the estimate, FRBNY anticipated payment in full on its loans, and payment in part on AIG's contribution. After repayment of the FRBNY loan, remaining funds from ML2 will be used to pay AIG's $1 billion subordinated interest and any residual value will be split five-sixths to FRBNY, one-sixth to AIG.[341] The ability of AIG to retain some upside was apparently designed to satisfy rating agencies.

FIGURE 16: OUTSTANDING PRINCIPAL BALANCE OF MAIDEN LANE II AS OF MARCH 31, 2010[342]

[Dollars in billions]

	FRBNY Senior Loan	AIG Contribution	Total
Funding, December 12, 2008	$19.5	$1	$20.5

[339] Board of Governors of the Federal Reserve System, Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet, at 17 (Oct. 2009) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200910.pdf) (hereinafter "Federal Reserve System Monthly Report").

[340] Maiden Lane II LLC, *Financial Statement for the Year Ended December 31, 2009, and for the Period October 31, 2008 to December 31, 2008, and Independent Auditors' Report* (Apr. 21, 2010) (online at www.fednewyork.org/aboutthefed/annual/annual09/MaidenLaneIIfinstmt2010.pdf) (hereinafter "ML II Financial Statement for Year End Dec. 31, 2009").

[341] Federal Reserve Bank of New York, *AIG RMBS LLC Facility: Terms and Conditions* (Dec. 16, 2008) (online at www.newyorkfed.org/markets/rmbs__terms.html).

FIGURE 16: OUTSTANDING PRINCIPAL BALANCE OF MAIDEN LANE II AS OF MARCH 31, 2010 [342]—Continued

[Dollars in billions]

	FRBNY Senior Loan	AIG Contribution	Total
Accrued and Capitalized Interest	.309	.044	.353
Repayments	(4.5)	—	(4.5)
Total	$15.3	$1	$16.4

[342] Credit and Liquidity Programs and the Balance Sheet, *supra* note 324; Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (Mar. 25, 2010) (online at www.federalreserve.gov/releases/h41/) (hereinafter "Federal Reserve H.4.1 Statistical Release").

4. Maiden Lane III

Following the initial rescue of AIG via the government's extension of an $85 billion line of credit, FRBNY increasingly sought a resolution of AIGFP's sizable multisector CDO CDS exposure, which had grown to $72 billion as of September 30, 2008.[343] The terms of the CDSs required collateral to be posted on a decline in market value of the reference securities, the CDOs, and also in the event of an AIG ratings downgrade. Hence, the rating downgrade of September 15 and the ongoing drop in CDO values resulted in collateral calls that put severe strain on AIG's liquidity.[344] At the end of September, AIG's management, financial advisors, and legal counsel presented certain options to FRBNY and its financial advisors "for addressing the liquidity and mark-to-market losses." [345] Also in late October, FRBNY took over from the Chief Financial Officer of AIGFP the ongoing negotiations with the CDS counterparties through which AIG and FRBNY sought to unwind the transactions and eliminate any further financial exposure to AIG from this business.[346] In late October and early November, BlackRock Solutions developed three options to accomplish this objective.

The first option developed by BlackRock Solutions would have required AIGFP's counterparties to cancel their credit default swap contracts and retain some of the risk in the underlying CDOs. This would be accomplished by having the counterparties sell the underlying CDOs to an SPV funded jointly by FRBNY, AIG and the counterparties themselves, with counterparties' interest subordinate to that of FRBNY. The problems with this option were the intensive work required to negotiate the arrangements with each counterparty and the lack of incentive for the counterparties to retain long term exposure to the performance of the CDOs through the subordinated loan to the SPV.

The second option entailed creation of an SPV to assume AIG's position in the CDS contracts with performance by the SPV guar-

[343] Written Testimony of Elias Habayeb, *supra* note 27, at 3.

[344] Collateral calls for AIGFP multi-sector CDOs totaled $16.1 billion at the end of July. On August 6, 2008, AIGFP announced a further $16.5 billion in collateral posting. The S&P rating for AIG was downgraded to A- with a negative outlook on September 15, 2008. As a result of this downgrade, AIGFP estimated it needed $20 billion to meet collateral demands and transaction termination payments. AIGFP was subsequently required to fund approximately $32 billion fifteen days following this rating downgrade. AIG Form 10–K for FY08, *supra* note 47, at 3–4; Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress,* at 140–141 (Oct. 21, 2009) (online at www.sigtarp.gov/reports/congress/2009/October2009_Quarterly_Report_to_Congress.pdf).

[345] Written Testimony of Elias Habayeb, *supra* note 27, at 7.

[346] Written Testimony of Elias Habayeb, *supra* note 27, at 8–9.

anteed by FRBNY. The counterparties would agree to give up the right to make further collateral calls in return for FRBNY's assurance against further loss in value of the CDOs. This option would have conferred no benefit to AIG's counterparties other than strengthening the credit quality of their CDSs. However, the result of the enhanced credit quality of the CDS would have required counterparties to return part of the collateral to the SPV which was replacing AIG. FRBNY chose not to pursue this option because of concerns about the open-ended taxpayer exposure through the FRBNY guarantee and legal impediments to the Federal Reserve's ability to provide the broad guarantee contemplated in this arrangement.[347] It appears that there was some discussion of using the TARP to provide a guarantee; in the end, the TARP was not used for this purpose.

Ultimately, FRBNY recommended, and the Federal Reserve and Treasury agreed, that the best option would be to have FRBNY, through an SPV, purchase the CDOs underlying the credit swap contracts from the counterparties and thereby extinguish those contracts. The selection of this option led to the counterparties permanently keeping $35 billion in cash collateral and in effect receiving the entire notional amount of the CDOs at a time when the market value for those CDOs was less than one half of that amount. Although taxpayers were exposed to downside risk in this arrangement, they also retained rights to the upside; the government however, as approximately 80 percent owner of AIG, participated in the losses which the $35 billion in collateral represented. At the same time, this arrangement terminated the CDS contracts and the ongoing liquidity pressure on AIG they were generating.

Hence, on November 10, 2008, the Federal Reserve authorized FRBNY to lend up to $30 billion to Maiden Lane III (ML3), a newly created SPV, to purchase the relevant CDOs.[348] In total, FRBNY loaned ML3 $24.3 billion, and AIG made a $5 billion equity investment in ML3. ML3 then purchased the CDOs from 16 of AIG's counterparties at a market value of about $27.2 billion.[349] The counterparties kept the $35 billion cash collateral they had already received from AIG in earlier collateral calls, and agreed to terminate AIG's CDS contracts. The combination of market value payments and cash collateral approximated the par value of the CDS contracts, or $62 billion.

All CDOs owned by ML3 were based on cash assets; no synthetic CDOs were accepted for inclusion in this SPV. Further, ML3 did not acquire all the CDSs of AIGFP. Regulatory filings reveal that, on December, 31 2008, AIG was left with roughly $12.5 billion of potentially risky multi-sector CDOs that were excluded from a larger $62.1 billion purchase by ML3. The multi-sector CDOs that re-

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[347] Written Testimony of Elias Habayeb, *supra* note 27, at 3, 7. For a description of other options considered, *see* Testimony of Thomas C. Baxter, *supra* note 319, at 7–11. *See also* Office of the Special Inspector General for the Troubled Asset Relief Program, *Factors Affecting Efforts to Limit Payments to AIG Counterparties,* at 13–14 (Nov. 17, 2009) (online at sigtarp.gov/reports/audit/2009/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf).

[348] Written Testimony of Elias Habayeb, *supra* note 27, at 8–10. For instance, on November 25, 2008, FRBNY made a senior loan to ML3 of $15 billion, and AIG made a $5 billion equity investment in ML3. *See* Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (Nov. 28, 2008) (online at www.federalreserve.gov/Releases/H41/20081128/). Actual transactions subsequently occurred on November 25, December 18, and December 22, 2008.

[349] ML II Financial Statement for Year End Dec. 31, 2009, *supra* note 340, at 4.

mained on AIG's books were either largely or entirely synthetics. In the fourth quarter of 2008, AIGFP's synthetic multi-sector CDOs had a net notional value of $9.8 billion, according to documents subpoenaed from the Federal Reserve and later shared with the Panel.[350]

As reflected in the $35 billion in payments noted above, both prior to receiving the federal bailout on September 16 and during the interim period when government assistance was limited to the RCF, AIG had made cash collateral payments to the counterparties. For example, as seen in Figure 17, the largest purchaser of credit protection on its CDO exposure, Societe Generale, received a total of $16.5 billion in full satisfaction of its contracts. These payments consisted of $5.5 billion received in the months prior to any government assistance being provided to AIG; $4.1 billion received between September 16 and November 10; and $6.9 billion from ML3, which was announced on November 10 and whose first closing occurred on December 3.

This example serves to illustrate the point that through the combination of collateral payments and the purchase of CDOs by ML3, FRBNY assured that counterparties in these cases received 100 percent of the notional value of their CDSs.[351] Although one counterparty, UBS, agreed to a 2 percent concession if the other counterparties took this haircut, FRBNY was not able to negotiate a concession with the other counterparties.[352] The report of SIGTARP notes there were a number of policy considerations that limited FRBNY's ability to secure concessions from AIG's CDS counterparties. The report states that FRBNY was unwilling to use its role as a regulator to compel haircuts from the institutions it oversaw. FRBNY also decided against any attempts to interfere with the sanctity of the contracts AIG had executed with its counterparties as well as refusing to threaten a possible bankruptcy of AIG since it never intended to allow the firm to collapse. Finally, FRBNY was concerned that imposed concessions by the counterparties would be negatively viewed by the rating agencies. Mr. Barofsky concludes that while these concerns were valid, these decisions greatly hampered any possibility of concessions from the counterparties.[353]

Indeed, in the course of settlement of the ML3 purchases, the SPV returned $2.5 billion in collateral overpayments to AIGFP. In

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[350] In the fourth quarter of 2008, CDS written on synthetic positions required the insurer to post approximately $3.0 billion of collateral on the aforementioned notional amount of $9.8 billion of synthetics. The larger figure ($12.5 billion) reported in AIG's SEC filings decreased to $12.0 billion net notional amount in the first quarter of 2009, and decreased further in the first quarter of 2010 to $7.6 billion. Spreadsheet provided to the Panel by FRBNY showing AIGFP multi-sector CDS as of Nov. 5, 2008 (FRBNY-TOWNS-R1-171934); AIG Form 10–K for FY08, *supra* note 47, at 41

[351] Amounts actually paid were in excess of par to compensate for "the economic costs borne by the counterparties", i.e., the charges paid "to break financing arrangement to deliver the bonds" and "forgone income" related to the lower interest that could be earned by reinvesting the cash collateral relative to the interest rates paid on that collateral to AIGFP.

[352] House Committee on Oversight and Government Reform, Written Testimony of Neil Barofsky, special inspector general for the Troubled Asset Relief Program, *The Federal Bailout of AIG,* at 5 (Jan. 27, 2010) (online at oversight.house.gov/images/stories/Hearings/Committee__on__Oversight/2010/012710__AIG__Bailout/Testimony__Jan__27__2010__House__Committee__on__Oversight__and__Government__Reform.pdf). For further discussion, please reference section below.

[353] SIGTARP Report on AIG Counterparties, *supra* note 246, at 29.

the table below, "pre-govt" refers to counterparty payments made before September 16, 2008.

FIGURE 17: MAIDEN LANE III RELATED PAYMENTS TO AIGFP COUNTERPARTIES [354]

[Dollars in billions]

Counterparty	Collateral			ML3	Total
	Pre-Govt	Post-RCF	Net		
Societe Generale	$5.5	$4.1	$9.6	$6.9	$16.5
Goldman Sachs	5.9	2.5	8.4	5.6	14.0
Deutsche Bank	3.1	2.6	5.7	2.8	8.5
Merrill Lynch	1.3	1.8	3.1	3.1	6.2
Calyon	2.0	1.1	3.1	1.2	4.3
UBS	0.5	0.8	1.3	2.5	3.8
DZ Bank	0.1	0.7	0.8	1.0	1.8
Barclays	0.0	0.9	0.9	0.6	1.5
Bank of Montreal	0.3	0.2	0.5	0.9	1.4
Royal Bank of Scotland	0.4	0.2	0.6	0.5	1.1
Wachovia	(0.5)	0.7	0.2	0.8	1.0
Bank of America	0.1	0.2	0.3	0.5	0.8
Rabobank	(0.2)	0.5	0.3	0.3	0.6
Dresdner Bank	0.0	0.0	0.0	0.4	0.4
HSBC Bank	0.0	0.2	0.2	0.0	0.2
LBW	0.0	0.0	0.0	0.1	0.1
Total	$18.5	$16.5	$35.0	$27.2	$62.2

[354] "Pre-Govt" refers to counterparty payments made prior to September 16, 2008. "Post-RCF" refers to payments made during the period from September 16 through November 9, 2008. The Post-RCF total excludes payments of $5.9 billion made on September 16 and thereafter to counterparties other than those that received payments from Maiden Lane III and listed in this table.

As in the case of ML2, cash flows generated by ML3 are now being used to pay down FRBNY's loans to the SPV.[355] As of March 31, 2010 (see Figure 18), the principal amount outstanding under the FRBNY loan to ML3 had decreased to $17.3 billion from its original level of $24.3 billion, a 40 percent reduction. Since the inception of this SPV, FRBNY has earned $390 million in accrued and capitalized interest from its investments in ML3. As of December 31, 2009, FRBNY had received $1.8 million in proceeds from the sales of assets in ML3.[356] The Federal Reserve estimates the market value of ML3 as of March 31, 2010 at $23.7 billion, well above the outstanding FRBNY loan balance of $17.3 billion and in excess of the total principal balance, including the $5.2 billion AIG equity contribution to ML3. After repayment of the loan to FRBNY, remaining funds from ML3 will be paid 2/3 to FRBNY and 1/3 to AIG.[357]

[355] Federal Reserve System Monthly Report, *supra* note 339, at 17.

[356] Federal Reserve Bank of New York, *Maiden Lane III LLC Financial Statements for the Year Ended December 31, 2009, and for the Period October 31, 2008 to December 31, 2008, and Independent Auditor's Report*, at 7 (Apr. 21, 2010) (online at www.newyorkfed.org/aboutthefed/annual/annual09/MaidenLaneIIIfinstmt2010.pdf).

[357] Federal Reserve Bank of New York, *AIG CDO LLC Facility: Terms and Conditions* (Dec. 3, 2008) (online at www.newyorkfed.org/markets/aclf_terms.html).

FIGURE 18: OUTSTANDING PRINCIPAL BALANCE OF MAIDEN LANE III AS OF MARCH 31, 2010 [358]

[Dollars in billions]

	FRBNY Senior Loan	AIG Contribution	Total
Funding, November 25, 2008	$15.1	$5	$20,.1
Funding, December 18, 2009	9.2	—	9.2
Funding subtotal	24.3	5	29.3
Accrued and capitalized interest	.390	.231	.621
Repayments	(7.4)	—	(7.4)
Principal Balance	$17.3	$5.2	$22.5

[358] Credit and Liquidity Programs and the Balance Sheet, *supra* note 324; Federal Reserve H.4.1 Statistical Release, *supra* note 342.

5. Additional Assistance and Reorganization of Terms of Original Assistance: March and April 2009

Although ML2, ML3, and Treasury's TARP initial capital infusion helped relieve AIG's financial pressures, asset valuations continued to decline, and AIG's losses increased through the end of 2008. The company reported a net loss of $61.7 billion for the fourth quarter of 2008 on March 2, 2009, capping off a year in which AIG incurred approximately $99 billion in total net losses. A substantial contributor to AIG's loss was the significant loss on investment holdings of AIG's insurance subsidiaries in the fourth quarter of 2008, which totaled $18.6 billion pre-tax. AIGFP suffered continuing losses of $16.2 billion as well during that quarter.

These losses raised the prospect of another round of rating agency downgrades and collateral calls that would require further cash postings from AIG. In response, the Federal Reserve and Treasury announced on March 2, 2009, that they would again restructure their existing aid to AIG and provide additional assistance. As with the November 2008 restructuring, this decision was driven by the recognition that AIG faced increasing pressure on its liquidity following a downgrade in its credit ratings and the real risk of further downgrades.[359] FRBNY and Treasury have stated that restructuring was also necessary to stabilize AIG and to protect financial markets and the existing investment.[360]

Under the March restructuring, Treasury substantially increased its involvement in AIG, with the goal of improving AIG's financial leverage. First, Treasury announced a new five-year standby $29.8 billion TARP preferred stock facility, which would allow AIG to make draw-downs as needed.[361] As AIG draws on this facility, the aggregate liquidation preference for Treasury's preferred stock is adjusted upward. Treasury also exchanged its November 2008 cu-

[359] Testimony of Sec. Geithner, *supra* note 11, at 8.

[360] *See* U.S. Department of the Treasury, *U.S. Treasury and Federal Reserve Board Announce Participation in AIG Restructuring Plan* (Mar. 2, 2009) (online at www.financialstability.gov/latest/tg44.html) (hereinafter "Participation in AIG Restructuring Plan"). *See also* House Committee on Financial Services, Written Testimony of William C. Dudley, president and chief executive officer, Federal Reserve Bank of New York, *Oversight of the Federal Government's Intervention at American International Group*, at 5 (Mar. 24, 2009) (online at www.house.gov/apps/list/hearing/financialsvcs_dem/hr03240923.shtml).

[361] *See* Participation in AIG Restructuring Plan, *supra* note 360; U.S. Department of the Treasury, *Troubled Asset Relief Program Transaction Report for Period Ending June 2, 2010*, at 20 (June 6, 2010) (online at www.financialstability.gov/docs/transaction-reports/6-4-10%20Transactions%20Report%20as%20of%206-2-10.pdf) (creating a $30 billion facility; this facility was reduced by $165 million, representing bonuses paid to AIG Financial Products employees).

mulative preferred stock interest for noncumulative preferred stock, which more closely resembles common stock and is, therefore, more favorably looked upon by the credit rating agencies.[362] By relaxing the dividend requirement on its preferred shares with no offsetting increase in principal owed, the exchange effected a concession to AIG and served to improve its financial leverage.

FRBNY also took several actions at this time with respect to the terms and structure of the RCF. First, it announced the creation of SPVs for American International Assurance Company, Limited (AIA) and American Life Insurance Company (ALICO), two of AIG's foreign insurance company subsidiaries, through which AIG would contribute the equity of AIA and ALICO in exchange for preferred and common interests in the SPVs. AIG would then transfer the preferred interests in the SPVs to FRBNY in exchange for a $25 billion reduction in the outstanding balance of the RCF, to $35 billion. In doing so, FRBNY essentially provided another bailout to AIG by purchasing these two subsidiaries and thereby improving its balance sheet. Second, FRBNY further relaxed the interest rate terms on amounts borrowed under the RCF.[363] The combined effect of these changes was to save AIG $1 billion in interest costs per year. While FRBNY will receive less compensation for its risk exposure, FRBNY concluded that restructuring the terms was in the government's long-term interest, especially in light of AIG's continued reliance on the RCF to pay its continuing obligations.[364]

While Treasury and FRBNY negotiated the formal terms of the restructuring throughout March, employee retention payments at AIGFP attracted congressional scrutiny and public animosity.[365] At the same time, Treasury and the Federal Reserve Board worked with outside counsel to consider a Chapter 11 filing, as one of several options.[366]

On April 17, 2009, AIG and Treasury executed the restructuring and additional equity purchase announced in March.[367] Although the $40 billion in preferred equity was converted into non-cumulative preferred stock, this investment cannot be fully redeemed until AIG repays the $1.6 billion in missed dividends associated with the preferred stock that Treasury acquired in November 2008.[368] Under the April 2009 purchase agreement, Treasury committed to invest up to $29.835 billion in AIG preferred stock with

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[362] Noncumulative preferred stock is more like common stock largely because its dividends are non-cumulative, which means that when the company fails to make dividend payments, the payments do not accumulate for later payment. Participation in AIG Restructuring Plan, *supra* note 360.

[363] As noted in Figure 1, the previous terms implemented in November 2008 called for an interest rate of LIBOR plus 3 percent, with a floor of 3.5 percent. In April 2009 the floor was eliminated.

[364] *See* Participation in AIG Restructuring Plan, *supra* note 360.

[365] See Section J, *infra*, for a discussion of Executive Compensation.

[366] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010).

[367] Specifically, the parties entered into the Series E Exchange Agreement (to exchange Series D Cumulative Preferred Stock for Series E Non-Cumulative Preferred Stock) and the Series F Purchase Agreement. American International Group, Inc., *Form 10-Q for the Quarterly Period Ended March 31, 2009,* at 11 (May 7, 2009) (online at www.sec.gov/Archives/edgar/data/5272/000095012309008272/y76976e10vq.htm) (hereinafter "AIG Form 10-Q for the First Quarter 2009").

[368] U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending April 14, 2010,* at 18 (Apr. 16, 2010) (online at www.financialstability.gov/docs/transaction-reports/4-16-10%20Transactions%20Report%20as%20of%204-14-10.pdf) (hereinafter "Treasury Transactions Report").

warrants,[369] of which $7.5 billion had been drawn down as of February 17, 2010.[370]

A summary of the Treasury's holding of preferred stock is shown in the following table.

FIGURE 19: TREASURY'S PREFERRED SHARES IN AIG

Type	Date Acquired	Par Value as of June 7, 2010	Dividend Rate	Comment/Status
Series C Preferred	September 16, 2008 ..	$23.8 billion	None	Fully tethered to AIG stock price
Series D Preferred	November 25, 2008 ...	$0 ($1.6 billion is outstanding from unpaid dividends).	10 percent quarterly, cumulative.	No longer in existence; exchanged for Series E Preferred
Series E Preferred	April 17, 2009	$40.0 billion	10 percent quarterly, non-cumulative.	Replaced Series D Preferred
Series F Preferred	April 17, 2009	$7.5 billion	10 percent quarterly, non-cumulative.	Par value will increase as AIG draws down more funds

6. Government's Ongoing Involvement in AIG

a. Status of Further Assistance

Since the restructuring of federal assistance in March and April 2009, there have been no further significant changes in the government's financial support for AIG. As previously announced in March 2009, on December 1, 2009 AIG entered into an agreement with FRBNY to reduce the debt AIG owed FRBNY, which on that date stood at $45.1 billion, by $25 billion.[371] In exchange, FRBNY received $25 billion of preferred equity interests in two SPVs that in turn held the equity of two foreign AIG subsidiaries, AIA and ALICO. FRBNY received preferred interests of $16 billion in the AIA SPV and $9 billion in the ALICO SPV. Dividends for these investments accrue as a percentage of FRBNY's preferred positions and are capitalized and added to FRBNY's preferred interests.[372] As of May 27, 2010, the book value of FRBNY's preferred investments, including accrued dividends, in the AIA SPV and the

[369] On April 17, 2009, Treasury provided additional assistance to AIG and restructured its original investment. In consideration for its investment through the Series D preferred shares Treasury received 2 percent of the issued and outstanding common stock on the original investment date of November 25, 2008. Following AIG's stock split on June 30, 2009, this represented 2,689,938.3 shares and has a strike price of $50. As part of its purchase of Series F preferred stock, Treasury received 150 common stock warrants, representing 3,000 common shares, with an exercise price of $0.00002. Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress,* at 46 (Apr. 20, 2010) (online at www.sigtarp.gov/reports/congress/2010/April2010_Quarterly_Report_to_Congress.pdf) (hereinafter "SIGTARP Quarterly Report to Congress"); Treasury conversations with Panel staff (June 2, 2010).

[370] This represents Treasury's commitment of $30 billion, less $165 million "representing retention payments AIG Financial Products made to its employees in March 2009." Treasury Transactions Report, *supra* note 368, at 18.

[371] The data for the level of the RCF at the time of the restructuring is as of November 25, 2009. This is the last reporting date prior to the restructuring. American International Group, Inc., *AIG Closes Two Transactions That Reduce Debt AIG Owes Federal Reserve Bank of New York by $25 Billion* (Dec. 1, 2009) (online at phx.corporateir.net/External.File?item=UGFyZW50SUQ9MjE4ODl8Q2hpbGRJRD0tMXxUeXBlPTM=&t=1) (hereinafter "AIG Closes Two Transactions"); Federal Reserve H.4.1 Statistical Release, *supra* note 342.

[372] Federal Reserve H.4.1 Statistical Release, *supra* note 2. ("Dividends accrue as a percentage of the FRBNY's preferred interests in AIA Aurora LLC and ALICO Holdings LLC. On a quarterly basis, the accrued dividends are capitalized and added to the FRBNY's preferred interests in AIA Aurora LLC and ALICO Holdings LLC").

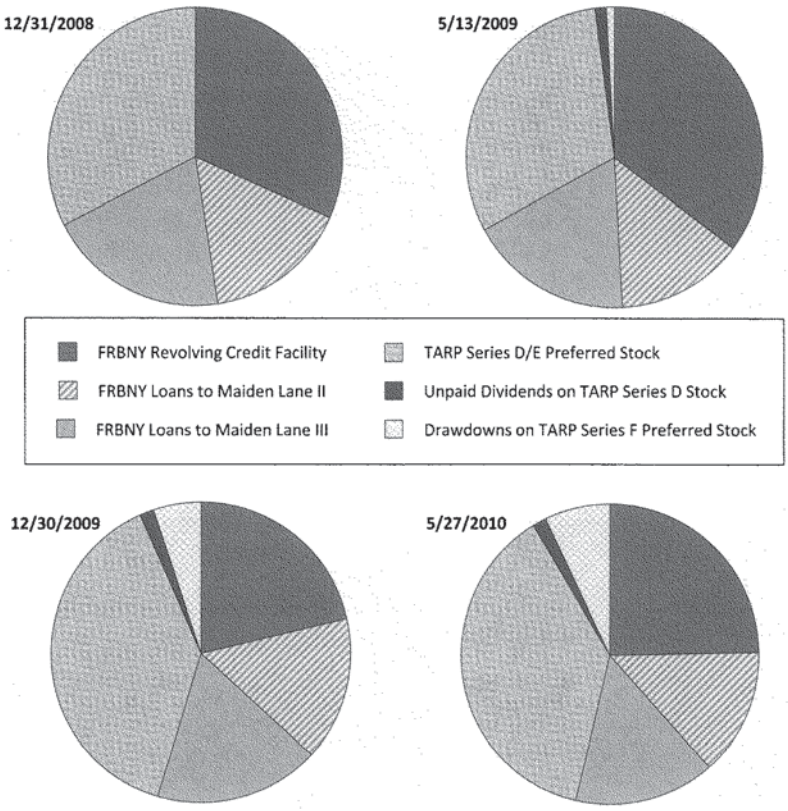
ALICO SPV are $16.4 billion and $9.2 billion, respectively.[373] AIG has announced that it intends to continue positioning AIA and ALICO for either an initial public offering or a third-party sale.[374]

As of May 27, 2010, the total amount of funds invested in AIG by the United States government, through both FRBNY and the TARP, was approximately $132.4 billion. There was $83.3 billion provided by FRBNY outstanding as of that date across four different initiatives. $26.1 billion was outstanding under the RCF as of May 27, 2010, a 64 percent decrease from the $72.3billion outstanding under the facility on October 22, 2008. ML2 and ML3 owe FRBNY $14.9 billion and $16.6 billion, respectively. FRBNY also owns a total of $25.6 billion of preferred interests and accrued dividends on in the AIA SPV and the ALICO SPV. Finally, the TARP currently owns $49.1 billion in AIG preferred stock as a result of the initial $40 billion investment, $1.6 billion in unpaid dividends associated with this investment, and $7.54 billion of draw-downs from the $30 billion facility provided to AIG on April 17, 2009. The value of these holdings, and the cashflow generated by them, is discussed in more detail in Section H below.

[373] Federal Reserve H.4.1 Statistical Release, *supra* note 2.

[374] AIG Closes Two Transactions, *supra* note 371 ("These transactions advance AIG's goal of positioning two of the company's leading international life insurance franchises, American International Assurance Company, Limited (AIA) and American Life Insurance Company (ALICO), for initial public offerings or third party sale, depending on market conditions and subject to customary regulatory approvals").

FIGURE 20: BREAKDOWN OF U.S. GOVERNMENT INVESTMENT IN AIG OVER TIME [375]



b. AIG Trust

As discussed earlier in this section, FRBNY received a 77.9 percent equity interest in AIG "for Treasury" [376] in return for providing the company with access to an $85 billion credit facility. On January 16, 2009, FRBNY announced the formation of a trust—called the AIG Credit Facility Trust (AIG Trust)—to oversee this equity interest "in the best interests of the U.S. Treasury." According to the trust agreement, the trustees must aim to dispose of this interest "in a value maximizing manner" and may not dispose of the stock without receiving approval from FRBNY, which may not grant its approval without first consulting with Treasury.[377]

FRBNY initially named three individuals to serve as trustees: Jill M. Considine, former chairman of the Depository Trust &

[375] Federal Reserve H.4.1 Statistical Release, *supra* note 342; U.S. Department of the Treasury, *TARP Transaction Reports* (Dec. 31, 2008 May 27, 2010) (online at www.financialstability.gov/latest/reportsanddocs.html); AIG Form 10–K for FY09, *supra* note 50, at 45.

[376] See discussion in Annex IV.

[377] Federal Reserve Bank of New York, *AIG Credit Facility Trust Agreement*, at 8 (Jan. 22, 2009) (online at www.newyorkfed.org/newsevents/news/markets/2009/AIGCFTAgreement.pdf) (hereinafter "AIG Credit Facility Trust Agreement").

Clearing Corporation; Chester B. Feldberg, former chairman of Barclays Americas; and Douglas L. Foshee, president and chief executive officer of El Paso Corporation. These trustees would be able to exercise control over the shares, but they would neither occupy a seat on the company's board nor supervise day-to-day management of the company. In announcing the formation of the trust, FRBNY emphasized that in order to avoid conflicts of interest that could result from its regulatory responsibilities, it would have no "discretion or control over the voting and consent rights associated with the equity interest in AIG."[378] On February 26, 2010, FRBNY announced that Peter A. Langerman, chairman, president, and chief executive officer of the Mutual Series fund group of Franklin Templeton Investments, would replace Mr. Foshee.[379]

AIG continues to operate with a CEO and corporate board and, as delineated in AIG's corporate governance guidelines, AIG management submits regular reports to its board that detail the company's performance, as well as "significant events, issues and risks" that may affect performance.[380] The company's Corporate Governance Guidelines also specify that the number of seats on the board may fluctuate between eight and 12, but it permits exceptions when a larger or smaller size is "necessary or advisable in periods of transition or other particular circumstances." The board currently has 13 directors. At least two-thirds of the directors must be independent, and these independent directors select the chairman.[381]

When AIG failed to pay dividends for four consecutive quarters on preferred stock held by Treasury, Treasury received the right to appoint two directors to the Board. It exercised this right on April 1, 2010, appointing Donald H. Layton, former Chairman and CEO of E*Trade and Ronald A. Rittenmeyer, former Chairman, President, and CEO of Electronic Data Systems.[382]

E. The Impact of the Rescue: Where the Money Went

The decision to force a failing institution into bankruptcy triggers a number of rules and processes, many of which are automatic.[383] The claims of some creditors are stayed,[384] and established rules let the creditors decide whether to seek to liquidate the failing

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[378] Federal Reserve Bank of New York, *Statement Regarding Establishment of the AIG Credit Facility Trust* (Jan. 16, 2009) (online at www.newyorkfed.org/newsevents/news/markets/2009/an090116.html). *See also* AIG Credit Facility Trust Agreement, *supra* note 377, at 2.

[379] *See* Federal Reserve Bank of New York, *Statement Regarding Appointment of New Trustee to AIG Credit Facility Trust* (Feb. 26, 2010) (online at www.newyorkfed.org/newsevents/news/markets/2010/an100226.html).

[380] *See* American International Group, Inc., *Corporate Governance Guidelines* (Apr. 7, 2010) (online at www.aigcorporate.com/corpgovernance/CorporateGovernanceGuidelines.pdf) (hereinafter "AIG Corporate Governance Guidelines") ("The Board, the Finance and Risk Management Committee and the Audit Committee receive reports on AIG's significant risk exposures and how these exposures are managed. AIG's Chief Risk Officer provides reports to the Compensation and Management Resources Committee with respect to the risks posed to AIG by its employee compensation plans").

[381] *Id.*

[382] *See* U.S. Department of the Treasury, *Treasury Names Two Appointees to AIG'S Board of Directors* (Apr. 1, 2010) (online at www.ustreas.gov/press/releases/tg623.htm).

[383] The bank resolution process triggers a similar set of rules and processes.

[384] Parties to various "financial contracts" are exempt from the automatic stay and receive certain protections including their ability to close their contracts, exercise contractual rights such as the ability to collect previously posted collateral, offset or net out other obligations, and assert deficiency claims, if any. *See, e.g.*, 11 U.S.C. §§ 101, 362(b)(6)–(7), 362(b)(17), 362(b)(27), 362(o), 546(e)–(g), 546(j), 553, 555, 556, 559, 560, 561.

business and distribute its assets, or to continue it as a going concern.[385] The creditors agree to a plan of reorganization, which is then presented to a bankruptcy court for approval.[386] Shareholders are wiped out, secured creditors look to their collateral, and unsecured creditors may suffer significant losses. The person running the business, who may be a trustee but is more likely to be the DIP, may seek financing from a DIP lender, whose lending has preference over other claims.[387] The DIP lender has significant leverage over the business and will generally be in a position to decide which commercial contracts will be continued and which terminated. As discussed above and in more detail in Annex VIII, the process is complicated for non-depository financial institutions by the fact that certain kinds of financial contracts are not subject to an automatic stay, which makes bankruptcy a less complete solution for such companies. The result of the bankruptcy process in general, however, is that unsecured creditors are unlikely to receive the full amount of their claims, and they will not all be treated the same: some will do better in the process than others.

The government's decision to rescue AIG in full rather than consider any alternatives is discussed in more detail below.[388] If AIG had sought bankruptcy protection and the government had become the DIP lender, as was the case in the bankruptcies of the automotive companies, it would have been in a powerful position to reorganize AIG's business and obligations and terminate commercial contracts.[389] It did not do so, however, and that choice had significant consequences in two respects.

First, the choice made by the government meant that it could no longer condition financial assistance on the willingness of AIG's creditors to accept discounts or other losses in performing under or closing out their contracts with AIG.[390] Bankruptcy law is designed

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[385] Creditors can literally force a debtor into an involuntary bankruptcy under certain conditions. *See* 11 U.S.C. § 303 (explaining the process for involuntary bankruptcies). Mounting creditor claims and collateral calls may also cause the debtor to voluntarily file for bankruptcy and choose whether to reorganize or liquidate under Chapter 11 or whether to liquidate under Chapter 7.

[386] *See* 11 U.S.C. 1129 (providing plan confirmation requirements). It should be noted that Chapter 11 includes a "cram down" provision that allows the bankruptcy court to confirm a bankruptcy plan over the objection of some creditors in certain circumstances (e.g., as long as one class of impaired creditors has accepted the plan, and the plan "does not discriminate unfairly, and is fair and equitable" to each class of impaired, dissenting creditors). *See* 11 U.S.C. § 1129(b).

[387] Generally, if the debtor seeks, or the creditors force the debtor into Chapter 11 bankruptcy proceedings, a trustee can be appointed or the debtor can remain in possession of the company during the reorganization or liquidation process. *See* 11 U.S.C. § 1105 (providing that the court can terminate the trustee and restore the debtor to possession); 11 U.S.C. § 1107 (explaining rights, powers, and duties of a DIP). *Cf.* 11 U.S.C. §§ 701–704, 721 (explaining that only a trustee can operate the business in Chapter 7). A DIP usually seeks financing (a "DIP loan") at the outset to provide cash or working capital during the bankruptcy proceedings and to provide some confidence to those necessary for a successful reorganization such as vendors, customers, and employees. The DIP lender receives a lien that has priority over pre-bankruptcy secured creditors (upon their consent), administrative expenses incurred during bankruptcy, and all other claims. *See* 11 U.S.C. § 364(c) (providing priority over administrative expenses, which have priority over other unsecured claims); 11 U.S.C. § 364(d) (allowing a priming lien or priority over existing liens).

[388] For additional discussion of the government's decision to intervene, see Section C.2.

[389] *See* Congressional Oversight Panel, *September Oversight Report: The Use of TARP Funds in the Support and Reorganization of the Domestic Automotive Industry,* at 44–45, 49, 111–12 (Sept. 9, 2009) (online at cop.senate.gov/documents/cop-090909-report.pdf) (hereinafter "September Oversight Report").

[390] Only in bankruptcy or equivalent proceedings can parties to a contract be made to accept less than they are owed under a contract. If a party does not voluntarily accept less than it is owed, then a default under the contract exists, and the aggrieved party may sue under the

Continued

to force creditors to take discounts or other losses under extant contracts. That being the case, the threat of bankruptcy—negotiating in the shadow of bankruptcy—also carries enormous power. As discussed in more detail below, the government did not use that power, with the result that all creditors were paid in full. This issue has received the most attention insofar as it relates to the CDS counterparties whose holdings were purchased by ML3. Those counterparties, however, only received $27.1 billion of the monies that AIG and related entities received from the government. The counterparties to *other* instruments and obligations have received larger sums, in total, as a result of the government's assistance to AIG.

AIG had run out of money, and it was able to make payments under all these claims only due to the intervention of the government. Paying less than the full amount owed would have amounted to contractual defaults that would likely have triggered the bankruptcy that the government was trying to avoid.[391] The only way to avoid this consequence would have been for every single creditor that had a contract big enough to trigger cross-default provisions with AIG and that the government wished to accept concessions to agree voluntarily to accept less than it was owed. Once the government made clear that it was committed to the wholesale rescue of AIG, however, as discussed in more detail in Section F, it lost the significant leverage it might have had over the thousands of AIG creditors. This course of action particularly benefitted those parties that would have fared worse in a bankruptcy—small unsecured creditors—as opposed to the ML3 counterparties, whose claims would have enjoyed a privileged position in bankruptcy.[392] The ML3 counterparties were not the only, or even the largest, counterparties to AIG credit instruments to be paid off in full.

For example, the counterparties to AIG's securities lending program [393] received a much larger aggregate cash settlement (in exchange for the return of securities borrowed from AIG) upon closing out their positions—$43.7 billion—than the $27.1 billion that went to the ML3 counterparties; in addition, the largest securities lend-

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law of the jurisdiction governing the contract. Cross-default provisions may be triggered by the default. It should be noted that at the time of the AIG rescue, AIG was attempting to negotiate with its creditors to reduce its obligations. These negotiations apparently ended once creditors realized that the government was going to rescue AIG.

[391] A cross-default is a common provision in loan and other credit agreements that provides that the obligor will default under the contract in question, despite otherwise being in compliance with its terms, if it defaults under one or more other agreements. The purpose of the cross-default is to permit a creditor to "accelerate" its claim (declare the whole amount of the loan or obligation to be due) when the debtor starts to show signs of distress by defaulting on another contract, so that the creditor can get in line with other creditors and pursue its claims, rather than having to wait till amounts on its own contracts become payable and are defaulted on. The dollar amount at which a default will cause a cross-default is usually set so that a cross-default will not occur inadvertently or by reason of a non-material default.

[392] Bankruptcy law is premised on an automatic stay to protect the assets of the business and to hold them while negotiations take place with creditors. This protects the failing business from the kind of bank run that would end its life in moments and it often forces creditors to negotiate for a substantial discount in what they are owed. But amendments to the Bankruptcy Code in 2005 (and following some earlier amendments as well) excerpted "financial contracts" from the automatic stay. *See* 11 U.S.C. §§ 362(b)(6), (b)(7), (b)(17), (b)(27), (o) (exempting various financial participants or holders of commodities contracts, forward contracts, securities contracts, repurchase agreements, swap agreements, and master netting agreements from the automatic stay). For additional discussion of the safe harbor provisions and how they would have applied to AIG's various financial instruments, see below as well as Section E.2 and Annex IV.

[393] See Section B.3 for additional information on AIG's securities lending program and Annex V for general background information on securities lending.

ing counterparty, Barclays, received more than the largest ML3 counterparty, Societe Generale.[394] Even when the $16.5 billion in collateral posted to the ML3 counterparties after government assistance began is included, the amounts paid out to the two sets of counterparties are comparable, and much less attention has been paid to payouts to securities lending counterparties.[395]

The second consequence of avoiding bankruptcy was that the government was not immediately able to reorganize any aspect of AIG's business. Although the government is now the controlling shareholder of AIG and has the ability to direct its operations (subject to the operating principles subscribed to by the Administration for companies in which the government holds a controlling stake),[396] the instant rearrangement of commercial contracts that is possible in bankruptcy was not possible here. Thus, AIG's normal course of business, such as putting up cash collateral for new or existing contracts (including both CDSs that would be eventually placed into ML3 and CDSs that AIG still covers), continued, so that counterparties to those contracts benefitted from the government cash. For example, $22.4 billion was provided to AIGFP to use as collateral;[397] presumably insurance subsidiaries were also putting up collateral, so some part of the $20.9 billion that went to insurance subsidiaries would have ended up as cash collateral.[398]

AIG's business is international, with a third of its revenues derived from East Asia.[399] In its normal (pre-rescue) business operations, to the extent that any part of AIG's non-U.S. business could not be funded locally, they received operating funds from the United States. As a result of the structure of the rescue, of the $21 billion of the government's cash that became capital contributions to AIG's insurance companies, $4.4 billion went to non-U.S. life insurance companies, primarily in Taiwan, Hong Kong, and Japan. One consequence of the nature of AIG's business is that some of

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[394] American International Group, Inc., *AIG Discloses Counterparties to CDS, GIA and Securities Lending Transactions* (Mar. 15, 2009) (online at media.corporate-ir.net/media_files/irol/76/76115/releases/031509.pdf) (hereinafter "AIG Discloses Counterparties to CDS, GIA and Securities Lending Transactions").

[395] This is possibly due to the nature of the collateral arrangements; the securities counterparties were highly collateralized and some of them were overcollateralized, as discussed in Section B.3.b above. At the time their securities lending arrangements were closed out, those parties thus delivered securities with a market value higher than the cash collateral returned to them.

[396] The major principles guiding Treasury's role as a shareholder with regard to corporate governance issues are the following: (1) as a reluctant shareholder, Treasury intends to exit its positions as soon as practicable; (2) Treasury does not intend to be involved in the day-to-day management of any company; (3) Treasury reserves the right to set conditions on the receipt of public funds to ensure that "assistance is deployed in a manner that promotes economic growth and financial stability and protects taxpayer value"; and (4) Treasury will exercise its rights as a shareholder in a commercial manner, voting only on core shareholder matters. House Oversight and Government Reform Committee, Subcommittee on Domestic Policy, Written Testimony of Herbert M. Allison, Jr., assistant secretary for financial stability, U.S. Department of the Treasury *The Government As Dominant Shareholder: How Should the Taxpayers' Ownership Rights Be Exercised?* (Dec. 17, 2009) (online at oversight.house.gov/images/stories/Allison_Testimony_for_Dec-17-09_FINAL_2.pdf) (hereinafter "Written Testimony of Herb Allison").

[397] AIG Discloses Counterparties to CDS, GIA and Securities Lending Transactions, *supra* note 394.

[398] *See* American International Group, Inc., *Supplemental Earnings Information 4Q 2008,* at 2 (online at media.corporate-ir.net/media_files/irol/76/76115/Supplemental_Earnings_Information_Q408.pdf).

[399] For additional information on AIG's business and corporate structure, see Section B.2, *supra*.

the government cash ended up in the hands of counterparties that the American public might not have supported assisting.[400]

In normal circumstances, the fact that money is fungible means that it is difficult to trace the beneficiaries of a cash infusion to a specific company. AIG in 2008 and 2009 presents an easier case. On a consolidated basis, the company generated so little cash from its operating activities[401] that nearly all the cash that flowed out of the company can be attributed to government intervention. AIG has published some useful detail on the "use of funds,"[402] which, combined with the company's financial statements, the Panel has used to follow the money to determine the ultimate recipients of government cash. While the Panel has been able to unearth the end recipient of government funds in some cases, the limitations of data and contract availability have prevented the determination of end recipients in others. The results of this exercise appear in Annex I.

1. The Beneficiaries of the Rescue

The beneficiaries of the AIG rescue were both direct and indirect. Some received cash that they would not otherwise have received, and others avoided exposure to liabilities that might otherwise have arisen.

It is impossible to itemize the benefits received by every single AIG creditor and counterparty, but the impact of the rescue can be gauged by dividing the beneficiaries into broad categories. Some individual beneficiaries appear in several different categories. Some of the beneficiaries, as noted below, were separately recipients of TARP funds. Some beneficiaries might have been viewed as innocent victims of the financial crisis had AIG failed and defaulted on its obligations to them. Others might have been viewed as themselves contributing to the conditions that produced the crisis. Many are non-U.S. entities. Regardless of their nature, they all benefitted from the rescue.

- **AIG Insurance Company Subsidiaries:** An aggregate $20.9 billion went as capital contributions to AIG's insurance company subsidiaries in 2008:
  - —$4.4 billion in total went to non-U.S. life insurance companies, with $1.8 billion to Nan Shan in Taiwan and the remaining amount flowing to insurance companies in Hong Kong and Japan.[403]
  - —$16.5 billion went to U.S. life insurance companies.

These entities were direct beneficiaries of the government rescue. By receiving capital contributions from the government, the foreign and domestic life insurance subsidiaries were able to meet their ob-

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[400] J. Michael Sharman, *Did AIG Give $70 billion of its Bailout Money to China?,* The Star Exponent (May 19, 2009) (online at starexponent.com/cse/news/opinion/columnists/article/did_aig_give_70_billion_of_its_bailout_money_to_china/35929/).

[401] AIG's reported cash flows from operating activities was a mere $755 million for the year ended December 31, 2008, compared to $35.2 billion for the prior year. The 2008 operating cash flows were actually adjusted in the 2009 financial statements to reflect a negative cash flows of $(122) million. AIG Form 10–K for FY08, *supra* note 47, at 197; AIG Form 10–K for FY09, *supra* note 50, at 199.

[402] AIG Discloses Counterparties to CDS, GIA and Securities Lending Transactions, *supra* note 394.

[403] The Panel did not have access to foreign subsidiaries' statutory filings and therefore does not know of any capital contributions in 2009.

ligations under the securities lending program and avoid liquidity or solvency concerns and potential ratings downgrades.[404]

In 2009 AIG's life insurance subsidiaries received $1,145.2 million in capital contributions from AIG. These contributions were made to strengthen the subsidiaries' capital position and risk-based capital ratios. American Home Assurance Company was the only property and casualty insurance subsidiary to receive capital contributions in 2009, receiving $234 million from AIG related to the sale of shares in Transatlantic Holdings, Inc.[405]

AIG's insurance subsidiaries suffered reputational harm, to the extent that people knew that the insurance company was related to AIG,[406] as a result of the government intervention and other subsequent unfavorable press (such as controversial bonus payments). The insurance regulators have provided that for several months, the insurance subsidiaries experienced heightened surrender activity and declining numbers of new customers with each release of information unfavorable to AIG.[407] However, the insurance subsidiaries may have avoided a higher level of reputational harm that could have resulted from a bankruptcy filing of the AIG parent company. As a result of avoiding the potentially more severe reputational effects of a parent bankruptcy, the insurance subsidiaries were able to avoid being seized by their regulators.[408] The

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[404] For example, the insurance subsidiaries benefited from downstream payments from the parent company to provide liquidity to the securities lending program (AIG borrowed $11.5 billion from FRBNY by September 30, 2008 to provide liquidity to the securities lending program) as well as from the purchase of ML2 of their interest in the RMBS held in connection with the securities lending program. *See* AIG Form 10–K for FY08, *supra* note 47, at 166–67, 250–51. See additional discussion of securities lending program below. AIG's domestic property/casualty insurance subsidiaries did not receive capital contribution or government funds to meet obligations under the securities lending program (they had minimal participation in the program). Some believe, however, that the insurance subsidiaries were sufficiently well capitalized that they would have been able to remain operating throughout a bankruptcy, and would have been able to resolve the securities lending issues on their own. Panel staff conversation with New York Insurance Department (June 3, 2010). The regulators have also asserted that, had there not been a "run" by securities lending counterparties caused by the liquidity crunch at AIGFP, the subsidiaries would have been able to slowly wind down the program on their own, and would not have experienced the immediate liquidity need. The regulators have also stated that the subsidiaries had a plan in place to manage an immediate securities lending liquidity crunch on their own, without the infusion of government funds. Panel staff conversation with Texas Department of Insurance (May 24, 2010).

[405] American Home Assurance Company, *PNC Annual Statement for the Year Ended December 31, 2009* (Feb. 25, 2010) AGC Life Insurance Company, *Annual Statement for the Year Ended December 31, 2009* (Feb. 2010); American General Life and Accident Insurance Company, *Annual Statement for the Year Ended December 31, 2009* (Feb. 13, 2010); American General Life Insurance Company of Delaware, *Annual Statement for the Year Ended December 31, 2009* (Feb. 2010); American General Life Insurance Company of New York, *Annual Statement for the Year Ended December 31, 2009* (Feb. 2010); American General Life Insurance Company, *Annual Statement for the Year Ended December 31, 2009* (Feb. 2010); Delaware American Life Insurance Company, *Annual Statement for the Year Ended December 31, 2009* (2010); SunAmerica Annuity and Life Assurance Company, *Annual Statement for the Year Ended December 31, 2009* (Feb. 17, 2010); SunAmerica Life Insurance Company, *Annual Statement for the Year Ended December 31, 2009* (Feb. 17, 2010); Variable Annuity Life Insurance Company, *Annual Statement for the Year Ended December 31, 2009* (Feb. 24, 2010); Western National Life Insurance Company, *Annual Statement for the Year Ended December 31, 2009* (Feb. 24, 2010).

[406] Some of AIG's insurance subsidiaries were insulated from reputational harm because they operated under different brand names. This may have prevented some existing customers from making a connection between their insurer and AIG.

[407] Panel staff conversation with NAIC (Apr. 27, 2010).

[408] *See* Eric Dinallo, *What I Learned at the AIG Meltdown: State Insurance Regulation Wasn't the Problem*, Wall Street Journal (Feb. 2, 2010) (online at online.wsj.com/article/SB10001424052748704022804575041283535717548.html) (hereinafter "State Insurance Regulation Wasn't the Problem") ("If AIG had gone bankrupt, state regulators would have seized the individual insurance companies. The reserves of those insurance companies would have been set aside to pay policyholders and thereby protected from AIG's creditors. However, . . . AIG's insurance companies were intertwined with each other and the parent company. Policyholders

Continued

subsidiaries thus had a greater ability to retain existing insurance customers, attract new insurance customers, and satisfy liabilities as they came due. Their customers benefited from the payment of their claims in full, without potentially protracted delay and without going through the process of obtaining new insurance coverage (cancelling existing policies and finding suitable replacement policies), if they felt such a change would have been necessary.

• **State Insurance Guarantee Funds and Non-AIG Insurance Companies:** The state insurance guarantee funds were potentially indirect beneficiaries of the rescue. If the parent had filed bankruptcy, the insurance regulators might have seized the insurance subsidiaries either to protect them from the bankruptcy or because of undercapitalization. To pay off policy holders it is likely that the receivers would have needed to access state insurance guarantee funds. These state funds are funded by assessments to other, solvent, insurance companies. The assessments required to cover the large numbers of policyholders would have likely been a significant burden on the state guarantee funds and other insurance companies.

• **Holders of AIG Commercial Paper:**[409] Commercial paper issued or guaranteed by AIG and some of its subsidiaries[410] appears to have been rolled over, and thus, no direct payout was made to the holders of this commercial paper. However, the commercial paper could not have been rolled without government support to AIG.[411] The commercial paper holders received a substantial indirect benefit from the government's intervention to the extent that they continued rolling over the paper they held or were repaid at maturity.[412] AIG had $15.1 billion and $5.6 billion of

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would have been paid, but only after a potentially protracted delay. It would have taken time to allocate the companies's [sic] assets"). *But see*, Panel staff conversation with Texas Department of Insurance (May 24, 2010) (the regulators would not necessarily have seized the subsidiaries, but would probably have monitored them closely); Panel staff conversation with New York Insurance Department (June 3, 2010) (the regulators would not have seized the subsidiaries, because they were well capitalized).

[409] Commercial paper is a short-term, unsecured promissory note issued by a corporation. *See* Thomas K. Kahn, *Commercial Paper*, Economic Quarterly, Vol. 79, No. 2, at 45–8 (Spring 2003) (online at www.richmondfed.org/publications/research/economic__quarterly/1993/spring/pdf/hahn.pdf).

[410] AIG Funding, Inc. issued commercial paper guaranteed by AIG to provide short-term funding to AIG and its subsidiaries. Some of AIG's other subsidiaries—such as International Lease Finance Corporation (ILFC), American General Finance (AGF), and AIG Consumer Finance Group (AIGCFG)—also issued commercial paper, but it was not guaranteed by AIG. *See* AIG Form 10–Q for the Second Quarter 2008, *supra* note 177, at 97–100. ILFC, AGF, and AIG maintained committed, unsecured revolving credit facilities to support the commercial paper programs, but ILFC and AGF had drawn the full amount of credit available in September 2008. *See* AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 50, 58, 133.

[411] AIG, like other issuers of commercial paper, also benefitted from the Federal Reserve's Commercial Paper Funding Facility (CPFF), which was designed to backstop the commercial paper market by purchasing three-month unsecured commercial paper directly from eligible issuers. For additional discussion of the CPFF, see Section D.1. *See also* Congressional Oversight Panel, *November Oversight Report: Guarantees and Contingent Payments in TARP and Related Programs*, at 30 (Nov. 6, 2009) (online at cop.senate.gov/documents/cop-110609-report.pdf) (hereinafter "November Oversight Report").

[412] The amount of relief would have depended on whether ILFC, AGF, and AIG Consumer Finance Group (AIGCFG) also filed for bankruptcy. Presumably, they would have because if they had not, they would likely have been unable to roll over their commercial paper and would have remained liable for their commercial paper obligations as they came due. If all AIG subsidiaries that issued commercial paper had filed for bankruptcy, then all of their commercial paper debt holders would have been treated as unsecured creditors. If ILFC and AGF had not filed, it is not clear that their commercial paper holders would have fared better even though they would not have been subject to the discount negotiated for unsecured creditors, at least not without direct or indirect government assistance. ILFC and AGF would likely not have been able to meet their commercial paper obligations as they came due considering that they had drawn the full amount of available credit in the committed, unsecured revolving credit facilities to meet pre-

commercial paper and extendible commercial notes outstanding, on a consolidated basis, at June 30, 2008[413] and September 30, 2008,[414] respectively.

• **Holders of Other AIG Debt:** $2.1 billion was received in principal and interest by holders of other AIG debt, who became direct beneficiaries of the government rescue. Total borrowings issued or guaranteed by AIG at June 30, 2008 amounted to $110 billion, with an additional $67 billion not guaranteed. AIG's debt includes notes, bonds, junior subordinated debt, loans, and mortgages payable. AIG guarantees debt issued by AIGFP, AIG Funding, Inc's commercial paper, AIGLH notes and bonds payable, and liabilities connected with the trust preferred stock. The non-guaranteed debt includes that issued by ILFC, American General Finance (AGF), AIGCFG, and other subsidiaries. AIG borrowed $500 million in unsecured funds in October 2007 from a third party bank, and this amount was outstanding as of June 30, 2008 and scheduled to mature in October 2008. AIG, ILFC, and AGF also maintain committed, unsecured syndicate revolving credit facilities to support their commercial paper programs and other general corporate purposes.[415]

• **Repo Counterparties:** AIG's outstanding repurchase agreements were approximately $9.7 billion and $8.4 billion as of June 30, 2008 and September 30, 2008, respectively.[416] AIG's repurchase agreement transactions were concentrated at AIGFP and were utilized as a method to support the company's liquidity, although the market significantly contracted during 2008. AIG refused to provide the identity of the counterparties to the repurchase agreements.[417]

• **Holders of AIGFP Debt:** Holders of AIGFP debt were direct beneficiaries of the government rescue, receiving cash for interest and principal. $12.5 billion was paid to holders of AIGFP debt.[418] Total AIGFP borrowings, all guaranteed by AIG, at June 30, 2008 equaled $54 billion. AIGFP's debt included GIAs, notes, bonds,

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vious obligations. AIG's guarantee of commercial paper issued by AGF is an executory contract that would have been rejected during the bankruptcy and would have provided no recourse to the commercial paper holders. *See* 11 U.S.C. 365.

[413] AIG Form 10–Q for the Second Quarter 2008, *supra* note 177, at 2, 96. Of the total $15.1 billion outstanding at June 30, 2008, AIG Funding had $5.8 billion, ILFC had $4.6 billion, AGF had $3.9 billion, AIGCFG had $0.3 billion, and AIG Finance Taiwan Limited had $0.003 billion outstanding. *Id.* at 96.

[414] *See* AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 2, 129. Of the total $5.6 billion outstanding at September 30, 2008, AIG Funding had $1.944 billion, ILFC had $1.562 billion, AGF had $1.918 billion, AIGCFG had $0.168 billion, and AIG Finance Taiwan Limited had $0.008 billion outstanding. *Id.* at 129.

[415] AIG Form 10–Q for the Second Quarter 2008, *supra* note 177, at 96–102.

[416] AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 2; AIG Form 10–Q for the Second Quarter 2008, *supra* note 177, at 2. Repurchase, or repo, agreements are a form of short-term borrowing and are treated as collateralized financing transactions in most instances. Repo agreements involve the sale of securities to investors with the agreement to buy them back at a higher price after a set time period, which is often overnight. The buy back exchange often involves securities considered equivalent to the original securities sold, with the specific characteristics necessary to be considered "equivalent" defined within the terms of each repo agreement (e.g., part of the same issue, identical in type and nominal value). Reverse Repurchase agreements are the purchases of securities with the agreement to sell them at a higher price at a specified future date.

[417] Panel staff conversation with AIG (June 3, 2010).

[418] This amount includes what AIG classified as payments on "maturing debt & other." AIG Discloses Counterparties to CDS, GIA and Securities Lending Transactions, *supra* note 394.

loans, mortgages payable, and hybrid financial instrument liabilities.[419]

• **Securities Lending Counterparties:** Securities lending counterparties were direct beneficiaries of the rescue, as AIG returned the cash collateral they had delivered against the securities they borrowed. $43.7 billion was paid to securities lending counterparties, which were a variety of U.S. and international (primarily European) banks. The largest beneficiaries in this category were Barclays ($7.0 billion), Deutsche Bank ($6.4 billion), BNP Paribas ($4.9 billion), Goldman Sachs ($4.8 billion)[420] and Bank of America ($4.5 billion).[421] In return, the securities lending counterparties delivered the borrowed securities. As discussed above, in many cases AIG was undercollateralized in relation to the securities lending counterparties, who thus returned securities with a greater market value than the collateral that was returned to them.[422]

• **ML3 Counterparties:** The ML3 counterparties were direct beneficiaries of the government rescue. They received government cash from two separate channels. As discussed above, $27.1 billion was paid to the ML3 counterparties for the CDOs that were placed into ML3. This money was channeled from the government through ML3. In addition, prior to the ML3 transaction, the counterparties received $22.5 billion in collateral directly from AIG as a direct result of government intervention.[423] The CDS counterparties were also benefited by the continuation of the CDS contracts, which would have been extraordinarily expensive to replace in light of the collapse of the CDO market.

—Some of those counterparties (Goldman, for example) were acting as market intermediaries with respect to the underlying CDOs or reference securities for the CDS contracts.[424] The actual benefit those second-level counterparties received from closing out their CDS contracts as part of the ML3 transaction would depend upon their view of the future direction of any reference securities that they held and the extent to which the first-level counterparties were able to make good on the second-level CDSs if AIG had failed to deliver on the first-level CDSs. Within the limitations of the fungibility of money, government cash flowed to these second-level counterparties upon closing out their CDSs. It should be noted that the details of the transactions with the second-level counterparties have not been made available to the Panel. The terms upon which the first-level counterparties closed out their contracts with the second-level counterparties could very well have differed from the terms upon which the first-level counterparties closed out

[419] AIG Form 10–Q for the Second Quarter 2008, *supra* note 177, at 96.

[420] Goldman Sachs received $10 billion through the TARP Capital Purchase Program.

[421] Bank of America received $25 billion, with $15 billion related to Merrill Lynch included due to the merger between the two entities, through the TARP Capital Purchase Program, and received $20 billion through the TARP TIP. The only other TARP recipients among the securities lending counterparties were Merrill Lynch ($1.9 billion; recipient of $15 billion of TARP funds included in Bank of America total), Citigroup ($2.3 billion; total TARP assistance of $20 billion from TIP and $25 billion from CPP) and Morgan Stanley ($1.0 billion; recipient of $10 billion of TARP funds).

[422] See additional discussion of securities lending counterparties at Section E.2.

[423] SIGTARP Report on AIG Counterparties, *supra* note 246, at 15.

[424] The counterparties that the Panel has spoken to who were acting as intermediaries have not identified their own counterparties. See discussion of Goldman's position in more detail in Section F.5.

their contracts with AIG, and the first-level counterparties may have been able to make a profit on that transaction. The mechanics for closing out these transactions is set out in more detail in Annex III.

—Looking at the ML3 transactions as a whole over time, the net effect of letting the counterparties keep the collateral already posted and then be paid "market value" (roughly speaking, the notional value of the CDOs minus the collateral posted) is that AIG and its controlling shareholder, the U.S. government, together paid a total of par, the principal amount of those CDOs, for them at a time when by definition they were worth only the market value paid upon closeout of the CDS contracts.

—Some of the counterparties had taken out additional protection against an AIG failure in the form of CDSs and other hedges on AIG itself. These counterparties included Goldman.[425] At least some of these CDSs on AIG (including those held by Goldman) required the posting of collateral. Upon closing out the ML3 CDSs, the counterparties would be able to close out their AIG protection and return any collateral to the providers of such protection, who would thus no longer be exposed to the risk of AIG's failure, and were thus indirect beneficiaries of the government rescue. Goldman declined to provide the Panel with the names of entities writing this protection.

- **Other CDS Counterparties:**

  —Regulatory Capital Swap Counterparties: As discussed in Section B3, *supra*, numerous European banks entered into CDSs with a France-based subsidiary of AIGFP in order to decrease the amount of regulatory capital they were required to hold. Unlike the CDSs on CDOs, these swaps were not terminated as part of the government rescue. As a result, the benefits that the counterparties received came not in the form of cash but rather in the continuation of contracts that led to more favorable regulatory treatment in the counterparties' home countries. In other words, the banks avoided having to raise additional capital or sell assets, as they might have had to do if AIG had filed for bankruptcy.

AIG has declined to release the full list of counterparties to these trades, citing confidentiality laws, but the Panel has obtained a copy of a list as of October 1, 2008 from FRBNY. This document lists the top seven counterparties on these trades as Dutch bank ABN AMRO ($56.2 billion notional exposure),[426] Danish bank Danske ($32.2 billion notional exposure), German bank KFW ($30 billion notional exposure), and French banks Credit Logement ($29.3 billion notional exposure), Calyon ($24.3 billion notional ex-

[425] See discussion of Goldman's position in more detail in Section F.5.

[426] In 2007, a consortium of Royal Bank of Scotland (RBS), Banco Santander, and Fortis purchased ABN AMRO, which was split into pieces. Then on October 3, 2008, less than three weeks after the U.S. government's bailout of AIG, the Dutch government nationalized Fortis' share of ABN AMRO. Fortis, *Fortis Statement on Transaction with the Government of the Netherlands* (Oct. 3, 2008) (online at www.holding.fortis.com/Documents/UK_PR_Fortis_03102008.pdf); Ageas, *Ageas and ABN AMRO* (online at www.holding.fortis.com/en/Pages/fortis_and_abn_amro.aspx) (accessed June 8, 2010). The documents reviewed by the Panel do not shed light on specifically how an AIG default on its regulatory capital swaps would have impacted RBS, Banco Santander, and Fortis, though in early 2009, AIG did identify RBS and Banco Santander as banks with exposure to its regulatory capital swaps book. AIG Presentation on Systemic Risk, *supra* note 92, at 18.

posure), BNP Paribas ($23.3 billion notional exposure) and Societe Generale ($15.6 billion notional exposure).[427]

Based on the capital rules under which these banks were operating in 2008, the loss of credit protection for ABN AMRO would have resulted in an estimated impact on its regulatory capital in the amount of $3.6 billion;[428] this means that had AIG filed for bankruptcy, ABN AMRO would have needed to raise an additional $3.6 billion in order to maintain its current regulatory capital ratios. For Danske and KFW, the estimated impact would have been around $2.1 billion each. For Credit Logement, it would have been about $1.9 billion.[429] Altogether, as of October 1, 2008, the banks that entered into these trades with AIGFP obtained an estimated $16 billion in capital relief, as shown in Figure 21.

FIGURE 21: LARGEST COUNTERPARTIES FOR AIGFP REGULATORY CAPITAL SWAPS AS OF OCTOBER 1, 2008[430]

[Dollars in billions]

Counterparty	Notional Amount	Estimated Capital Relief
ABN AMRO (Netherlands)	$56.0	$3.5
Danske (Denmark)[431]	32.2	2.1
KFW Bank (Germany)	30.0	1.9
Credit Logement (France)	29.3	1.9
Calyon (France)	24.3	1.6
BNP Paribas (France)	23.3	1.5
Societe Generale (France)	15.6	1.0
Other counterparties	38.9	2.4
Total	$249.9	$16.0

[430] *Reg Capital Arb,* E-mail from Paul Whynott, Federal Reserve Bank of New York, to Alejandro LaTorre, vice president, Federal Reserve Bank of New York (Nov. 4, 2008) (FRBNY-TOWNS-R1–188408).

[431] The Panel attempted to quantify the impact that the loss of this credit protection would have had on capitalization of seven counterparties listed in Figure 21. *Infra* note 428. For most of the banks listed there, third-quarter 2008 data on tier 1 capital were not available, but for Danske they were available. Danske had a tier 1 capital ratio of 10.0 percent in the third quarter of 2008, based on tier 1 capital of $17.8 billion and risk-weighted assets of $176.9 billion. If Danske had lost its credit protection from AIGFP, its risk-weighted assets would have risen by $25.8 billion, and its tier 1 capital ratio would have fallen to 8.8 percent. These calculations rely on the same assumptions the Federal Reserve used in calculating the capital relief for each of the seven banks in Figure 21 See *infra* 429, for more about these assumptions. Data provided by Danske Bank to the Panel (May 21, 2010).

It is impossible to know, however, how the bank regulators in various European countries would have responded to this problem in September 2008. Given the extreme market unrest, and the difficulties banks would have had raising capital at that time, it seems possible that some countries would have granted forbearance to their banks. FRBNY officials say they did not consult European

[427] *Reg Capital Arb*, E-mail from Paul Whynott, Federal Reserve Bank of New York, to Alejandro LaTorre, vice president, Federal Reserve Bank of New York (Nov. 4, 2008) (FRBNY–TOWNS–R1–188408).

[428] Under Basel I, banks were required to hold 8 percent capital against assets such as corporate loans that were assigned a 100 percent risk weighting. But when AIGFP's regulated bank provided credit protection, the risk weighting fell to 20 percent, and the banks were only required to hold 8 percent capital against the 20 percent weighted value of the loans, which equaled 1.6 percent of the assets. The difference between these two regulatory treatments, 6.4 percent of the assets, was the amount that the banks did not have to hold as capital as a result of the AIGFP swaps. The regulatory capital relief would be less for assets that would otherwise receive a risk weighting of less than 100 percent under Basel I.

[429] It is impossible to calculate the exact capital charges avoided by these banks without knowing the risk weighting of each underlying asset that received credit protection from AIGFP. The calculations here reflect the methodology that AIG and FRBNY used to calculate the exposure that the counterparties would have had in a bankruptcy. Whether losing this cushion would have resulted in inadequate regulatory capital (and thus a need to raise capital or sell assets in a volatile market) depends on the extent to which each bank was over-capitalized, and the extent to which their other assets lost value.

regulators about the consequences of a bankruptcy prior to the Federal Reserve's decision to rescue AIG,[432] and the Federal Reserve's reluctance to discuss with European regulators the impact of an AIG bankruptcy on European banks continued until at least late October 2008.[433] But a memo circulated within FRBNY over the weekend of September 14–15 noted that forbearance by the European regulators could address the problem.[434] On the other hand, it is certainly possible that the European regulators would have taken a tough stance, in which case their options included seizure, which would have amounted to bailouts by European governments;[435] it is also possible that the various banking regulators in different countries would have had different reactions.

• **GIA Counterparties:** $12.1 billion of the government's money ended up in the hands of municipalities and state agencies that had GIAs with AIGFP.[436] Municipalities raising funds through bond and note issuances for public works projects do not need access to all of the funds immediately. They would thus lend the money to AIGFP under GIAs. AIGFP used the proceeds from GIA issuances to invest in a diversified portfolio of securities, including trading, available-for-sale, those purchased under agreement to resell, and derivative transactions. The proceeds from the disposal of these securities were then used to fund maturing GIAs, other AIGFP debt obligations, or new investments.[437] GIAs are generally not collateralized, but many of AIGFP's GIAs required the posting of collateral or allowed the obligations to be called at various times prior to maturity at the option of the counterparties (for example, because of a rating downgrade). AIG guaranteed the obligations of AIGFP under GIA borrowings.[438] Recipients of payments under AIGFP's GIAs, who benefitted directly from the government rescue, included California ($1.02 billion), Virginia ($1.01 billion) and Hawaii ($0.77 billion). Indirect beneficiaries of the government funds include the projects that the GIA counterparties fund, including affordable housing grants and complexes, college tuition savings plans and student loans, fire stations, and military housing.[439]

• **Holders of Stable Wrap Contracts:** Trustees and investment managers of defined contribution plans held approximately $38 billion of stable value wrap contracts. Stable value funds, a

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[432] FRBNY conversation with the Panel (May 11, 2010). FRBNY apparently remained reluctant to discuss AIG's regulatory capital swap portfolio even after establishing the $85 billion line of credit. *See* Federal Reserve Bank of New York draft memo, Systemic Risks of AIG (Oct. 24, 2008) (FRBNY-TOWNS-R1–122617) ("To avoid shouting "Fire!" in a crowded theater, we have not approached the European regulators to quantify the capital relief more precisely").

[433] *See* Federal Reserve Bank of New York draft memo, Systemic Risks of AIG (Oct. 24, 2008) (FRBNY-TOWNS-R1–122617) ("To avoid shouting "Fire!" in a crowded theater, we have not approached the European regulators to quantify the capital relief more precisely.").

[434] *Pros and Cons on AIG Lending,* E-mail and attachments from Alejandro LaTorre, assistant vice president, Federal Reserve Bank of New York (Sept. 14, 2008) (FRBNYAIG00496–505).

[435] KFW Bank is a government-owned bank, 80 percent owned by the German government and 20 percent owned by federal states in Germany, so the German taxpayers are responsible for its losses in any case. *See* KfW Bankengruppe, *Our Group* (online at www.kfw.de/EN__Home/KfW__Bankengruppe/Our__Group/index.jsp).

[436] For AIGFP, a guaranteed investment agreement (GIA) is the same as a guaranteed investment contract (GIC) (the terms are used interchangeably). Panel staff conversation with AIG (May 27, 2010).

[437] *See* AIG Form 10–K for FY08, *supra* note 47, at 158.

[438] *See* AIG Form 10–K for FY08, *supra* note 47, at 51, 59, 277; AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 132, 134; AIG Form 10–Q for the Second Quarter 2008, *supra* note 177, at 40, 98, 101.

[439] *See, e.g.*, Colorado Housing and Finance Authority, *What Is CHFA?* (online at chfainfo.com) (accessed June 8, 2010).

type of highly liquid investment only offered in defined contribution and tuition assistance plans, are designed to provide a high quality, fixed income portfolio with a wrap contract to allow for the stability of a money market but greater potential return. Wrap contracts for stable value funds allow for the maintenance of principal and benefit payments and participant investment transfers at book or contract value by guaranteeing the participant's fund liquidity at book, or initial investment, value. Gains and losses on the fund assets are smoothed through amortized adjustments to future benefit credits by the insurance company of financial institution providing the wrap contract. When market value falls below book value, the wrap contract requires the wrap provider to make up the difference in the case of participant withdrawal; when the reverse occurs, the insurance provider maintains the excess for potential future losses.[440] These contracts allow workers to withdraw their pension funds at book value as opposed to market value in times of market dislocation, thus avoiding any loss of book value due to market deterioration. While only a small amount of government funds was used to make payments under these wrap contracts, the pension plans holding the wrap contracts benefitted significantly from not losing this insurance.[441]

- **Employees and Contractors:** To the extent that cash flowed into the company through operations and government funds, employees, suppliers, and contractors were paid in the normal course of business.

As noted throughout this section, some of the beneficiaries of the AIG rescue were also recipients of TARP funds themselves. Goldman Sachs, Bank of America, and Merrill Lynch received an aggregate of $12.9 billion, $5.2 billion, and $6.8 billion, respectively, in government funds as AIGFP CDS counterparties, recipients of ML3 payments, and securities lending counterparties. Effectively Bank of America received $12.0 billion when factoring in its merger with Merrill Lynch. Citigroup received $2.3 billion solely as a result of its being a securities lending counterparty. Wachovia received a total of $1.5 billion as a CDS counterparty and recipient of ML3 payment, and Morgan Stanley received $1.2 billion as a CDS and securities lending counterparty. JP Morgan is the TARP-recipient bank to obtain the least amount of government funds from AIG, receiving $0.4 billion as a CDS counterparty. The top ten AIG counterparties were the recipients of $72.2 billion of the government funds received by the company. The following are the top ten recipients: Goldman Sachs ($12.9 billion), Societe Generale ($11.9 billion), Deutsche Bank ($11.8 billion), Barclays ($7.9 billion), Merrill Lynch ($6.8 billion),[442] Bank of America ($5.2 billion), UBS ($5.0 billion), BNP Paribas ($4.9 billion), HSBC ($3.5 billion), and Calyon

[440] If there is a difference between the book and market values of a stable value fund due to external circumstances, such as a rapid decline in interest rate benchmarks, the wrap investment contract will typically close the difference between the book and market values. These investments are not mutual funds. *See* Stable Value Investment Association, *Employee Benefits Plans Stable Value Concurrent Sessions,* at 13 (May 11, 2010).

[441] During the time leading up to the rescue, the government considered providing government backing to these contracts if AIG had not been rescued wholesale. Proposal to Insulate Retail Impact of AIGFP Failure, *supra* note 251.

[442] As noted earlier, when accounting for the merger between Merrill Lynch and Bank of America, the funds received from AIG amount to $12.0 billion, the second highest amount received.

($2.4 billion). Though these ten counterparties account for over half of the government funds received by AIG, there were countless other recipients through GIAs, debt obligations, and the remaining CDS and securities lending counterparties.

2. How the Beneficiaries Would Have Fared in Bankruptcy

In order to assess the consequences of the decision to rescue AIG, the Panel considered what might have happened, in general terms, to these various constituencies if AIG had filed for bankruptcy.

• **AIG Insurance Company Subsidiaries:** As indicated above, insurance companies are not allowed to file for bankruptcy,[443] and the impact on the insurance subsidiaries from a parent company bankruptcy would depend on a variety of factors and how these factors influenced the actions of their insurance regulators.[444] Whether the insurance regulators took informal action (such as heightened supervision) or more formal action (some form of seizure or receivership) would have depended on the bankruptcy's impact on the insurance subsidiaries' books of business (for example, whether current policyholders took their business elsewhere), the subsidiaries' ability to attract new policyholders, and the ability of the state insurance funds to satisfy liabilities after the insurance subsidiaries' assets had been exhausted, if necessary. It would also depend on the existence of intercompany lending arrangements or guarantees and the impact of the securities lending program on the solvency or financial health of the subsidiaries.[445] The ultimate question is whether AIG would be able to preserve the value of the insurance subsidiaries and whether the insurance subsidiaries continued to maintain sufficient assets to pay their policyholders.[446] Around the time of the rescue, the insurance regulators stated that the insurance subsidiaries were solvent.[447] They have since explained that, because the subsidiaries were well-capitalized, they would not necessarily have seized them in the event of a parent bankruptcy and that they would have taken into consideration the factors described above when determining whether they needed to take regulatory action to protect the subsidiaries and their policyholders.[448]

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[443] 11 U.S.C. 109(b)(2).

[444] The shares of an insurance company are in the estate of the bankrupt holding company and can be sold if the relevant regulator consents. In AIG's case of course, the shares were pledged as collateral for the Revolving Credit Facility and are being sold in any event to repay the government.

[445] *See, e.g.*, AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 126–27 ("AIG's Domestic Life Insurance and Retirement Services companies have three primary liquidity needs: the funding of surrenders; returning cash collateral under the securities lending program; and obtaining capital to offset other-than-temporary impairment charges"). AIG believed that the insurance subsidiaries had sufficient resources to fund surrenders, but significant capital contributions were made in the first nine months of 2008 to provide liquidity to the securities lending pool to fund securities lending payables and to the insurance subsidiaries to offset reductions in capital due to significant other-than-temporary impairment charges. *Id.* The need for capital infusions suggests that securities lending obligations could have resulted in liquidity or solvency concerns for some of AIG's insurance subsidiaries.

[446] For additional discussion of the potential impact on AIG's insurance subsidiaries from a parent company bankruptcy and of the various options available to the insurance regulators, see Annex VIII.

[447] Written Testimony of Eric Dinallo, *supra* note 289.

[448] Panel staff call with National Association of Insurance Commissioners (Apr. 27, 2010). The NY insurance regulators have provided Executive Life of New York as an example of seizure not being automatic for solvent insurance subsidiaries upon the bankruptcy filing of the holding company but later becoming necessary; the NY insurance regulators seized Executive Life of

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• **State Insurance Funds and Non-AIG Insurance Companies:** Since insurance subsidiaries cannot seek bankruptcy protection, state insurance regulators would have had to address any insolvent or illiquid insurance subsidiaries through their resolution tools and use state insurance funds to satisfy liabilities to policyholders in excess of the value of their assets. To the extent that an insurance subsidiary was undercapitalized,[449] state insurance regulators—and state insurance guarantee funds—would have had to step in. If that turned out to be the case, an AIG bankruptcy could have affected all of the non-AIG insurance companies that would have been assessed to replenish or expand state insurance funds.[450]

• **Holders of AIG Commercial Paper:** If AIG had filed for bankruptcy, its commercial paper would not have been rolled over, that is, the parent company and subsidiaries would have been unable to access the commercial paper market for short-term funding absent government support. Because AIG's commercial paper debt was unsecured, the holders would have been subject to the substantial discount negotiated for unsecured creditors in a bankruptcy plan and might have received next to nothing for their unsecured claims. Thus, the commercial paper debt holders received a substantial indirect benefit by AIG's avoidance of bankruptcy.[451]

• **Parties to AIG Repo Funding:** If AIG had filed for bankruptcy, the parties to AIG's repurchase ("repo") agreements would have benefited from safe harbor provisions in the bankruptcy code giving them additional protection or favorable treatment.[452] Counterparties "to any repurchase agreement" are exempted from the automatic stay that prevents creditors from taking action to collect on their debts after the bankruptcy filing.[453] The repo par-

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New York insurance subsidiaries several months after the parent company bankruptcy filing because a run on the insurance subsidiaries had developed. Panel staff conversation with New York State Insurance Department (June 3, 2010).

[449] See discussion of state insurance company oversight in Section B.2 above.

[450] It should be noted that state insurance guarantee funds carry statutory caps on the amounts that can be assessed annually from solvent insurers. *See, e.g.*, Tex. Insur. Code 463.153(c). Because of AIG's size, it is likely that guarantee fund assessments would have reached these caps. Panel staff conversation with Debra Hall, expert in insurance receivership (May 14, 2010); Panel staff conversation with David Merkel, insurance actuary (May 18, 2010).

[451] The amount of the benefit would have depended on whether ILFC, AGF, and AIGCFG also filed for bankruptcy. Presumably, they would have because if they did not, they would likely have been unable to roll over their commercial paper and would remain liable for their commercial paper obligations as they came due (without the guarantee of the parent company, which would have been rejected during the bankruptcy).

[452] This discussion also applies to a bankruptcy filing by AIGFP; AIGFP obtained funding for its operations, in part, through repurchase agreements. *See* AIG Form 10–K for FY08, *supra* note 47, at 51.

[453] *See* 11 U.S.C. 362(b)(7) (providing that a bankruptcy filing does not operate as stay "of the exercise by a repo participant or financial participant of any contractual right . . . under any security agreement or arrangement or other credit enhancement forming a part of or related to any repurchase agreement, or of any contractual right . . . to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements"). The term "repo participant" is defined broadly to include any entity that had an outstanding repurchase agreement with the debtor. 11 U.S.C. 101(46). The term "repurchase agreement" is also broadly defined to include agreements "for the transfer of one or more certificates of deposit, mortgage related securities . . ., mortgage loans, interests in mortgage related securities or mortgage loans, eligible bankers' acceptances, qualified foreign government securities . . ., or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptance, securities, mortgage loans, or interests of the kind described in this clause, at a date certain not later than 1 year after such transfer or on demand, against the transfer

ticipants are specifically allowed to exercise any contractual right to cause the liquidation, termination, or acceleration of their repurchase agreements based on the bankruptcy filing.[454] If the repo participants liquidate one or more repurchase agreements and have agreed to deliver the assets subject to the repurchase agreements to the debtor, they will be able to keep the market prices received to the extent of the stated repurchase prices; any excess as well as the liquidation expenses will be considered property of the estate subject to the normal rights of setoff.[455] Thus, the effect of an AIG bankruptcy filing on parties to AIG's repurchase agreements would have been minimal. Because of the nature of repurchase agreements, the counterparties would have been fully secured or collateralized.[456]

• **Holders of Other AIG or AIGFP Debt:**[457] If AIG and AIGFP had filed for bankruptcy, their creditors would have been protected to the extent that their claims were secured.[458] To the extent that the creditors were unsecured or undersecured, they would have been subject to the substantial discount negotiated in the bankruptcy plan and, as a result, would have incurred substantial losses. Thus, unsecured (and undersecured) creditors received a significant indirect benefit from the government's decision to rescue AIG.[459]

• **Securities Lending Counterparties:** If AIG had filed for bankruptcy, it is unclear what would have happened to capital contributions from the parent company to the insurance subsidiaries, past or future, related to the securities lending program.[460] Capital

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of funds" (as well as reverse repurchase agreements). 11 U.S.C. 101(47). *See also* 11 U.S.C. 362(b)(27) (providing the same protection to parties to repurchase agreements under master netting agreements).

[454] *See* 11 U.S.C. 362(b)(7); 11 U.S.C. 559 ("The exercise of a contractual right of a repo participant or financial participant to cause the liquidation, termination, or acceleration of a repurchase agreement because of a condition of the kind specified in section 365(e)(1) of this title [including a bankruptcy filing] shall not be stayed, avoided, or otherwise limited by operation of any provision of this title . . ."). *See also* 11 U.S.C. 362(b)(27); 11 U.S.C. 561 (providing the same protection to parties with various repurchase agreements under a master netting agreement). For the purposes of this section. the term "contractual right" is specifically defined to include "a right set forth in a rule or bylaw of a derivatives clearing organization . . ., a multilateral clearing organization . . ., a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade . . . or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice." 11 U.S.C. 559.

[455] *See* 11 U.S.C. 559 ("In the event that a repo participant or financial participant liquidates one or more repurchase agreements with a debtor and under the terms of one or more such agreements has agreed to deliver assets subject to repurchase agreements to the debtor, any excess of the market prices received on liquidation of such assets (or if any such assets are not disposed of on the date of liquidation of such repurchase agreements, at the prices available at the time of liquidation of such repurchase agreements from a generally recognized source or the most recent closing bid quotation from such a source) over the sum of the stated repurchase prices and all expenses in connection with the liquidation of such repurchase agreements shall be deemed property of the estate, subject to the available rights of setoff").

[456] For additional explanation of repurchase agreements, see Section E.1 above.

[457] For additional information on the holders of AIG and AIGFP debt, see Section E.1 above.

[458] *See* 11 U.S.C. 362(b)(3), 546(b), 547(c)(3). 547(c)(5), 547(e)(2)(A) (regarding perfection of security interests), 1129(b)(2)(A) (providing that secured creditors retain their interest in property or receive the value of their secured claims or interest for plan confirmation).

[459] *See* 11 U.S.C. 507 (priority of bankruptcy claims); 1129 (requirements for plan confirmation).

[460] For example, AIG made capital contributions to offset realized losses from the sale of securities in the pool ($5 billion), to maintain capital and surplus levels after unrealized losses from the decline in market value of the securities in the pool, and contributions to make up the shortfall when securities lending transactions had collateral levels less than 100 percent ($434 mil-

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contributions made to the insurance subsidiaries within 90 days of the bankruptcy filing could technically have been challenged as preferential transfers,[461] but such challenges would have practical limitations. Because AIG's stock in its insurance subsidiaries was its most valuable asset, it is unlikely that creditors would have wanted to diminish the value of the insurance subsidiaries by taking action to weaken their financial strength. Subsequent collateral transfers might even have been allowed in order to preserve their value, although this might have been less likely.[462] In addition, the insurance regulators might have seized the insurance subsidiaries, making it difficult or impossible for the creditors to undo previous capital contributions.[463]

As discussed above, the insurance subsidiaries would not have been able to file for bankruptcy and would have remained liable for all outstanding securities lending obligations, and their ultimate ability to survive or reorganize would have depended on the impact of the bankruptcy filing on their business and customers and the actions taken by their insurance regulators through state regulatory procedures.[464] It is unclear whether all of the insurance subsidiaries had sufficient capital or resources to meet these obligations. The securities lending collateral pools were already experiencing liquidity strains, and AIG was providing significant capital to fund collateral calls or returns of cash collateral and to offset losses recognized by the insurance subsidiaries. The securities lending counterparties had the contractual right to terminate the loans at any time or because of an event of default (such as failing to pay or repay cash collateral to either mark collateral to market or on termination of the loan, an act of insolvency, or certain regulatory actions).[465] They would have been able to accelerate performance, set off against any other obligations, and withhold delivery or sell borrowed securities to satisfy any unpaid obligations.[466] Thus, they would have been protected to the extent that they were collateralized and would have been able to assert a claim for any shortfall as well as for reasonable costs and expenses incurred.[467]

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lion). The contributions to offset realized losses (make whole agreements) and to make up the difference in collateral levels (between agreed upon level and 100 percent) were part of guarantees provided by AIG to the insurance subsidiaries. Panel call with Texas Department of Insurance (May 24, 2010).

[461] 11 U.S.C. 547(b).

[462] The guarantee could have been rejected under 11 U.S.C. 365. Transfers between the parent and the insurance subsidiaries would have been greatly constrained and would have depended on the decisions of the interested parties on how best to maximize the value of AIG's assets.

[463] Panel call with Texas Department of Insurance (May 24, 2010).

[464] Because the insurance subsidiaries would not have been able to file for bankruptcy, the bankruptcy safe harbor provisions would not have applied to these contracts.

[465] Events of default include failing to pay or repay cash collateral to either mark collateral to market or on termination of the loan, an act of insolvency, or certain regulatory actions. *See* International Securities Lending Association, *Global Master Securities Lending Agreement*, at 16–19 (July 2009).

[466] *See id.* Generally, neither party is required to make delivery to the other unless that party is satisfied that the other party will make the necessary delivery in return. *See id*., at 17. These rights were the contractual equivalent of the bankruptcy safe harbor provisions for various financial contracts.

[467] Securities lending counterparties have the right to mark the securities lending collateral to market so that the "posted collateral" (or cash collateral provided to the AIG securities lending program) equals the aggregate of the "required collateral values" (or market value of securities equivalent to the loaned securities and the applicable margin). *See id.* If at any time on any business day, the aggregate market value of posted collateral (cash) exceeds the aggregate of the required collateral values, the Borrower (securities lending counterparty) may demand the Lender (AIG insurance subsidiaries) to repay or deliver equivalent collateral (cash) to eliminate the excess. *Id.* The parties also have the right to set off other obligations under the collateral

The impact of a bankruptcy on the securities lending counterparties would depend on whether they were overcollateralized or undercollateralized.

—If the securities lending counterparties were overcollateralized (or AIG's securities lending agreements were undercollateralized), the value of the securities loaned by AIG to the counterparties would have exceeded the value of the cash collateral provided to AIG by some margin.[468] As a result, these counterparties would have been fully secured if the insurance subsidiaries defaulted on their obligations or had been unable to return the cash collateral. The counterparties would have been able to sell the lent securities to satisfy any unpaid obligations of the AIG insurance subsidiaries.

—If the securities lending counterparties were undercollateralized (or AIG's securities lending agreements were overcollateralized), the value of the securities loaned by AIG to the counterparties would have been less than the value of the cash collateral provided to AIG by some margin.[469] Thus, in the event of default, the securities lending counterparties would not have been able to satisfy any unpaid obligations of the AIG insurance subsidiaries by selling the lent securities. Without help from the AIG parent, the funds for these obligations would have needed to come from the assets of the insurance subsidiaries. Further, the termination or payout process may have been complicated or prolonged in the event of intervention by the insurance regulators. If the regulators had placed the insurance subsidiaries into receivership, the securities lending counterparties would have been treated as general creditors for any deficiency claims asserted, would likely not have received anything from the regulators for these deficiency claims, and would have had to wait several years for the determination of whether and to what extent they would have been paid. They would, for example, have had to wait for priority claims—such as the claims of policyholders—to be paid in full. The counterparties thus benefited by receiving their cash collateral, in full, on demand, and by avoiding the need to sell securities in a depressed or distressed market (and the accompanying costs and expenses) to cover their positions, assert and seek payments for any deficiency, and deal with insurance regulators (if, for example, the regulators had seized the insurance subsidiaries).

The charts in Annex VIII also compare the impact of bankruptcy or rescue on both undercollateralized and overcollateralized counterparties.

• **CDS Counterparties:** If AIG had filed for bankruptcy, the counterparties to AIG's various CDS contracts would have benefited from safe harbor provisions giving them additional protection

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agreement. *Id*., at 12–13. If the collateral had been marked to market, the counterparties would not have been exposed to early termination because the value of lent securities held by the counterparties would have matched the amount of cash collateral that had not yet been repaid. The counterparties would also have been able to demand reasonable costs and expenses incurred as a result of failure to deliver equivalent collateral. *See id*., at 18, 21, 23.

[468] According to regulators at the Texas Department of Insurance, by July 31, 2008, roughly 1/4 to 1/3 of AIG's securities lending counterparties were asking for collateral requirements of less than 100 percent (or were asking AIG to loan securities in return for cash collateral below the value of the lent securities), some as low as 90 percent. AIG made up the difference between the collateral required and 100 percent, contributing $434 million as of July 31, 2008. Panel call with Texas Department of Insurance (May 24, 2010).

[469] *See* AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 49 ("Historically, AIG had received cash collateral from borrowers of 100–102 percent of the value of the loaned securities).

or favorable treatment. Counterparties "to any swap agreement" are exempted from the automatic stay that prevents creditors from taking action to collect on their debts after the bankruptcy filing.[470] The counterparties are specifically allowed to terminate their CDS contracts based on the bankruptcy filing and exercise their contractual rights, if any, to seize previously posted collateral or to offset or net out any other obligations.[471] If the counterparties were undersecured, however, they would have had to assert any deficiency claims as general unsecured creditors. Thus, the benefit to the CDS counterparties of government assistance such as ML3 or AIG's avoidance of bankruptcy depends on the extent that the creditors were undersecured or non-collateralized and the extent to which the counterparties would have been subject to the substantial discount negotiated in a bankruptcy plan. The counterparties' level of security would change as market conditions or fair values of outstanding affected transactions (or the values of underlying reference securities, such as CDOs and CLOs) fluctuated and depending on AIG's ability to post additional collateral, among other things. On an aggregate basis, the CDS counterparties that participated in ML3 were overcollateralized; they returned $2.5 billion to AIG as part of the ML3 closeout.[472] For second-level CDS counterparties, the benefit of the government assistance depends on the soundness of the first-level counterparties or their ability to make good on the second-level CDSs if AIG fails to perform on the first-level CDSs.

The charts in Annex VIII also compare the impact of rescue or bankruptcy on differently-placed counterparties.

- **Other CDS Counterparties:**

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[470] *See* 11 U.S.C. 362(b)(17) (providing that a bankruptcy filing does not operate as stay "of the exercise by a swap participant or financial participant of any contractual right . . . under any security agreement or arrangement or other credit enhancement forming a part of or related to any swap agreement, or of any contractual right . . . to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements"). The term "swap participant" is defined broadly to include any entity that had an outstanding swap agreement with the debtor. 11 U.S.C. 101(53C). The term "swap agreement" is also broadly defined to include a variety of instruments including interest rate, currency, equity index, equity, debt index, debt, total return, credit spread, credit, commodity index, commodity, weather, emissions, and inflation swaps. 11 U.S.C. 101(53B). *See also* 11 U.S.C. 362(b)(27) (providing the same protection to counterparties with various derivative contracts under master netting agreements).

[471] *See* 11 U.S.C. 362(b)(17); 11 U.S.C. 560 ("The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title [including a bankruptcy filing] or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title . . . "). *See also* 11 U.S.C. 362(b)(27); 11 U.S.C. 561 (providing the same protection to counterparties with various derivative contracts under a master netting agreement).

[472] For additional information on ML3, see Section D.4. It should be noted that if AIG or AIGFP had filed for bankruptcy, many of the CDS counterparties would have been undercollateralized because collateral calls were calculated at mid-mark. Thus, they would have had to assert an unsecured claim for any deficiency that would have been subject to the bankruptcy discount. Whether the counterparties would have been better off in a bankruptcy would depend on whether or how long they continued to hold (or intermediate on behalf of clients who held) the underlying reference securities or CDOs. The insurance on the CDOs would have disappeared, and the counterparties would have had "naked exposure" to changes in the value of the CDOs. If the counterparties attempted to sell the CDOs immediately or at a price below the difference in value of the CDS contract and the collateral posted on the bankruptcy date, the counterparties would have been worse off. If the counterparties held the CDOs or sold the CDOs after the value rebounded beyond the value of the difference in value of the CDS contract and the collateral posted on the bankruptcy date, then they would have been better off. Thus, it is likely that some of the counterparties would have been better off in bankruptcy if they continued to hold the CDOs in light of the increase in the valuation of the ML3 securities.

—Other CDO Swap Counterparties: Like the CDS counterparties discussed above, if AIG filed for bankruptcy, its other CDO swap counterparties would be able to terminate their CDS contracts, seize previously posted collateral, and offset or net out any other obligations. To the extent that the other CDO swap counterparties were unsecured or undersecured, they would be subject to the substantial discount negotiated for unsecured creditors as part of the bankruptcy plan. These counterparties benefited from AIG's avoidance of bankruptcy by receiving additional collateral as a result of the government rescue (a direct benefit) and from continuing their CDS contracts and avoiding forced losses as a result of an AIG bankruptcy (indirect benefits).

—Regulatory Capital Swap Counterparties: The regulatory capital CDS counterparties also would have benefited from the safe harbor provisions in the bankruptcy code, but only to the extent of the limited collateral that they held. The protection issued by AIGFP to Banque AIG would end, and Banque AIG is not likely to have been able to continue providing such protection after the failure of its parent. As described in Section E1, it seems likely that the impact of a bankruptcy on the counterparties that held these swaps would have hinged on the performance of the banks' other assets held as regulatory capital and whether or not the banking regulators in their countries provided forbearance.

Based on the capital rules under which these banks were operating in 2008, the loss of credit protection for ABN AMRO would have resulted in an estimated impact on its regulatory capital in the amount of $3.6 billion;[473] this means that had AIG filed for bankruptcy, ABN AMRO would have needed to raise an additional $3.6 billion in order to maintain its current regulatory capital ratios. For Danske and KFW, the estimated impact would have been around $2.1 billion each. For Credit Logement, it would have been about $1.9 billion.[474]

• **Municipalities and State Agencies with Guaranteed Investment Agreements:** GIAs are similar to traditional loans that would not benefit from the safe harbor provisions. If AIG and AIGFP filed for bankruptcy, municipalities with GIAs would have been subject to the automatic stay, would not have been able to close out their contracts immediately, and would have been subject

[473] Under Basel I, banks were required to hold 8 percent capital against assets such as corporate loans that were assigned a 100 percent risk weighting. But when AIGFP's regulated bank provided credit protection, the risk weighting fell to 20 percent, and the banks were only required to hold 8 percent capital against the 20-percent weighted value of the loans, which equaled 1.6 percent of the assets. The difference between these two regulatory treatments, 6.4 percent of the assets, was the amount that the banks did not have to hold as capital as a result of the AIGFP swaps. The regulatory capital relief would be less for assets that would otherwise receive a risk weighting of less than 100 percent under Basel I.

[474] It is impossible to calculate the exact capital charges avoided by these banks without knowing the risk weighting of each underlying asset that received credit protection from AIGFP. The calculations here reflect the methodology that AIG and FRBNY used to calculate the exposure that the counterparties would have had in a bankruptcy. Whether losing this cushion this would have resulted in inadequate regulatory capital (and thus a need to raise capital or sell assets in a volatile market) depends on the extent to which each bank was over-capitalized, and the extent to which their other assets lost value.

to the normal rights of setoff.[475] To the extent that they were secured or collateralized, they could request relief from the stay.[476] However, the trustee or DIP could challenge the level of security and potentially void some of the transfers made to the municipalities (e.g., if the security interests of the municipalities were not properly perfected or the transfer would constitute preferential transfers).[477] The municipalities would assert general unsecured claims for any deficiency that would be subject to the substantial bankruptcy discount.[478] By avoiding bankruptcy, these municipalities benefited to the extent that the payments they received as a result of government assistance exceeded the value of posted collateral that could not be recovered through various avoidance actions.[479] They also benefited by avoiding delays in payment, legal fees incurred to protect and maximize collection on their claims, and potential ratings downgrades or disruptions in the municipal bond market.

• **Pension Plans with Wrap Contracts:** An AIG or AIGFP bankruptcy would have terminated pension funds' wrap coverage and, in turn, would have resulted in instability and additional risk in stable value funds.[480] Pension funds holding the stable value wrap contracts would not have lost the entire $38 billion of their stable value funds in the event of bankruptcy, but they would have lost the insurance [481] in a market where replacement insurance of

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[475] 11 U.S.C. 362 (providing no exemption for municipalities from the automatic stay); 365(e)(1)(A)–(B) (providing that creditors cannot terminate or modify an executory contract on account of the financial condition of the debtor or the filing of a bankruptcy petition); 553 (providing setoff rights).

[476] 11 U.S.C. 362(d)(2)(A)–(B) (providing relief "if the debtor does not have an equity in such property; and such property is not necessary to an effective reorganization"). *See also* 11 U.S.C. 506 (explaining the determination of secured status). As of September 2008, AIG had outstanding GIA obligations of $13.6 billion. AIG had posted $8.5 billion of collateral for these GIAs, leaving $5.1 billion of the GIAs uncollateralized. Panel staff conversation with AIG (May 25, 2010).

[477] *See, e.g.*, 11 U.S.C. 547(b) (providing that a transfer to a creditor may be avoided if it was made for the benefit of the creditor, on account of an antecedent debt, while the debtor was insolvent, within 90 days of the bankruptcy filing, and would enable the creditor to receive more than the creditor would have received in bankruptcy if the transfer had not been made); 11 U.S.C. 547(c)(3), 547(c)(5), 547(e)(1) (relating to the perfection of security interests). The trustee or DIP has the burden of proving avoidability. 11 U.S.C. 547(g).

[478] AIG's guarantees of AIGFP's GIA obligations were executory contracts that would have been rejected during the bankruptcy and would have provided no recourse to the municipalities with GIAs. *See* 11 U.S.C. 365.

[479] According to the 2007 and 2008 AIG annual reports, AIG had outstanding GIA obligations of $19.9 billion at December 31, 2007 and $13.9 billion at December 31, 2008, and the fair value of securities pledged as collateral were $14.5 billion and $8.4 billion (or roughly 72.9 percent and 60.4 percent of the outstanding amounts), respectively. *See* AIG Form 10–K for FY08, *supra* note 47, at 53, 277; AIG Form 10–K for FY07, *supra* note 41, at 89, 171.

[480] *See* Testimony of Thomas C. Baxter, *supra* note 319, at 4. It should be noted that in the event of an AIG or AIGFP bankruptcy, the wrap contracts would likely have been rejected under 11 U.S.C. 365.

[481] *See* Testimony of Thomas C. Baxter, *supra* note 319, at 4 ("AIG also had approximately $38 billion of what are called stable value wrap contracts . . . . Workers whose 401(k) plans had purchased these contracts from AIG to insure against the risk that their stable value funds would decline in value could have seen that insurance disappear in the event of an AIG bankruptcy"); House Committee on Financial Services, Written Testimony of Ben S. Bernanke, chairman, Board of Governors of the Federal Reserve System, *Oversight of the Federal Government's Intervention at American International Group*, at 2 (Mar. 24, 2009) (online at www.house.gov/apps/list/hearing/financialsvcs_dem/statement_-_bernanke032409.pdf) (hereinafter "Written Testimony of Ben Bernanke") ("Workers whose 401(k) plans had purchased $40 billion of insurance from AIG against the risk that their stable value funds would decline in value would have seen that insurance disappear"). *See also* AIG Presentation on Systemic Risk, *supra* note 92, at 18 ("Failure to provide a wrap on $38 billion of stable value funds could result in millions of lost value . . . "); Stable Value Investment Association, *FAQ: Your Questions Answered About Stable Value* (Mar. 23, 2009) (online at stablevalue.org/help-desk/faq/) ("If an issuer of a contract that wraps or covers a fixed income portfolio (synthetic GIC) became insolvent, it is important to remember that the bulk of the assets—the portfolio of fixed income securities that support

this type was becoming increasingly unavailable.[482] Pension funds would have had to write down their assets from book to market value, resulting in significant losses to workers' portfolios in the markets of late 2008,[483] although the precise amount of these losses cannot be ascertained. Workers or retail investors may have been encouraged to withdraw funds, and confidence in the stability of pension plans would have been damaged. The extent of the potential impact on pension investors is unclear.

• **Employees:** Employees of the AIG companies filing for bankruptcy would have received wages, salaries, and commissions for services rendered during the bankruptcy, and with some limitations, they would have received wages, salaries, and commissions that were earned within six months of the bankruptcy filing but not yet paid, if any.[484] However, avoiding bankruptcy likely saved many employees of the AIG parent company and various subsidiaries—both filing and non-filing—from losing their jobs. In addition, AIG employees were able to avoid limitations or prohibitions related to bonuses, retention bonuses, severance payments, and other payments outside of the ordinary course of business.[485]

• **Suppliers and Contractors:** Contractors are generally unsecured creditors subject to the substantial discount negotiated in the bankruptcy plan. The treatment of suppliers is more complicated and depends on when the goods were received and whether the suppliers were secured (or had a perfected security interest). Suppliers would have been protected to the extent that they were secured and would have had an unsecured claim for any deficiency.[486] They would have had the right to reclaim goods provided,

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the stable value fund—are already owned by the 401(k) plan and its participants. In the event of any ultimate claim against the issuer for failure to meet any financial obligation under the contract, such claim would be settled during the normal bankruptcy process").

[482] *See* Eleanor Laise, *"Stable" Funds in Your 401(k) May Not Be*, Wall Street Journal (Mar. 26, 2009) (online at www.wsj.com/article/SB123802645178842781.html#articleTabs%3Darticle) ("[M]any banks and insurance companies are growing reluctant to provide the 'wrap contracts' that help smooth the funds' returns, leaving some stable-value managers scrambling to find alternatives. . . . Even stable-value funds with strong market-to-book rations are finding wrap providers less than welcoming. . . . [M]ost wrap providers aren't taking in any new money"). Vanguard Group principal Sue Graef further explained that AIG wrapped about 10 percent of the fund's assets, and it had been a slow process to replace them. *Id*.

[483] *See* Financial Accounting Standards Board ASC 715–30–35 (requiring pension plan assets to be marked to market). *See also* Testimony of Thomas C. Baxter, *supra* note 319, at 4 ("Pension plans would have been forced to write down their assets from book to market value, resulting in significant losses in participants' portfolios").

[484] Employees receive administrative expense priority for wages, salaries, and commissions earned during the bankruptcy proceedings and, unless they agree otherwise, must be paid in full before the plan can be confirmed. *See* 11 U.S.C. 503(b)(1), 507(a)(2) (providing administrative expense priority); 11 U.S.C. 1129(a)(9)(A) (requirement payment for plan confirmation). They also receive administrative expense priority for up to $10,000 of wages, salaries, and commissions (including vacation, severance, and sick leave) that were earned within 180 days of the bankruptcy filing but not yet paid. *See* 11 U.S.C. 507(a)(4) (providing administrative expense priority); 11 U.S.C. 1129(a)(9)(B) (requiring payment for plan confirmation).

[485] *See* 11 U.S.C. 503(c)(1) (providing that the debtor cannot make a transfer to induce an insider to stay unless the court finds that it is essential for retention, the employee is essential to the survival of the business, and the transfer is not greater than 10 times the mean amount paid to nonmanagement or not greater than 25 percent of previous amounts paid to the insider); 11 U.S.C. 503(c)(2) (providing that the debtor cannot make severance payments unless they are part of a plan offered to all full-time employees and the amount is not greater than 10 times the mean amount paid to nonmanagement); 11 U.S.C. 503(c)(3) (prohibiting payments outside the ordinary course of business and not justified by the facts and circumstances of the case, including payments to officers, managers, or consultants hired after the bankruptcy filing).

[486] *See* 11 U.S.C. 362(b)(3), 546(b), 547(c)(3). 547(c)(5), 547(e)(2)(A) (regarding perfection of security interests), 1129(b)(2)(A) (providing that secured creditors retain their interest in property or receive the value of their secured claims or interest for plan confirmation).

but not yet paid for, around the time of the bankruptcy filing.[487] They would also have received administrative expense priority for the value of goods provided during the bankruptcy.[488]

The Panel is not questioning whether it was appropriate for AIG to fulfill its obligations to any specific category of beneficiary. The Panel notes, however, that in cases where the government intervenes on a more discriminating basis—such as when the Federal Deposit Insurance Corporation (FDIC) seizes a bank or in bankruptcy, as was the case in the support to General Motors and Chrysler—the government has the ability to select among the relationships and obligations that it believes it most needs to continue in order to best extract value from the failing business and protect the taxpayers. Like any post-crisis financer, the government would have the ability to condition the extension of new credit on an assurance that the business would be using the money in ways that would cause the business to survive, not just to pay off old debt. Thus, if some form of resolution authority had existed for AIG, the government might have chosen to make capital contributions to AIG's insurance subsidiaries so they could continue as adequately funded businesses, generating cash flow for their parent.[489] It might have chosen to sell off some parts of AIG's business in Section 363-type sales.[490] Some bondholders[491] might have been forced to take their place in line in liquidation, while other creditors might have fared better.

As a result of the government's decision to rescue AIG, pre-bailout shareholders were diluted, but not completely wiped out, as they would have been in bankruptcy, and as occurred in the bankruptcies of the automotive companies several months later. How-

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[487] *See* 11 U.S.C. 546(c)(1)(A)–(B) (providing supplier with the right of reclamation for goods sold in the ordinary course of business, if the debtor was insolvent, and within 45 days before the bankruptcy filing and requiring the supplier to demand the goods in writing within 45 days of receipt or 20 days after the bankruptcy filing); 11 U.S.C. 503(b)(9), 546(c)(2) (providing administrative expense priority for such goods if the supplier does not demand reclamation in writing).

[488] *See* 11 U.S.C. 503(b)(9), 507(a)(2) (providing administrative expense priority for goods received within 20 days before the bankruptcy filing and in the ordinary course of business); 11 U.S.C. 1129(a)(9)(A) (requiring payment for plan confirmation).

[489] *See* Congressional Oversight Panel, Testimony of Timothy F. Geithner, secretary, U.S. Department of the Treasury, *COP Hearing with Treasury Secretary Timothy Geithner* (Sept. 10, 2009) (online at cop.senate.gov/hearings/library/hearing-121009-geithner.cfm) ("This is the tragic failure about the regime we came in with because we did not have the legal capacity to manage the orderly unwinding of a large, complex financial institution. We do have the capacity to unwind small banks and thrifts, but did not have it for an entity like AIG. And that forced us to do things that we would not ever want to do.")

[490] Section 363 of the Bankruptcy Code allows the debtor to propose to sell property of the estate outside of the ordinary course of business as part of the reorganization effort. 11 U.S.C. 363(b). The proceeds of the sale can be used to fund the debtor's operations or to raise capital to pay creditors. Section 363 sales provide substantial advantages: buyers have clear title to the purchased assets and the estate can maximize the value of the assets sold, ultimately benefiting the creditors. 11 U.S.C. 363(f) ("The trustee may sell property . . . free and clear of any interest in such property of an entity other than the estate, only if (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest; (2) such entity consents; (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property; (4) such interest is in bona fide dispute; or (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.") Distributions to creditors will be made in accordance with priority rules. *See* 11 U.S.C. 507. There are no restrictions on how the purchaser subsequently uses the purchased assets. *See* September Oversight Report, *supra* note 389, at 44–45, 49, 111–12. However, state insurance regulators would have to approve the sale of insurance subsidiaries domiciled within their state under state insurance laws, and as discussed in the next section, it would be difficult to get value if there had been a "run" on the insurance subsidiaries as a result of the bankruptcy filing of the AIG parent company and other domestic, non-regulated subsidiaries.

[491] Bondholders are included in the discussion of other holders of AIG and AIGFP debt in Section E.1. These bondholders would be treated as unsecured creditors; see explanation of treatment of AIG and AIGFP unsecured debt holders above.

ever, pre-bailout shareholders of AIG were much more significantly diluted than shareholders were in the subsequent rescues of Citigroup and Bank of America.

This means that even though the taxpayers may lose some portion of the government's investment in AIG—which could be in the billions of dollars—pre-bailout shareholders still have the potential to profit from AIG's future recovery.[492]

F. Analysis of the Government's Decisions

1. Initial Crisis: September 2008

a. The Government's Justification for the Rescue

The following section sets forth the justifications offered by the Federal Reserve and Treasury with respect to their rescue of AIG; the Panel's analysis of those justifications follows.

Officials at FRBNY, Treasury, and the Federal Reserve say they became fully aware of the fact (if not the full extent) of the severe liquidity problems facing AIG on September 12.[493] The Panel notes, however, that FRBNY had earlier awareness of at least some of the looming issues facing AIG. Mr. Willumstad, then-AIG CEO, had a conversation with FRBNY President Geithner in late July 2008 regarding possible access to the Federal Reserve's discount window. In addition, on September 9, 2008, Mr. Willumstad spoke to President Geithner about the potential for AIG to become a primary dealer in order to gain access to the Federal Reserve's discount window, and again made no progress. Mr. Willumstad clarified, however, that during these conversations, he did not state that "AIG was facing serious issues."[494]

While the Federal Reserve had no role in supervising or regulating AIG and was also not lending to the company,[495] the Federal Reserve was the only governmental entity at the time with the legal authority to provide liquidity to the financial system in emer-

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[492] *See* Congressional Oversight Panel, *March Oversight Report: The Unique Treatment of GMAC under TARP,* at 88 (Mar. 10, 2010) (online at cop.senate.gov/documents/cop-031110-report.pdf) (hereinafter "March Oversight Report") (discussing a similar issue with pre-bailout shareholders of GMAC).

[493] Testimony of Thomas C. Baxter, *supra* note 215; Congressional Oversight Panel, Testimony of Sarah Dahlgren, executive vice president of special investments management and AIG monitoring, *Federal Reserve Bank of New York, COP Hearing on TARP and Other Assistance to AIG* (May 26, 2010) (stating that FRBNY understood the threat AIG posed to the economy on September 12, and acknowledging that "AIG was not one of the top 10 exposures" for the institutions that it supervised at that time); e-mail from Hayley Boesky, vice president, Federal Reserve Bank of New York, to William Dudley, executive vice president, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept., 12, 2008) (FRBNYAIG00511) (stating "Now focus is on AIG. I am hearing worse than LEH [Lehman]. Every bank and dealer has exposure to them. People I heard from worry they can't roll over their funding . . . Estimate I hear is 2 trillion balance sheet"); E-mail from Alejandro LaTorre, vice president, Federal Reserve Bank of New York, to Timothy F. Geithner, president and chief executive officer, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept. 12, 2008) (FRBNYAIG00509) (providing an update on the AIG situation ("[t]he key takeaway is that they are potentially facing a severe run on their liquidity over the course of the next several (approx. 10) days if they are downgraded by Moody's and S&P early next week") and noting that FRBNY and Board of Governors of the Federal Reserve Board officials met with senior executives at AIG to discuss their liquidity and risk exposure).

[494] Testimony of Robert Willumstad, *supra* note 179.

[495] Given this role, FRBNY emphasized that it had three main tasks with respect to helping facilitate an AIG resolution: (1) a "need to understand the exposures of our firms (banks and IBs);" (2) a "need to stay in the information loop, but 'low key' our interactions with NYS-Insurance and the UK–FSA. We will have some light interface with other supervisors (OTS, etc.);" and (3) "[t]hrough Legal, we want to understand how the bankruptcy process will play out." E-mail from Brian Peters, senior vice president, risk management function, Federal Reserve Bank of New York, to Federal Reserve Bank of New York officials (Sept. 15, 2008) (FRBNYAIG00491).

gency and exigent circumstances.[496] Through internal discussions and a dialogue with AIG and its state insurance regulators, the Board and FRBNY ultimately chose to provide AIG with assistance after identifying the systemic risks associated with the company and contemplating the consequences of an AIG bankruptcy or partial rescue.[497] As discussed above, on September 16, the Board, with the full support of Treasury,[498] authorized FRBNY under section 13(3) of the Federal Reserve Act to lend up to $85 billion to AIG in order to assist the company in meeting its obligations as they came due. The Board determined that, in the then-existing environment, "a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance."[499] According to Mr. Liddy, who became AIG's CEO the following day, "[t]his facility was the company's best alternative."[500] Later that day, the AIG Board of Directors voted to approve the transaction.[501]

Secretary Geithner has stated that "[t]he decision to rescue AIG was exceptionally difficult and enormously consequential."[502] Chairman Bernanke has said the Federal Reserve's decision-making was driven by the "prevailing market conditions and the size and composition of AIG's obligations,"[503] as well as "AIG's central

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[496] For further discussion of the legal options available to AIG in September 2008, see Section B3, *infra.* The Federal Reserve's ability to act was dependent upon the Board's authorization to invoke Section 13(3) of the Federal Reserve Act, which was provided on September 16, 2008.

[497] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010).

[498] At the time FRBNY provided AIG with the $85 billion revolving credit facility, Treasury only provided a very short statement, with then-Secretary Paulson noting that "[t]hese are challenging times for our financial markets. We are working closely with the Federal Reserve, the SEC and other regulators to enhance the stability and orderliness of our financial markets and minimize the disruption to our economy. I support the steps taken by the Federal Reserve tonight to assist AIG in continuing to meet its obligations, mitigate broader disruptions and at the same time protect the taxpayers." U.S. Department of the Treasury, *Statement by Secretary Henry M. Paulson, Jr., on Federal Reserve Actions Surrounding AIG* (Sept. 16, 2008) (online at www.treas.gov/press/releases/hp1143.htm). In a subsequent letter to Timothy F. Geithner, then-president and CEO of the Federal Reserve Bank of New York, Secretary Paulson stressed that "the situation at AIG presented a substantial and systemic threat" to our financial markets, and that the government's decision to assist AIG "was necessary to prevent the substantial disruption to financial markets and the economy that could well have occurred from a disorderly wind-down of AIG." Letter from Henry M. Paulson, Jr., secretary, U.S. Department of the Treasury, to Timothy F. Geithner, president and chief executive officer, Federal Reserve Bank of New York (Oct. 8, 2008) (online at www.federalreserve.gov/monetarypolicy/files/letter_aig.pdf).

[499] Federal Reserve Press Release, *supra* note 266. In its review of FRBNY documents and e-mails from this time, the Panel verified that FRBNY officials analyzed the systemic impact of an AIG bankruptcy, and concluded that AIG could be more systemic in nature than Lehman due to the retail dimension of its business. E-mail from Alejandro LaTorre to Timothy Geithner and other FRBNY personnel (Sept. 16, 2008) (FRBNY AIG00483–486); E-mail from Alejandro LaTorre, vice president, Federal Reserve Bank of New York, to Timothy F. Geithner, president and chief executive officer, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept. 14, 2008) (FRBNYAIG00496–499); E-mail from Hayley Boesky, vice president, Federal Reserve Bank of New York, to William Dudley, executive vice president, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept., 12, 2008) (FRBNYAIG00511).

[500] American International Group, Inc., *AIG Signs Definitive Agreement with Federal Reserve Bank of New York for $85 Billion Credit Facility* (Sept. 23, 2008) (online at media.corporate-ir.net/media_files/irol/76/76115/releases/092408.pdf).

[501] American International Group, Inc., *AIG Statement on Announcement by Federal Reserve Board of $85 Billion Secured Revolving Credit Facility* (Sept. 16, 2008) (online at www.aigcorporate.com/newsroom/index.html) (hereinafter "AIG Statement on $85 Billion Secured Revolving Credit Facility").

[502] Testimony of Sec. Geithner, *supra* note 11, at 1.

[503] Senate Committee on Banking, Housing, and Urban Affairs, Written Testimony of Ben S. Bernanke, chairman, Board of Governors of the Federal Reserve System, *Turmoil in US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions,* at 2 (Sept. 23, 2008) (online at banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=bbba8289-b8fa-46a2-a542-b65065b623a1). *See*

role in a number of markets other firms use to manage risks, and the size and composition of AIG's balance sheet."[504] The Federal Reserve's actions were also informed by its judgment that an AIG collapse would have been much more severe than that of Lehman Brothers because of its global operations, substantial and varied retail and institutional customer base, and the various types of financial services it provided.[505]

i. Systemic Risks

a. Systemic Risks Articulated in September 2008

At the time of the initial decision to assist AIG, the Federal Reserve and Treasury publicly identified three primary ways in which an AIG failure posed systemic risk.

First, the Federal Reserve and Treasury assert that they concluded that, given AIG's role as a large seller of CDSs on CDOs, an AIG failure could have exposed its counterparties to large losses and disrupted the operation of the payments and settlements system.[506] According to Secretary Geithner, if the AIG parent holding company had filed for bankruptcy, defaults on over $100 billion of debt and on trillions of dollars of derivatives would have resulted.[507] The Federal Reserve and Treasury argue that this would have adversely impacted numerous financial institutions and the fi-

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also E-mail from Alejandro LaTorre, assistant vice president, Federal Reserve Bank of New York, to Timothy Geithner (and other FRBNY personnel), president and chief executive officer, Federal Reserve Bank of New York (Sept. 16, 2008) (FRBNYAIG00483–486); E-mail from Alejandro LaTorre, vice president, Federal Reserve Bank of New York, to Timothy F. Geithner, president and chief executive officer, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept. 14, 2008) (FRBNYAIG00496–499); E-mail from Hayley Boesky, vice president, Federal Reserve Bank of New York, to William Dudley, executive vice president, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept., 12, 2008) (FRBNYAIG00511).

[504] Ben S. Bernanke, chairman, Board of Governors of the Federal Reserve System, *Current Economic and Financial Conditions,* Remarks at the National Association for Business Economics, 50th Annual Meeting, Washington, DC (Oct. 7, 2008) (online at www.federalreserve.gov/newsevents/speech/bernanke20081007a.htm) (hereinafter "Remarks by Ben Bernanke"). *See also* E-mail from Alejandro LaTorre, assistant vice president, Federal Reserve Bank of New York, to Timothy Geithner (and other FRBNY personnel), president and chief executive officer, Federal Reserve Bank of New York (Sept. 16, 2008) (FRBNYAIG00483–486); E-mail from Alejandro LaTorre, vice president, Federal Reserve Bank of New York, to Timothy F. Geithner, president and chief executive officer, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept. 14, 2008) (FRBNYAIG00496–499); E-mail from Hayley Boesky, vice president, Federal Reserve Bank of New York, to William Dudley, executive vice president, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept., 12, 2008) (FRBNYAIG00511).

[505] *See* Ben S. Bernanke, chairman, Board of Governors of the Federal Reserve System, *Four Questions About the Financial Crisis,* Speech at the Morehouse College, Atlanta, GA (Apr. 14, 2009) (online at www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm); Remarks by Ben Bernanke, *supra* note 504; E-mail from Alejandro LaTorre, assistant vice president, Federal Reserve Bank of New York, to Timothy Geithner (and other FRBNY personnel), president and chief executive officer, Federal Reserve Bank of New York (Sept. 16, 2008) (FRBNY AIG00483–486); E-mail from Alejandro LaTorre, vice president, Federal Reserve Bank of New York, to Timothy F. Geithner, president and chief executive officer, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept. 14, 2008) (FRBNYAIG00496–499).

[506] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010); E-mail from Dianne Dobbeck, assistant vice president, financial sector policy and analysis, Federal Reserve Bank of New York, to Federal Reserve Bank of New York officials (Sept. 15, 2008); E-mail from Hayley Boesky, vice president, Federal Reserve Bank of New York, to William Dudley, executive vice president, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept., 12, 2008) (FRBNYAIG00511). For further analysis of the impact of an AIG failure on the entire derivatives market, see Section F.1(b), *infra.*

[507] Testimony of Sec. Geithner, *supra* note 11, at 6. *See also* Testimony of Jim Millstein, *supra* note 44, at 2 (stating that without government assistance, "AIG would have then defaulted on more than $2 trillion notional of derivative obligations and on over $100 billion of debt to institutions").

nancial system as a whole. The primary fear of the Federal Reserve and Treasury was that defaults directly related to AIG would have spread throughout the financial system, affecting transactions between other counterparties, negatively affecting investor confidence, and further destabilizing the economy. Furthermore, the Federal Reserve and Treasury contend that banks and other counterparties that used the AIGFP CDSs as credit protection in the event of loss on the underlying securities would likely have suddenly seen their positions become unhedged and uncollateralized[508] as market conditions worsened and the underlying assets further declined in value, resulting in reduced capital levels.[509]

Second, the Federal Reserve and Treasury attribute some of their actions to a stated belief that an AIG default could have triggered severe disruptions to an already distressed commercial paper market.[510] The Federal Reserve and Treasury concluded that an AIG default on its commercial paper could have adversely impacted money market mutual funds since AIG had issued $20 billion in commercial paper to money market mutual funds, approximately four times as much as Lehman Brothers.[511] In the government's view, this could have substantially disrupted the commercial paper market by reducing credit availability for borrowers even on a short-term basis and causing higher lending rates. This concern escalated after the money market disruptions that occurred in the wake of the Lehman Brothers bankruptcy filing, including the "breaking of the buck" seen at the Reserve Primary Fund.[512]

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[508] The Panel notes, however, that some of AIGFP's CDS counterparties have stated that they were not exposed to credit risk from AIG's default. For further discussion of AIGFP CDS counterparties and the creation of Maiden Lane III, *see* Section F.5, *infra.* The Panel notes that in a bankruptcy filing, virtually all of the multi-sector CDO CDS counterparties would have terminated as of the petition date and would have been entitled to retain all previously posted cash collateral (which essentially means their unsecured claim would become secured to the extent of that collateral), hold onto the referenced CDOs (for those that were not holding naked positions), or continue the contract.

[509] E-mail from Alejandro LaTorre, assistant vice president, Federal Reserve Bank of New York, to Timothy Geithner, president and chief executive officer, Federal Reserve Bank of New York, and other FRBNY personnel (Sept. 16, 2008) (FRBNY AIG00483–486); E-mail from Alejandro LaTorre, vice president, Federal Reserve Bank of New York, to Timothy F. Geithner, president and chief executive officer, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept. 14, 2008) (FRBNYAIG00496–499); E-mail from Hayley Boesky, vice president, Federal Reserve Bank of New York, to William Dudley, executive vice president, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept. 12, 2008) (FRBNYAIG00511).

[510] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010); E-mail from Alejandro LaTorre, assistant vice president, Federal Reserve Bank of New York, to Timothy Geithner (and other FRBNY personnel), president and chief executive officer, Federal Reserve Bank of New York (Sept. 16, 2008) (FRBNY AIG00483–486) (attaching a memo referencing how a bankruptcy of AIG commercial paper "has significant contagion potential" and that if its commercial paper could not be rolled over, "issuers draw down on bank lines," causing credit extension to dry up, bank capitalization to further deteriorate, and ratings downgrades to take place). For further analysis of the impact of an AIG failure on the commercial paper market, see Section F.1(b), *infra*.

[511] E-mail from Alejandro LaTorre, assistant vice president, Federal Reserve Bank of New York, to Timothy Geithner (and other FRBNY personnel president and chief executive officer, Federal Reserve Bank of New York (Sept. 16, 2008) (FRBNY AIG00483–486).

[512] As the Panel noted in its November 2009 oversight report, the Lehman Brothers bankruptcy "quickly triggered a broad-based run of investor redemptions in prime funds and the reinvestment of capital into government funds." November Oversight Report, *supra* note 411, at 29. In response, on September 19, 2008, two weeks before EESA was signed into law, Treasury announced the Temporary Guarantee Program for Money Market Funds, a voluntary program that allowed all publicly offered money market funds meeting certain criteria to participate in exchange for signing a guarantee agreement and paying fees.

Although no other money market mutual funds "broke the buck," investors liquidated $169 billion from prime funds and reinvested $89 billion into government funds. International Banking and Financial Developments, *supra* note 187, at 72.

Third, the Federal Reserve and Treasury assert that they feared that an AIG failure could have undermined an already fragile economy by weakening business and investor confidence.[513] After the placement of Fannie Mae and Freddie Mac into government conservatorship on September 7 and the Lehman Brothers bankruptcy filing on September 15, financial markets destabilized considerably. AIG maintained financial relationships with a large number of banks, insurance companies, and other market participants across the globe. A failure of AIG in this environment, according to the Federal Reserve and Treasury, could have further shaken investor confidence and contributed to increased borrowing costs and additional economic deterioration. In this context, the Federal Reserve and Treasury officials state that they believed that the unfolding crisis and the increasingly fragile state of the economy necessitated swift action to prevent a total collapse of the financial system.[514]

b. Evolution of Systemic Risk Justifications

The focus of the government's systemic risk justification changed over time. The Panel notes that, at the time of their initial intervention, the Federal Reserve and Treasury seem to have been cautious in their public statements about the systemic risks associated with AIG for fear that they might further destabilize the economy and weaken investor confidence if they itemized all of the potential consequences associated with a company as large and interconnected as AIG. Nonetheless, rather than staying committed to the idea that a rescue of AIG was necessary given the environment in September 2008 and in order to stem the rapid loss of confidence in our financial system that was occurring, the Federal Reserve and Treasury have changed the emphasis of the rationales underlying their intervention in the months since then.[515]

In September 2008, neither the Federal Reserve nor Treasury publicly expressed specific concern about the effect of an AIG bankruptcy on existing insurance policyholders.[516] As discussed above,

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[513] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010); E-mail from Alejandro LaTorre, assistant vice president, Federal Reserve Bank of New York, to Timothy Geithner, president and chief executive officer, Federal Reserve Bank of New York, and other FRBNY personnel (Sept. 16, 2008) (FRBNY AIG00483–486) (attaching a memo analyzing the systemic impact of an AIG bankruptcy on market liquidity and related spillover effects).

[514] FRBNY and Treasury briefing with Panel and Panel staff (May 11, 2010).

[515] The Panel notes that the rationales supporting the AIG intervention appear well-coordinated between the Federal Reserve and Treasury, with Chairman Bernanke and Secretary Geithner's speeches and testimonies (as well as those given by their colleagues) in the months subsequent to the initial intervention adhering to a consistent story line, even as the story has evolved.

[516] The Panel recognizes, however, that internal FRBNY e-mails and memos circulated at this time indicate that while the impact of an AIG bankruptcy on the insurance subsidiaries did not appear to be a main focus of concern, there was at least some thought given to the impact of an AIG bankruptcy on regulated insurance subsidiaries. E-mail from Alejandro LaTorre, vice president, Federal Reserve Bank of New York, to Timothy F. Geithner, president and chief executive officer, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept. 14, 2008) (FRBNY AIG00496–499) (attaching a memo with six reasons for support to AIG focused on AIG's institutional trading partners in capital markets operations); E-mail from Alejandro LaTorre, vice president, Federal Reserve Bank of New York, to Timothy Geithner, president and chief executive officer, Federal Reserve Bank of New York, and other FRBNY personnel (Sept. 16, 2008) (FRBNY AIG00483–486) (attaching a memo with analysis of an AIG bankruptcy on the insurance subsidiaries (both if financially healthy and not financially healthy); E-mail from Dianne Dobbeck, assistant vice president, financial sector policy and analysis, Federal Reserve Bank of New York, to Federal Reserve Bank of New York officials (Sept. 15, 2008); E-mail from Hayley Boesky, vice president, Federal Reserve Bank of New York, to

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AIG's insurance operations were viewed as generally sound (excluding the liquidity issues stemming from AIG's securities lending program on the life insurance side), and its insurance subsidiaries had significant value as going concerns at the time the government intervened.[517] Toward the end of 2008 and into early 2009, however, the Federal Reserve and Treasury began to voice concerns about the desire to preserve value at the insurance company subsidiary level and the consequences of the unraveling of AIG's insurance subsidiaries on households and businesses.[518] According to the Federal Reserve and Treasury, letting AIG's business units start to fail would have resulted in catastrophe.[519] In his January 2010 testimony before the House Oversight and Government Reform Committee, Secretary Geithner stated:

> AIG was one of the largest life and health insurers in the United States. AIG was also one of the largest property & casualty insurers in the United States, providing insurance to 180,000 small businesses and other corporate entities, which employ about 100 million people. History suggests that the withdrawal of a major underwriter from a particular market can have large, long-lasting effects on the households and businesses that rely on basic insurance protection.

Beginning in March 2009, the Federal Reserve and Treasury publicly raised concerns that a sudden loss of AIG insurance capacity could have severely disrupted the market, potentially creating a market capacity shortage and significant premium increases for consumers, businesses, and financial institutions. They also feared a run driven by a substantial influx of life insurance policyholders either drawing on the savings and credit features of their policies or surrendering their policies entirely, especially since some such "runs" were seen in foreign jurisdictions.[520]

William Dudley, executive vice president, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept, 12, 2008) (FRBNY AIG00511).

[517] For further discussion of the financial condition of the insurance company subsidiaries at the time of the government's intervention in AIG, see Section E.2 (AIG Insurance Company Subsidiaries), *infra*.

[518] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010). *See, e.g.*, Testimony of Sec. Geithner, *supra* note 11, at 5–6 (stating that "if AIG had failed, the crisis almost certainly would have spread to the entire insurance industry." And that "the seizure by local regulators of AIG's insurance subsidiaries could have delayed Americans' access to their savings, potentially triggering a run on other institutions"); House Committee on Financial Services, Written Testimony of Timothy F. Geithner, secretary, U.S. Department of the Treasury, *Oversight of the Federal Government's Intervention at American International Group* (Mar. 24, 2009) (online at www.house.gov/apps/list/hearing/financialsvcs_dem/statement_-_geithner032409.pdf); Board of Governors of the Federal Reserve System, *U.S. Treasury and Federal Reserve Board Announce Participation in AIG Restructuring Plan* (Mar. 2, 2009) (online at www.federalreserve.gov/newsevents/press/other/20090302a.htm) (hereinafter "Treasury and the Federal Reserve Announce Participation in Restructuring") (stating that since "AIG provides insurance protection to more than 100,000 entities, including small businesses, municipalities, 401(k) plans, and Fortune 500 companies who together employ over 100 million Americans," as well as having "over 30 million policyholders in the U.S." and a role as a "major source of retirement insurance for, among others, teachers and non-profit organizations," the "potential cost to the economy and the taxpayer of government inaction would be extremely high"). *See also* AIG Presentation on Systemic Risk, *supra* note 92.

[519] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010) (noting that this was already starting to happen as the insurance regulators notified AIG on September 16, 2008 that it would no longer be permitted to borrow funds from its insurance company subsidiaries under a revolving credit facility that AIG had maintained, and they subsequently required AIG to repay any outstanding loans under this facility and terminate it).

[520] E-mail from Alejandro LaTorre, assistant vice president, Federal Reserve Bank of New York, to Timothy F. Geithner, president and chief executive officer, Federal Reserve Bank of New York and other FRBNY personnel (Sept. 16, 2008) (FRBNY AIG00483–486); FRBNY and Treasury briefing with Panel and Panel staff (May 11, 2010); FRBNY and Treasury briefing

In recent interviews with Panel staff, the Federal Reserve and Treasury have stated that an AIG bankruptcy would have likely resulted in both domestic and foreign regulatory seizure of the regulated insurance company subsidiaries.[521] Furthermore, the Federal Reserve and Treasury contend that with respect to foreign regulatory seizure, the seizure by one regulator in a given region would have likely had a domino effect and led to the seizure of insurance businesses in multiple jurisdictions across the region. In both the domestic and foreign realms, the Federal Reserve and Treasury have asserted that there might have been insufficient capital or liquidity to pay all policyholder claims, that some policyholders might not have been able to qualify for coverage at other companies, and that a significant amount of policy cancellations would have further undermined the stability of the subsidiaries.[522]

Given that the parent company and its insurance company subsidiaries are also very closely intertwined through the credit rating system, the Federal Reserve and Treasury stressed that a bankruptcy by the parent entity would have adversely impacted both the credit and insurance ratings of its subsidiaries. Credit rating agency guidelines typically stipulate that the parent company cannot move more than three notches in ratings from those of its subsidiaries without the subsidiaries themselves also being impacted by downgrades. Had the AIG parent entity filed for bankruptcy, it would have received a "D" credit rating, and because of the three notch rule, the subsidiaries would have likely been downgraded to CCC+, CC−, or lower. While a downgrade of a parent does not necessarily result in the downgrade of a well-capitalized subsidiary, A.M. Best, a leading rating agency for the insurance industry, has indicated that if the parent is no longer rated investment-grade, then this would be an important factor in its assessment of both credit ratings and financial strength ratings for the insurance subsidiaries.[523] According to the Federal Reserve and Treasury, any ratings downgrades that might have occurred would have increased the odds that the subsidiaries would be subject to heightened scrutiny by the regulators or placed into conservatorship or receivership.

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with Panel and Panel staff (Apr. 12, 2010). Policymakers have pointed out that some runs were seen in foreign jurisdictions. According to press reports, insurance policyholders in Singapore, Taiwan, Thailand, Vietnam, and Hong Kong sought to terminate their insurance policies with two of AIG's insurance subsidiaries (AIA and Nan Shan Life Insurance) after learning of AIG's financial troubles and despite the Federal Reserve's $85 billion rescue. *See, e.g., Hundreds of AIG Policyholders Throng Asian Offices*, Agence France Presse (Sept. 17, 2008) (online at afp.google.com/article/ALeqM5iTq3SSoWfqiVVsrYgM0hnTOp0ZdQ); *The Good, the Bad and the Opportunity,* Financial Express (Sept. 24, 2008); *AIG Insurance Woes Will Not Affect Vietnam,* Asia Pulse (Sept. 22, 2008). After a number of policyholders in Singapore terminated their insurance policies, Mr. Low Kwok Mun, an official with the Monetary Authority of Singapore (MAS), issued the following statement on September 18, 2008: "AIA currently has sufficient assets in its insurance funds to meet its liabilities to policyholders. Policyholders should not act hastily to terminate their insurance policies as they may suffer losses from the premature termination and lose the insurance protection they may need." Low Kwok Mun, executive director of Insurance Supervision, Monetary Authority of Singapore, Statement on AIA's Policy Conservation Programme (Sept. 18, 2008) (online at www.mas.gov.sg/news_room/press_releases/2008/Comments_from_MAS_on_AIA_Policy_Conservation_Programme.html).

[521] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010). For further discussion of the possible impact of an AIG bankruptcy on the insurance company subsidiaries, see Section F.1(b), *infra.*

[522] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010).

[523] A.M. Best conversations with Panel staff (May 18, 2010); Treasury conversations with Panel staff (Jan. 5, 2010).

According to the Federal Reserve and Treasury, AIG's insurance company subsidiaries would not have been insulated from the adverse consequences of a bankruptcy due to the substantial ties they enjoyed with each other by virtue of securities lending requirements and other intercompany funding.[524] Many of AIG's subsidiaries also owned interests in, or had provided intercompany funding to, other AIG entities, and these investments typically formed part of their regulatory capital. Any defaults on the underlying securities and loans as a result of a bankruptcy filing might have further destabilized AIG's subsidiaries.

Recent statements by Federal Reserve and Treasury officials suggest that the regulators have tried to respond to public displeasure with the AIG bailout by looking for more sympathetic beneficiaries of their decision to intervene than financial institutions. In his March 2009 testimony before the House Financial Services Committee, Chairman Bernanke stressed that an AIG failure would have also had detrimental impacts on market confidence in other areas, including state and local governments that invested with AIG, retirement plans that purchased insurance from AIG, and banks that extended loans and credit lines to the company.[525] In January 2010, former Treasury Secretary Paulson testified that "if AIG had gone down, [he] believe[d] that we would have had a situation where Main Street companies, industrial companies of all sizes, would not have been able to raise money for their basic funding. And they wouldn't have been able to pay their employees. They would have had to let them go. Employees wouldn't have paid their bills. This would have rippled through the economy."[526] Furthermore, Secretary Paulson added that had AIG failed, he believes that it "would have taken down the whole financial system and our economy. It would have been a disaster."[527]

On the one hand, these expanded rationales might suggest that many observers have perhaps understated AIG's risk to the financial system as a whole by focusing primarily on the direct effects of a default on AIG's counterparties. At the point of initial intervention, there were so many different problems posed by AIG that the regulators might have responded to any one of them with a rescue, and in totality they felt they had no option but to step in. On the other hand, the lack of complete transparency at the time of the initial intervention indicates that the government has failed to follow a consistent and cohesive message with respect to its rationale for assisting AIG, calling into question the factors that were actually driving the decision-making at the various points in time

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[524] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010).

[525] Written Testimony of Ben Bernanke, *supra* note 481, at 2.

[526] House Committee on Oversight and Government Reform, Testimony of Henry M. Paulson, Jr., former secretary, U.S. Department of the Treasury, *The Federal Bailout of AIG* (Jan. 27, 2010) (publication forthcoming) (online at oversight.house.gov/index.php?option=com_content&task=view&id=4756&Itemid=2) (hereinafter "Testimony of Henry M. Paulson, Jr.").

[527] *Id.* Additionally, Secretary Geithner built on these concerns in his January 2010 testimony before the House Committee on Oversight and Government Reform, stating that as the regulators considered how to respond to AIG's problems, "[s]tate and local governments halted public works projects because they couldn't obtain financing. School construction and renovation projects stopped. Hospitals postponed plans to add beds and equipment. Universities across the nation faced difficulty paying employees. High school students changed plans for college education, which suddenly appeared much more expensive. Ships that transport goods sat empty, in part because trade credit was simply unavailable. Factories were closing and millions of Americans were losing their jobs." Testimony of Sec. Geithner, *supra* note 11, at 4.

that assistance was offered and restructured. While the Panel recognizes that there is a fair amount of agreement on the systemic consequences of an AIG failure, there are differing opinions on what would have been the consequences for the insurance subsidiaries, the retail distribution network and policyholders. Thus, to some extent, at least some of the government's justifications seem to have pivoted over time into a political argument (that has less factual support) with respect to the impact of an AIG failure on the insurance subsidiaries, retail sectors and policyholders.

In its assessment of government actions to deal with the current financial crisis, the Panel has regularly called for transparency, accountability, and clarity of goals. While the government had to make the bailout decision in a very short amount of time and with incomplete information, the Panel stresses that the government also has a special obligation to be transparent (and consistent) in explaining why it was committing $85 billion of public funds.

ii. Balance Sheet Considerations

Two other areas of concern for the Federal Reserve and Treasury were AIG's inability to articulate the amount of assistance it needed and the speed with which its requests for assistance escalated between September 12 and 16.[528] Not only was the company not able to provide a sense of its balance sheet and its exposure to either potential private sector investors or the government, but its capital deficit was growing much faster than available capital. This also appears to have been a factor in the breakdown in private-sector efforts to provide a solution for AIG, as AIG could not produce certainty on any of the metrics on which lenders typically lend.[529] This lack of knowledge and awareness, according to the Federal Reserve and Treasury, was due to the sheer size of the company, the company's involvement in complex derivatives transactions, the substantial intercompany ties, and the global aspect of its business.[530] Further, there was no regulator monitoring systemic risk who might have called for such an accounting. As Secretary Paulson has noted, the fact that AIG was "seriously underregulated" meant that the parent entity essentially functioned as an

[528] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010); Testimony of Sec. Geithner, *supra* note 11, at 3 (noting that "neither AIG's management nor any of AIG's principal supervisors—including the state insurance commissioners and the OTS—understood the magnitude of risks AIG had taken or the threat that AIG posed to the entire financial system").

[529] The private rescue participants state that although they were working on a term sheet for a facility in the amount of $75 billion there was never any certainty with respect either to the amount of money needed for the rescue or the value of the collateral to support that rescue. Panel conversation with Rescue Effort Participants. FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010). For further discussion of the private sector rescue attempt, see Section C.1, *supra.*

[530] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010); Testimony of Sec. Geithner, *supra* note 11, at 3 (stating that AIG's parent holding company "was largely unregulated" and that, "[d]espite regulators in 20 different states being responsible for the primary regulation and supervision of AIG's U.S. insurance subsidiaries, despite AIG's foreign insurance activities being regulated by more than 130 foreign governments, and despite AIG's holding company being subject to supervision by the Office of Thrift Supervision (OTS), no one was adequately aware of what was really going on at AIG").

unregulated holding company with no single regulator having "a complete picture of AIG."[531]

iii. International Considerations

Given the sheer size of AIG as well as its substantial exposure and interconnectedness across the globe, there were other practical considerations at play in the decision to assist AIG. Numerous non-U.S. parties had an interest in AIG, but it remains unclear whether they contacted the Federal Reserve Board and Treasury to express their concerns. These included several European central bankers who were worried about the impact of an AIG failure on European financial institutions and markets, and who, according to one journalist, spoke with Chairman Bernanke on September 16, urging the Federal Reserve to do whatever it could to prevent an AIG failure.[532]

In explaining its decision to lend to AIG, the government has not emphasized the international ramifications of the choice it faced. But as discussed in Section F, the shocks of an AIG bankruptcy would have been felt across the globe and perhaps especially in Europe. Records from around the time of the rescue show that FRBNY did take these international considerations into account.[533]

b. Panel's Analysis of Options Available to the Government and Decisions Made

While recognizing that policymakers faced a deepening financial crisis and that there were many issues of serious concern and a limited amount of time in which to respond, the Panel notes that several conclusions can be drawn from the actions taken by FRBNY with respect to AIG in September 2008. FRBNY's decisions were made in the belief that it alone could act and that it had to choose between options that were all unattractive. There is nothing unusual about central banks acting as the lender of last resort. However, by adopting the term sheet developed by the private sector consortium and retaining most of its terms and conditions, FRBNY chose to act, in effect as if it were a private investor in many ways, when its actions also had serious public consequences whose full extent it may not have appreciated.[534] FRBNY also failed to recognize the AIG problem and get involved at a time when it could have had more options. While the reasons for FRBNY's failure are not clear, it is clear that when FRBNY finally

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[531] Testimony of Henry M. Paulson, Jr., *supra* note 526. See Section E.2 for further discussion of regulatory capital issues and foreign banks' receipt of some of the U.S. government assistance provided to AIG.

[532] James B. Stewart, *Eight Days*, The New Yorker, at 59 (Sept. 21, 2009) (online at www.newyorker.com/reporting/2009/09/21/090921fa_fact_stewart). The Panel has asked both the Federal Reserve Board and FRBNY whether these conversations between foreign central bankers and Chairman Bernanke took place in the hours preceding the Federal Reserve Board's decision to authorize the rescue of AIG under section 13(3), but was unable to verify that these did in fact take place.

[533] *See* E-mail from Alejandro LaTorre, assistant vice president, Federal Reserve Bank of New York, to Timothy Geithner, president, Federal Reserve Bank of New York, and other FRBNY personnel (Sept. 16, 2008) (FRBNY AIG00483–486) (with attached memo); E-mail from Alejandro LaTorre, vice president, Federal Reserve Bank of New York, to Timothy F. Geithner, president, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept. 14, 2008) (FRBNYAIG00496–499).

[534] The Panel notes, however, that many parties benefitted from the AIG rescue, and FRBNY, unlike a private entity, did not ask for any kind of fee or consideration for the reduction in risk that occurred due to the avoidance of bankruptcy.

realized AIG was failing and that there would be no private sector solution, Chairman Bernanke and President Geithner failed to consider any options other than a full rescue. To have the government step in with a full rescue was not the approach used in prior crises, including Bear Stearns and Long-Term Capital Management. It is also clear that by the time FRBNY focused on the problem, time was limited, and the breadth and scope of legal counsel sought were narrow. FRBNY chose lawyers from a limited pool and did not seek legal advice from a debtor's counsel (such as AIG's bankruptcy counsel or independent bankruptcy counsel). As a result, there were many options FRBNY evidently did not consider, including a combined private/public rescue (which would have maintained some market discipline), a loan conditioned on counterparties granting concessions, and a short-term bridge loan from FRBNY to provide AIG time for longer-term restructuring. Providing a full government rescue with no shared sacrifice among the creditors who dealt with AIG fundamentally changed the relationship between the government and the markets, reinforcing moral hazard and undermining the basic tenets of capitalism. The rescue of AIG dramatically added to the public's sense of a double standard—where some businesses and their creditors suffer the consequences of failure and other, larger, better connected businesses do not.

The FRBNY's decision-making also suggest that it neglected to give sufficient attention to the crucial need—more important in a time of crisis than ever—for accountability and transparency. In his testimony before the Panel, Mr. Baxter of FRBNY commented that one of his take-away lessons from the financial crisis is that "we need to be more mindful of how our actions can be perceived" and that the policymakers "need to be more mindful of that and perhaps change our behavior as a result of the perception."[535] This perception, and, in particular, FRBNY's failure to be more sensitive with respect to potential conflicts of interest and the way in which the public and members of Congress would view its actions, has colored all the dealings between the government and AIG in the eyes of the public.

The omissions of FRBNY and Treasury pointed out above also indicate that the government chose not to exploit its negotiating leverage with respect to the counterparties. In particular, it seems that some of the individuals involved in the AIG rescue were relatively junior in terms of seniority, so the active involvement of Secretary Paulson and President Geithner in trying to negotiate concessions with their peers at institutions who stood to lose most from an escalation of financial panic and market dislocation might have made a difference. It is possible that had individuals other than those who stood to gain the most from an AIG rescue been at the table in September 2008 (even recognizing the severe time pressure that policymakers then faced), other potential alternatives could have been developed. And by choosing a law firm that had previously represented private parties in the same matter and had strong ties to Wall Street, FRBNY at least created the perception

[535] Testimony of Thomas C. Baxter, *supra* note 215.

of being guided in its actions by parties with an interest in a complete government rescue of AIG's creditors.[536]

The Panel asked several questions with respect to the decisions made by the government in September.

i. Were all Private Sector Solutions Exhausted?

Before addressing the manner in which the government chose to rescue AIG, it is worth asking whether all the private options for rescue had in fact been exhausted. As discussed above, at least several different private sector proposals were contemplated in the days between September 12 and 16, 2008.[537] The Panel discussed the issue with some of the parties that had presented options to AIG in the period preceding the rescue. While FRBNY and Treasury officials remained hopeful that the private sector would formulate an appropriate solution for AIG, all potential private sector solutions eventually collapsed.

At this time, however, other possible alternatives could have also included a public-private hybrid solution built on some government funding or guarantee combined with some private sector funding. According to FRBNY, there was no attempt to do such a hybrid approach because "[t]here was no time" and it was also felt that "that could be counterproductive, given what we were seeing in the markets at the time."[538] However, according to Mr. Willumstad, AIG had initially sought $20 billion on the weekend spanning September 12, 2008 and believed (at least initially) that he would be successful in finding that amount through a combination of the New York State Insurance Department's authorization to allow AIG to transfer $20 billion in assets from its subsidiaries to use as collateral for daily operations, a $20 billion loan from banks, and $10 billion from private equity investors.[539] Although that target number grew to $40 billion within a day (in large part due to the uncertainty as to what would happen in the financial markets after Lehman's bankruptcy filing), Mr. Willumstad had explained to President Geithner and Secretary Paulson that AIG "could probably raise $30 billion" that weekend, "but the investors and New York State Insurance Department would not go ahead unless they would be assured that the company would survive after receiving that money."[540] While FRBNY continued to assert that there would be no government support for AIG up until it announced that it was rescuing AIG, Mr. Willumstad believes that AIG had a verbal commitment for approximately $30 billion from the private sector, conditioned on FRBNY providing guarantees or some alternative support mechanism to signal to the market sufficiently that AIG would remain viable going forward.[541] Based on Panel staff conversations with Scott Alvarez, general counsel at the Federal Reserve Board, it is clear that the Federal Reserve would not have been able to provide an open-ended guarantee or blanket assurance

[536] Written Testimony of Martin Bienenstock, *supra* note 307, at 4 (stating that "it would be awkward for it to devise strategies to obtain concessions" from those very same institutions it routinely represents).

[537] For a detailed discussion of the various private sector solutions considered between September 12 and 16, 2008, see Section C.1, *supra.*

[538] Testimony of Thomas C. Baxter, *supra* note 215.

[539] Testimony of Robert Willumstad, *supra* note 179.

[540] Testimony of Robert Willumstad, *supra* note 179.

[541] Testimony of Robert Willumstad, *supra* note 179.

to AIG's creditors that AIG or its insurance subsidiaries would continue to be viable or to operate as going concerns in the near or medium term,[542] but it could have done targeted guarantees or a "capped" guarantee to a private consortium loan in September 2008 (assuming adequate collateral) if it had properly explored that approach.[543] While the Federal Reserve (and the taxpayers) would still have been liable (or at risk) for the full amount of the guaranteed private loan or the guaranteed AIG obligations, a major benefit of this approach is that the Federal Reserve would not have had to provide the funds to AIG initially.

While Mr. Willumstad believes that this alternative "would have been much more attractive," [544] it is not certain that a deal could have been reached if the Federal Reserve Board and FRBNY had taken this approach. It should also be noted that a public-private hybrid solution might not have stabilized AIG. AIG would still have been required to raise the capital from the private parties to satisfy its liquidity needs. In the event that the capital raised was in the form of debt rather than equity, it may not have been able to avoid a ratings downgrade, although, again, as discussed in more detail below,[545] FRBNY and Treasury could have played a more active role in managing the reactions of the credit ratings agencies. Credit ratings are based, in part, on the amount of leverage a company has, and before acquiring capital through new debt, AIG already had a large amount of debt or a high debt to equity ratio. A guarantee could have provided partial or targeted relief, and AIG's creditors would still have been able to address any claims remaining after the government intervention through bankruptcy or by other negotiations. A joint effort by the government and private sector to support a struggling financial services institution that had consolidated total assets of more than $1 trillion might have also kept some market discipline in the deal and sent a strong signal to the markets at a time of great economic turmoil and uncertainty.

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[542] This is because AIG would not have had sufficient collateral for such an open-ended guarantee.

[543] Panel staff conversations with Federal Reserve (May 28, 2010). Section 13(3) of the Federal Reserve Act requires that assistance provided must be "indorsed or otherwise secured to the satisfaction of the Federal Reserve bank." 12 U.S.C. 343. Thus, the amount of the guarantee would be "capped" by the value of available or unencumbered assets that could be posted as collateral.

Without the proposed terms and conditions, it is difficult to say whether the Federal Reserve could have authorized or FRBNY could have provided a certain type of guarantee under Section 13(3). If the insurance subs have liabilities of $1.9 trillion, and assets that presumably at least match those liabilities (because state law requires adequate coverage), and the Federal Reserve estimated the value of the insurance subs was at least $85 billion as going concerns (but maybe not much more), however, then a guarantee of a private obligation might have been a feasible option.

As part of a hybrid public-private solution, AIG may have pledged the same assets as collateral for both the private loan and the public guarantee. In that case, the private creditors would have had to agree to release collateral to FRBNY in the amount of any claims that they asserted in relation to the public guarantee. In the alternative, the private consortium or syndicate may not have required AIG to provide collateral for the loan because the protection offered by the Federal Reserve's guarantee provided sufficient security.

Internal FRBNY correspondence after FRBNY's provision of the Revolving Credit Facility to AIG indicates that there was some general discussion of guarantees, but the Federal Reserve did not believe it had the authority to do so, but it might have been an option for Treasury to consider. *AIG Call Tonight,* E-mail from Sarah Dahlgren, senior vice president, Federal Reserve Bank of New York, to Timothy Geithner, Thomas Baxter, and other FRBNY officials (Oct. 15, 2008) (FRBNY–TOWNS–R1–209923).

[544] Testimony of Robert Willumstad, *supra* note 179.

[545] See discussion in Section G.

Under the circumstances,[546] it stands to reason that FRBNY might have made a greater effort to save the system by forming a broader private sector rescue coalition than the group it assembled after the Lehman weekend (the actual consortium of private bankers that was ultimately assembled consisted of only two members—JP Morgan and Goldman Sachs—whose efforts to syndicate the potential secured lending facility among a number of large financial institutions appear to have made little or no headway). Assuming the economy was truly "on the brink," as Secretary Paulson's recent memoir attests, why was FRBNY's eleventh-hour rescue effort limited only to a few key players? A broader group with more resources might have had better odds of success and, given the stakes at hand, it might have been worth it for FRBNY to solicit the involvement of more players. Some firms had ample amounts of cash during that period and the European banks that were AIG's largest counterparties also had strong incentives (if not purely a motivation based on their own self-interest) to help.

While acknowledging that a private sector solution may not have been likely to succeed given the combination of AIG's escalating liquidity needs and increased concerns by potential lenders about capital preservation in the wake of the Lehman Brothers bankruptcy filing, the Panel notes that the upside of a private sector rescue would have been two-fold and significant. First, it would have saved billions of taxpayer dollars and mitigated if not eliminated the serious moral hazard and "too big to fail" concerns. Second, a successful private sector rescue would have served as a very strong and calming signal that the U.S. financial system was strong enough to function without a full government bailout. The Panel also notes that had private parties been involved they—and not the government—could have managed much of the post-bailout reorganization of the company.

ii. Was It Truly an All-or-Nothing Choice?

The government presents the decision to rescue AIG as an all-or-nothing "binary" decision.[547] In other words, the government asserts that it was necessary to rescue AIG in its entirety or let it fail in its entirety; it was not possible to pick and choose which businesses or subsidiaries could be saved. The Panel tested this assertion and considered whether bankruptcy had to be an all-or-nothing option, in terms of the entities covered, the obligations covered, or in terms of timing: if a bankruptcy was not a real option in September 2008, was it later?[548]

The Panel looked first at whether some parts of AIG could have been permitted to fail. Since insurance companies cannot file for bankruptcy under the U.S. Bankruptcy Code, subsidiaries holding

[546] See discussion of extreme market dislocation in September 2008 in Section C.1.

[547] Joint Written Testimony of Thomas C. Baxter and Sarah Dahlgren, *supra* note 255, at 3 (stating that "[i]n the early days of the intervention, when we knew precious little about AIG, but knew that it needed billions of dollars, we were truly facing a binary choice to either let AIG file for bankruptcy or to provide it with liquidity."); FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010).

[548] In conversations with Panel staff, FRBNY and Treasury have asserted that they considered bankruptcy as a possible option in the months subsequent to their September 2008 decision to rescue AIG (and it appears that this was under consideration at least until March 2009). *See* AIG Presentation on Systemic Risk, *supra* note 92 (detailing the impact of an AIG failure on the U.S. Government's efforts to stabilize the economy).

the vast majority of AIG's assets could not have sought bankruptcy protection and might have been subject to the specific regimes applicable to insurance companies.[549] The most obvious candidate to be forced into bankruptcy, nonetheless, would have been AIGFP.[550] It was the cause of much of AIG's original distress and continuing liquidity problems and was unlikely to have any value as a going concern. Approximately $54 billion of AIGFP's debt, however, was guaranteed by its parent, AIG.[551] AIGFP's bankruptcy would have triggered cross-default acceleration provisions in AIG's own debt and resulted in AIG becoming immediately liable to pay $65 billion of AIGFP debt and approximately $36 billion of its own debt.[552] It would have thus pushed the parent itself into bankruptcy since it did not have cash to meet these obligations. That bankruptcy might have triggered the immediate seizure of many of AIG's insurance subsidiaries (which represented any value that existed in the AIG franchise) by state regulators.[553] Exacerbating the situation was the fact that many of the insurance companies had interlocking holdings and intercompany borrowing arrangements.[554] The government asserted in interviews with Panel staff that "once one entity goes, the rest go."[555] In these circumstances, it is difficult to see how anything other than a bankruptcy of AIG's parent company would have been possible.

The government does not contend that bankruptcy in September 2008 was impossible, but that it was the much less attractive of the two options that it considered possible. A bankruptcy could have addressed many of AIG's problems: it could have wiped out the old equity, limited losses, forced losses on all creditors, and perhaps given the company the chance to improve its prospects. The Panel does not take a position on whether the government was correct to choose rescue and acknowledges that this report is reviewing decisions made under very stressful conditions, but offers several observations on the decision and the justification offered for that decision and asks whether the government considered all the options that were available to a party with the enormous bargaining power that being the lender of last resort brings. While the government has claimed that the choice was binary (either let AIG file for bankruptcy on September 16, 2008 or step in to back AIG fully, which effectively meant it was guaranteeing that all creditors would be paid in full), this binary choice is too simplistic.

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[549] For further discussion of the application of the U.S. Bankruptcy Code to AIG, see Annex IV.

[550] In making this assertion, the Panel does not imply that this would have been an easy or controlled bankruptcy, however. The overall complexity of AIGFP's business, its operations in multiple foreign countries, and the impact of bankruptcy roles on swaps would have combined to make an AIGFP bankruptcy extremely difficult.

[551] AIG Form 10–Q for the Second Quarter 2008, *supra* note 177, at 96. The $54 billion included AIG's insurance subrogation liability to insurance companies who paid out claims while standing in the shoes of AIG. The actual subrogation value (which refers to circumstances in which an insurance company tries to recoup expenses for a claim it paid out when another party should have been responsible for paying at least a portion of that claim) would have likely lowered the amount of AIGFP's debt.

[552] AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 116.

[553] Panel staff conversation with Jay Wintrob, CEO of the SunAmerica Financial Group (May 17, 2010). As discussed in Annex IV, insurance companies are subject to their own resolution process in lieu of bankruptcy; the term "bankruptcy" as used here is intended to encompass that process at the state level.

[554] For further details, see Section C.3

[555] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010).

Bankruptcy law is designed to force creditors to accept discounts or other losses under extant contracts. Without the law to force AIG's creditors to accept discounts or other losses, the Panel notes that whatever leverage the government could have applied to get AIG's creditors to take less than full payment was extra-legal and thus less certain to yield results. But that leaves the question of whether the government adequately used the negotiating leverage it had, outside of bankruptcy, to persuade AIG's counterparties to accept some losses, given the realities that AIG simply did not have the money to pay all of them in full, and that the government knew or should have known that keeping our financial system running was already putting or was about to put enormous demands on taxpayer resources and create systemic problems of its own.

Additionally, the Panel notes that the initial decision to rescue AIG need not have been treated as permanent. FRBNY and Treasury could have provided the RCF on a temporary bridge loan basis in order to allow AIG to keep making collateral payments, for example, with immediate plans to then go to Congress for authority to allow a managed bankruptcy under some sort of resolution authority. FRBNY and Treasury's arguments also seem to assume that the government would or could not have taken responsive actions to address some of the "innocent victims" (for example, employees relying on pension funds who would have lost insurance in the event of an AIG bankruptcy). As demonstrated by the bankruptcies of Chrysler and General Motors, during which the government negotiated with the unions and bond holders in its role as a post-petition lender,[556] post-petition financiers have enormous leverage, and if the money is being funded post-petition (as would have been the case here), it could have been spent at its discretion. In these circumstances, the government would have had a number of alternatives on the table, and it could have used its huge leverage arising from its post-financing position.

iii. Could the Government Have Negotiated Concessions from AIG's Creditors?

Throughout this financial crisis, as in past crises, the Federal Reserve and FRBNY, with the assistance or at least acquiescence from Treasury, have used their leverage with financial institutions, along with the institutions' recognition of financial realities and their own self-interest, to negotiate and reach compromises.[557] By doing so, the parties have been able to craft extra-legal compromises that involve financial institutions taking on risk; that is, financial institutions have realized potential or actual losses so that the entire system continues to function in extraordinary cir-

[556] September Oversight Report, *supra* note 389, at 49–50 (discussing the government's provision of both pre- and post-petition financing to Chrysler and GM as their financial conditions deteriorated and the government's power and leverage as a DIP financier, on account of its post-petition claim).

[557] Following the private-sector bailout of Long-Term Capital Management in 1998, then-Chairman Alan Greenspan testified: "Officials of the Federal Reserve Bank of New York facilitated discussions in which the private parties arrived at an agreement that both served their mutual self interest and avoided possible serious market dislocations. Financial market participants were already unsettled by recent global events. Had the failure of LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own." Written Testimony of Alan Greenspan, *supra* note 217.

cumstances in a more or less orderly way. There is no evidence, however, that after the early-morning hours of September 16, 2008, the government made any effort to do so with AIG. Time pressures, it is true, were great. Moreover, this crisis involved not one failing institution, but multiple institutions simultaneously near failure or in unprecedented trouble.

On the other hand, it is important to ask whether the government was in this time-pressured position in no small part because of its own failure to organize and prepare themselves effectively many months earlier.[558] Earlier in 2008, the Federal Reserve and FRBNY could have established teams to monitor each easily identifiable financial institution that might have found itself in trouble for the same reasons that Bear Stearns collapsed, as well as teams to think more broadly about problems that might be hidden from view. For example, the governmental entities could have assembled teams to try to determine the size of the CDS market and whether particular institutions were on the hook for an outsized share of the derivatives that the government was able to identify.[559] While it is unclear whether this approach would have made a difference in the end, it is certainly worth considering. In 2008, FRBNY examiners sought a meeting with the OTS to open a dialogue with them about AIG and its operations and to discuss issues that the FRBNY examiners had seen with respect to the monoline financial guarantors.[560] There is also some evidence that Treasury (under the leadership of Steven Shafran, senior adviser to Secretary Paulson) had, since the early summer of 2008, been looking into systemic risk in the financial sector and coordinating between various agencies, with a specific focus on Lehman Brothers.[561] Nonetheless had the government made earlier and broader efforts to ob-

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[558] For example, the government could have started preparing in March 2008, when Bear Stearns' dire situation became apparent, or in late 2007, when many large financial institutions incurred substantial write-downs on mortgage-related assets, just to pick two timeframes. The report of the bankruptcy examiner for Lehman Brothers indicates that the SEC and FRBNY were conducting onsite monitoring of Lehman beginning in March 2008. Report of Anton R. Valukas, court-appointed bankruptcy examiner, *In re Lehman Bros. Holdings, Inc.,* No. 08–13555, at 1488–89 (JMP) (Bankr. S.D.N.Y. Mar. 11, 2010) (online at lehmanreport.jenner.com/VOLUME%204.pdf) ("After March 2008 when the SEC and FRBNY began onsite daily monitoring of Lehman, the SEC deferred to FRBNY to devise more rigorous stress-testing scenarios to test Lehman's ability to withstand a run or potential run on the bank. The FRBNY developed two new stress scenarios: "Bear Stearns" and "Bear Stearns Light." Lehman failed both tests. The FRBNY then developed a new set of assumptions for an additional round of stress tests, which Lehman also failed. However, Lehman ran stress tests of its own, modeled on similar assumptions, and passed. It does not appear that any agency required any action of Lehman in response to the results of the stress testing").

[559] For example, in 2007, as the housing market deteriorated, OTS increased its surveillance of AIGFP and its portfolio of mortgage-related credit default swaps. Among other things, OTS recommended that AIGFP review its CDS modeling assumptions in light of worsening market conditions and that it increase risk monitoring and controls. Beginning in February 2008, in response to a material weakness finding in AIG's CDS valuation process, OTS again stepped up its efforts to force AIG to manage risks associated with its CDS portfolio. For further discussion of OTS' supervisory actions with respect to AIG before the government's rescue, see Section B.6, *supra.*

[560] The Panel notes that this meeting eventually took place on August 11, 2008.

[561] Andrew Ross Sorkin, *Too Big To Fail,* at 216 (2009). It seems possible that some of this monitoring dealt with AIG, though the Panel has seen no evidence that it did. If there were such efforts with respect to AIG, they likely would have been overshadowed over time as Treasury increasingly focused on preparing for the possibility of a Lehman bankruptcy.

tain a more precise picture of the looming danger at AIG, it might have used its inherent negotiating leverage to great effect.[562]

The government should have had the foresight to collect information earlier and begin the process of informing AIG's creditors and counterparties, including financial institutions and foreign governments, that no one should expect to emerge from the situation unscathed. It is still not clear however, that the government did all that it could, even in the little time available, to convince AIG's creditors to accept less than full compensation.

Until the afternoon of September 16, 2008, it was at least possible for the government to suggest that it would let AIG fail, as a means to demand concessions from AIG's counterparties; this would have been a credible threat given that the government had just let Lehman fail. For example, the Federal Reserve could have conditioned its lending to AIG in September 2008 by mandating that the counterparties either take a haircut or face the risk of bankruptcy proceedings and the associated uncertainty. There is also the possibility that the Federal Reserve could have told the counterparties that it was willing to make immediate settlement for a certain percentage on the dollar, that it would permit AIG to default on all other arrangements, and that a Chapter 11 bankruptcy would handle the remaining debts.

The Panel also discussed with FRBNY and Treasury whether some alternative to a rescue that paid off all of AIG's obligations to its creditors and counterparties (and particularly AIGFP's obligations) in full might have been possible. While FRBNY acknowledges that it had the legal authority to impose such conditions on its lending, it believes that such constraints would have substantially impeded its goals of assisting AIG so that it could meet its obligations as they came due and serving as a reassurance that AIG would not further destabilize the financial markets.[563] FRBNY also states that while such tactics have been used in certain sovereign debt restructurings, "they can be used there only because sovereigns cannot go bankrupt, and only with months of pre-planning."[564]

The Panel tested these assertions and considered whether it might have been possible for FRBNY to condition its lending to AIG on a requirement that the company obtain concessions from some of its major creditors. While the government argues that the bankruptcy threat was no longer viable after its initial decision not to place AIG into bankruptcy, the evidence shows that long after September 16, 2008, and indeed well into 2009, the government was still considering the possibility of some form of bankruptcy for at least part of AIG.[565]

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[562] As part of its negotiating leverage, the government could have pointed to the fact that demands on taxpayer funds were not infinite, and that failing to accept concessions might have yielded worse results for the counterparties than taking a haircut.

[563] FRBNY and Treasury briefing with Panel and Panel staff (May 11, 2010). FRBNY states that "[a]ny attempt to condition our lending would have created further uncertainty in a time of panic as to which of AIG's counterparties would get paid and which would be forced to take substantial losses. One of our objectives was to calm market participants, and uncertainty (and the allegations of favoritism that surely would have followed) does not do that—it fuels fear." Joint Written Testimony of Thomas C. Baxter and Sarah Dahlgren, *supra* note 255, at 6.

[564] Joint Written Testimony of Thomas C. Baxter and Sarah Dahlgren, *supra* note 255, at 6.

[565] FRBNY and Treasury briefing with Panel and Panel staff (May 11, 2010); FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010); *See* AIG Presentation on Systemic Risk, *supra* note 92.

In his recent testimony before the Panel, Mr. Bienenstock of Dewey & LeBoeuf asserted that the rescue of AIG could have incorporated some "shared sacrifice" by certain of AIG's creditors. In his view, for several reasons, it was "very plausible to have obtained material creditor discounts from some creditor groups" without undermining the government's goals of preventing the further destabilization and potential collapse of the financial system.[566] First, according to Mr. Bienenstock, since AIG was granting FRBNY a lien against all available assets as security for its $85 billion RCF (and was no longer permitted to borrow funds from its insurance company subsidiaries effective September 22, 2008), creditors that might have obtained a judgment for any subsequent default would not necessarily have been able to collect.[567] Second, since AIG was current on its debt obligations, it was not going to voluntarily file for bankruptcy, and any parties that might have filed an involuntary bankruptcy petition against AIG would have been unable to show that AIG was not paying its debts as they came due.[568] Third, FRBNY "was saving AIG with taxpayer funds due to the losses sustained by the business divisions transacting business with these creditor groups, and a fundamental principle of workouts is shared sacrifice, especially when creditors are being made better off than they would be if AIG were left to file for bankruptcy."[569] Therefore, Mr. Bienenstock concludes, AIG was in a position to convince its CDS counterparties to grant debt concessions.

While it is unclear what the impact of any such concessions would have been, given that they did not occur, the Panel notes that certain potential ramifications might have occurred had such negotiations been successful. Some potential ramifications involve the rating agencies.

The ratings agencies assign a separate rating-type designation to companies that have engaged in what is called a "Distressed Exchange." Under published rating agency criteria, a company's settlement of its obligations with counterparties at a significant discount to what was due under contract may be considered a "Distressed Exchange." This designation can have an adverse impact on a company's ratings.[570] Rating agency criteria set forth various factors to be considered in assessing whether a particular transaction will be deemed a Distressed Exchange.[571] While the rating agen-

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[566] Written Testimony of Martin Bienenstock, *supra* note 307, at 1.

[567] Written Testimony of Martin Bienenstock, *supra* note 307, at 2.

[568] Written Testimony of Martin Bienenstock, *supra* note 307, at 2. Mr. Bienenstock also describes how if creditors filed involuntary bankruptcy petitions against AIG, they might have rendered themselves liable for compensatory and punitive damages if the court found "AIG was generally paying its debts as they came due and the creditors had been warned in advance of that fact." (citing 11 U.S.C. 303(i)(2)).

[569] Written Testimony of Martin Bienenstock, *supra* note 307, at 3.

For example, the AIGFP CDS and securities lending counterparties got $105.8 billion, which is a large portion of the overall $182.4 billion expended.

[570] For example, upon the completion of a "Distressed Exchange," Standard & Poor's lowers its ratings on the affected issues to "D," and the issuer credit rating is reduced to "SD" (selective default).

[571] According to Standard & Poor's criteria, a selective default determination is based on the investor receiving less value than the promise of the original securities and the settlement being distressed, "rather than purely opportunistic." A "Distressed Exchange" occurs where holders "accept less than the original promise because of the risk that the issuer will not fulfill its original obligations," and also requires a "realistic possibility of a conventional default (i.e., the company could file for bankruptcy, become insolvent, or fall into payment default) on the instrument subject to the exchange, over the near to medium term." Upon the determination of a Distressed

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cies note that the impact of such exchange offers on ratings generally depends on the particular facts and circumstances of a situation, and say they cannot address hypothetical situations definitively,[572] several conclusions can be drawn. For some of the rating agencies, there could be in theory a finding that a Distressed Exchange has taken place even if the counterparties technically accepted the offer voluntarily, and no legal default occurred.[573] The rating committees, however, always consider various factors, such as whether default, insolvency or bankruptcy in the near or medium term would be likely without the exchange offer, in deciding whether a selective default has occurred.[574]

The Panel notes that government-sponsored burden-sharing as a condition of its lending would have been very different from the usual situations addressed in the credit rating agency criteria, so such an occurrence would have necessitated a heightened level of scrutiny within the credit rating agencies.[575] Greater government involvement could have helped to guide the rating agencies in this scrutiny in order to help them understand the government intervention as a positive event with respect to AIG's credit.

The lack of very energetic efforts by senior Treasury and FRBNY officials to assure the rating agencies that the concessions were made solely out of a sense of equity and fairness to the taxpayer may have meant that if the government assistance had "included negotiated settlements with either AIGFP's derivative counterparties or AIG's debt holders at less than 100 cents," the credit rating agencies would have downgraded AIG's ratings to reflect a default.[576] According to Fitch Ratings, "negotiated settlements at

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Exchange, Standard & Poor's issues a separate credit rating of "SD," or selective default, assuming the issuer continues to honor its other obligations. Standard & Poor's Financial Services, *General Criteria: Rating Implications of Exchange Offers and Similar Restructurings, Update* (May 12, 2009) (online at www.standardandpoors.com/prot/ratings/articles/en/us/?assetID=1245199775643) (hereinafter "Standard and Poor's Rating Criteria") (free registration required). According to Standard & Poor's, the selective default rating would have applied to both the AIG parent and AIGFP. Panel staff conversations with Standard & Poor's (May 13, 2010).

According to Moody's, "[t]he two required and sufficient conditions for an exchange offer to be deemed a distressed exchange are 1) the exchange has the effect of allowing the issuer to avoid default and 2) creditors incur economic losses relative to the original promise to pay as a result of the exchange." Furthermore, "[e]xchanges made by distressed issuers at discounts to par which have the effect of allowing the issuer to avoid a bankruptcy filing or a payment default (i.e., 'distressed exchanges') are considered default events under Moody's definition of default. However, since whether an issuer would have defaulted absent an exchange is unobservable, the determination of whether an exchange constitutes a default event is inherently a judgment call." Moody's does not have separate symbols to use upon finding that a Distressed Exchange has occurred, but instead incorporates the occurrence into its ratings assessment. Moody's Global Credit Policy, *Moody's Approach to Evaluating Distressed Exchanges* (Mar. 2009) (hereinafter "Moody's Approach to Evaluating Distressed Exchanges").

According to Fitch Ratings, a coercive debt exchange (which results in a default) occurs when "an issuer is essentially forced to restructure its debt obligations in an effort to avert bankruptcy or a liquidity crunch. By definition, this will cause a reduction in contractual terms from the creditor's perspective . . ." Fitch further elaborates by stating that a coercive debt exchange must either involve "an explicit threat of bankruptcy" or "a high probability of bankruptcy or insolvency over the near term absent the exchange." Fitch Ratings, *Coercive Debt Exchange Criteria* (Mar. 3, 2009) (hereinafter "Coercive Debt Exchange Criteria").

[572] Written Testimony of Rodney Clark, *supra* note 80, at 6–7; Panel staff conversations with Standard & Poor's (May 13, 2010); Panel staff conversations with Moody's (May 19, 2010); Panel staff conversations with Fitch Ratings (May 20, 2010).

[573] Standard and Poor's Rating Criteria, *supra* note 571 (free registration required); Moody's Approach to Evaluating Distressed Exchanges, *supra* note 571.

[574] Panel staff conversations with Standard & Poor's (May 19, 2010); Panel staff conversations with Moody's (May 19, 2010); Panel staff conversations with Fitch Ratings (May 20, 2010).

[575] Panel staff conversations with Fitch Ratings (May 20, 2010).

[576] Congressional Oversight Panel, Written Testimony of Keith M. Buckley, group managing director, Global Insurance, Fitch Ratings, *COP Hearing on TARP and Other Assistance to AIG,*

anything less than 100 cents, especially if the offer is accepted because Fitch believes that the counterparty fears (or is threatened) it may receive less if it does not accept the offer, would be viewed as a default under [its] criteria."[577] This is largely based upon the premise that "[t]he promise of full payment is the very essence of an investment grade credit rating."[578] A Distressed Exchange determination would have likely had a negative impact on AIG's creditworthiness and caused catastrophic consequences for the company, with further collateral calls leading to the bankruptcy the government was trying to avoid all along.[579]

Even if the concessions were not taken for the specific purpose of allowing AIG to save money or liquidity (since that might have been assured by FRBNY's lending facility), but, rather, out of a sense of fairness to the taxpayers, Mr. Clark of S&P, testified before the Panel that this would not have precluded a determination that a "distressed exchange" had occurred. The ratings committees would have looked at a situation "where AIG has significant funding, but isn't able to use it to satisfy its financial obligations in whole, be it for the CDSs or other obligations. We would have to form an opinion; well, will that funding be available to future financial obligations to pay them on time and in whole?"[580] It does not appear that any governmental agencies considered that they could play a role in helping to form that opinion.

There are two other points to consider. First, it appears that the government might have been able to structure the concessions so as not to trigger a default by, for example, requiring a discount that would have been less than "significant."[581] Second, had a distressed exchange occurred, it is possible that AIG could have benefitted financially, since the savings would have helped it to avoid insolvency and reduce risk going forward (creating the potential for higher ratings in the future). Nonetheless, the ratings would have taken into account AIG's failure to pay in accordance with the terms of its financial obligations, and any subsequent benefit would have only been reflected afterward.[582] Mr. Bienenstock testified be-

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at 5 (May 26, 2010) (online at cop.senate.gov/documents/testimony-052610-buckley.pdf) (hereinafter "Written Testimony of Keith Buckley"); Congressional Oversight Panel, Testimony of Rodney Clark, managing director of insurance ratings, Standard & Poor's, *COP Hearing on TARP and Other Assistance to AIG* (May 26, 2010) (hereinafter "Testimony of Rodney Clark") (stating that "we would consider a distressed payment of less than what is owed to be a default or a selective default under our ratings criteria.").

[577] Written Testimony of Keith Buckley, *supra* note 576, at 5.

[578] Testimony of Jim Millstein, *supra* note 44, at 9.

[579] The Panel notes that even if the downgrades had been short-lived, the mere fact that the downgrades occurred would have triggered the consequences that the government was trying to avoid. *See* Standard and Poor's Rating Criteria, *supra* note 571 (free registration required) (noting that "[a]fter an exchange offer is completed, the entity is no longer in default—similar to an entity that has exited from bankruptcy. The 'SA' issuer credit rating is no longer applicable—and we change it as expeditiously as possible, that is, once we complete a forward-looking review that takes into account whatever benefits were realized from the restructuring, as well as any other interim developments").

[580] Testimony of Rodney Clark, *supra* note 576.

[581] For example, in conversations with Panel staff, Standard & Poor's indicated that a discount that covers the time value of money would not necessarily constitute a distressed exchange. Panel staff conversations with Standard & Poor's (May 19, 2010). There is also the argument that downgrades could have been avoided and moral hazard concerns lessened if the discount was negotiated as a matter of principle rather than as a way to significantly restructure the underlying obligations of AIG under its CDS contracts.

[582] Standard and Poor's Rating Criteria, *supra* note 571 (free registration required); Moody's Approach to Evaluating Distressed Exchanges, *supra* note 571 stating that ratings uplifts could occur after the exchange "[s]ince the reduction of debt at a substantial discount to par often

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fore the Panel that, "[i]ntuitively, it should be illogical that AIG would be viewed as a lesser credit risk once it procured concessions from creditors which would reduce the amount AIG needed to borrow from FRBNY and would reduce further debt expense."[583] Greater government guidance could have helped the credit rating agencies focus on the end result, rather than the process, of exchange.

Ultimately, the government could have used its leverage to attempt to negotiate concessions, but it failed to do so. The potential impact of Secretary Paulson, President Geithner, and Chairman Bernanke (individually or in tandem) discussing the advantages of shared sacrifice with the counterparties, and, if necessary, speaking to the rating agencies, seems to have been overlooked by the government. If such powerful overtures had been rejected, the names of the non-complying counterparties could have been disclosed to the public. FRBNY and Treasury had powerful non-financial tools at their disposal; they did not use them.

iv. Would Bankruptcy Have Been as Bad as the Government Claims?

If AIG had filed for bankruptcy, as discussed elsewhere,[584] the life insurance subsidiaries would not have been included in that filing. The impact on the AIG parent company and its non-insurance subsidiaries filing for bankruptcy cannot be known with any certainty. The Panel notes, however, that the survival of financial companies depends on confidence in the marketplace. Parties will not trade with a financial services company offering long-term products that is facing financial trouble and uncertainty. Without sufficient reassurances about AIG's ongoing viability, policyholders might also have cashed in their life insurance policies as a form of savings.[585] Reputational harm might have led to the same result

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improves an issuer's ability to meet its remaining debt obligations."); *Id.* (stating that "[f]ollowing the completion of the exchange, the ratings of the stub instrument will be reevaluated by a rating committee to reflect expected loss on a look forward basis."); Coercive Debt Exchange Criteria, *supra* note 571; Testimony of Rodney Clark, *supra* note 576 (stating that "it is true that in many cases following a restructuring, following either a distressed exchange or a series of distressed exchanges, that the credit condition could be better than before the time of the exchange.').

[583] Written Testimony of Martin Bienenstock, *supra* note 307, at 4.

[584] For further discussion, see Section E.2 and C.4, *supra*.

[585] The consensus among industry analysts is that once confidence is lost in an insurance company like AIG, policyholders will pull their policies, insurance agents will dissuade clients from purchasing insurance policies from the company, and that, in effect, all the insurance companies would have become "run-off" businesses. Panel staff conversations with industry analysts. Warren Buffett maintains that the property/casualty business would have gone into run-off, while there would have been a disastrous run on the life insurance companies. Panel staff conversation with Warren Buffett (May 25, 2010).

The events of the Great Depression are a useful comparison. There were two financial holidays in 1933: the first was a full banking holiday that shut down every bank in the United States for 10 days and ushered in sweeping changes in banking regulation, and the second was a partial life insurance holiday that suspended the payment of cash surrender values and the granting of policy loans for a period of roughly six months. During the Great Depression, insurance policyholders substantially accelerated the rate at which they drew on the savings and credit features of their life insurance contracts, and with the banks closed or allowing withdrawals on only a restricted basis, individuals turned to their life insurance for cash. These circumstances caused the insurance companies, like the banks, to face the possibility of a run that would force them into failure.

Although there may have been a shortage of market capacity with respect to some of AIG's insurance lines (for example, some of its specialized lines), and it therefore may have taken a while for competition to replace some of AIG's business, industry analysts concur that there was no shortage of market capacity in the industry with respect to most other product lines (for example, its P&C and life insurance businesses), meaning that those policyholders would have been capable of finding coverage at other companies. Panel staff conversations with industry an-

and, in fact, AIG suffered significant policy surrenders, even in the wake of the government's assistance.[586]

While the Panel acknowledges that it is not certain what would have happened to AIG's various insurance subsidiaries if the parent company had filed, there are some general conclusions that can be drawn. Since the state insurance regulators had been closely monitoring the activities and financial condition of AIG's insurance subsidiaries prior to September 2008 and believed that they were solvent or sufficiently capitalized, they would not necessarily have changed their approach as a result of the parent's bankruptcy filing.[587] Since the first priority of the insurance regulators is to protect the interests of policyholders, they would have been concerned about the impact of the parent's filing on the subsidiaries' books of business and the behavior of policyholders (i.e., increased surrender activity and decreased renewal rates). If the insurance regulators believed that there was sufficient harm to the insurance subsidiaries or that liquidity or insolvency concerns had emerged during the course of the bankruptcy, they would have placed the relevant insurance subsidiaries under heightened supervision or into rehabilitation or liquidation. If a policyholder run had developed, the insurance regulators had tools to prevent it. Many insurance policies give the company management the ability to place a six month hold on paying claims. If this were the case, management could put this hold into place, possibly at the request of the regulators. Alternatively, if the regulators have taken the company into some form of supervision or receivership, they may issue a directive to place a hold on payment of claims for a period of time.[588] Depending on the form of the seizure, if the company were taken into receivership, policyholders might experience delays in claims payment well beyond a six month hold on payments.

There are several issues regarding the stability of AIG's insurance subsidiaries in the event of the bankruptcy of the parent company. First, there is at least some concern that a number of the insurance subsidiaries may have been less solvent than generally believed at the time—as seen by the amount of government assistance they received to recapitalize and meet their obligations.[589]

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alysts; Panel staff conversation with Jay Wintrob, CEO of the SunAmerica Financial Group (May 17, 2010).

[586] FRBNY and Treasury briefing with Panel and Panel staff (May 11, 2010) (stating that AIG suffered $5 billion of domestic life insurance policy surrenders through the third quarter of 2009); Senate Committee on Banking, Housing, and Urban Affairs, Written Testimony of Testimony of Donald Kohn, *supra* note 245, at 11 (stating that "general economic weaknesses, along with a tendency of the public to pull away from a company that it viewed as having an uncertain future, hurt AIG's ability to generate new business during the last half of 2008 and cause a noticeable increase in policy surrenders").

[587] Standard & Poor's, for example, testified before the Panel in May 2010 that because "the insurance subsidiaries' capital is generally insulated by state insurance laws and regulations," an AIG bankruptcy might have only had a "marginal impact" on AIG's insurance subsidiaries, but that AIG's financial problems would have indirectly impacted the creditworthiness of the insurance subsidiaries in two ways: (1) the financial pressures at the parent would have made it "less likely that AIG will be in a position to provide additional capital to its subsidiaries in the event the subsidiaries suffer investment losses of their own or otherwise require recapitalization; and (2) "overall reputational risk resulting from the parent company's financial problems." Written Testimony of Rodney Clark, *supra* note 80, at 6–7 .

[588] Panel staff conversation with Texas Department of Insurance (May 24, 2010).

[589] Given that a substantial portion of certain companies' assets were loans to the parent entity, intercompany funding, and ownership interests in other AIG entities (which were typically treated as part of their regulatory capital) it seems to be possible that the subsidiaries may have been undercapitalized—particularly domestic life insurance operations—and would have become

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Second, while the seizure of the insurance company subsidiaries would have resulted in claims on state guarantee funds, given the large scope of AIG's operations, it is unclear whether each state guarantee fund had enough capital (or, where unfunded, access to capital) and what steps they would have taken if there were a shortfall.[590] State insurance regulators have the ability to "ring-fence" solvent insurance entities to shield them from the parent entity's losses or bankruptcy in order to protect existing policyholders. For its part, NAIC has emphasized that the state guarantee system would typically allow for an orderly disposition of policyholder claims. This view, however, is premised on the fact that, ordinarily, when an insurance company is placed into receivership, other companies would likely either fill the void in the marketplace and/or purchase their policies or groups of policies, which are typically attractive assets (but this might not have occurred quickly in the context of a global financial crisis). If there was a shortfall, the state guarantee funds might have had to resort to imposing higher assessments on other industry players, pushing more liquidity out of the system at a time when there was already a substantial liquidity crunch.[591]

It is also unlikely that consumers would have taken out new insurance policies with AIG's insurance subsidiaries, further impacting their revenue potential and destabilizing their ongoing operations.[592] While AIG has its own personnel devoted to sales, its insurance policies are mainly distributed through independent agents affiliated with broker-dealers.[593] Due to suspensions by broker-dealers (getting closed out of many of its distribution outlets) related to AIG's financial risk and the losses that it incurred over the course of 2008 (and that occurred despite AIG's receipt of substantial government assistance), AIG's ability to issue new insurance policies was significantly curtailed between September 2008 and March 2009.[594] SunAmerica Financial, AIG's umbrella for its life and retirement insurance companies, has estimated that it lost be-

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destabilized upon the parent's bankruptcy. State Insurance Regulation Wasn't the Problem, *supra* note 408 ("If AIG had gone bankrupt, state regulators would have seized the individual insurance companies. The reserves of those insurance companies would have been set aside to pay policyholders and thereby protected from AIG's creditors. However, * * * AIG's insurance companies were intertwined with each other and the parent company. Policyholders would have been paid, but only after a potentially protracted delay. It would have taken time to allocate the companies's [sic] assets"). For additional discussion of the government assistance provided to the AIG insurance subsidiaries, see Section E.1, *supra*.

[590] Panel staff conversation with Debra Hall, expert in insurance company receiverships (May 14, 2010).

[591] Panel staff conversation with Debra Hall, expert in insurance company receiverships (May 14, 2010); David Merkel, *To What Degree Were AIG's Operating Insurance Subsidiaries Sound?*, at 6 (Apr. 28, 2009) (online at alephblog.com/ wp-content/uploads/ 2009/04/ To%20What%20Degree%20
Were%20AIG%E2%80%99s%20Operating%20Subsidiaries%20Sound.pdf) (hereinafter "AIG's Insurance Subsidiaries").

[592] Panel staff conversations with industry analysts; Written Testimony of Rodney Clark, *supra* note 80, at 6–7 (stating that "it may be more difficult for the subsidiaries to retain and attract new customers where there is uncertainty surrounding the parent company—particularly in light of a dampened demand for insurance and, more significantly, marginal pricing").

[593] Panel staff conversation with Jay Wintrob, the CEO of the SunAmerica Financial Group (May 17, 2010).

[594] Panel staff conversation with Jay Wintrob, the CEO of the SunAmerica Financial Group (May 17, 2010).; Senate Committee on Banking, Housing, and Urban Affairs, Written Testimony of Testimony of Donald Kohn, *supra* note 245, at 11 (stating that "general economic weaknesses, along with a tendency of the public to pull away from a company that it viewed as having an uncertain future, hurt AIG's ability to generate new business during the last half of 2008 and cause a noticeable increase in policy surrenders").

tween $2 and $3 billion in sales during this time period.[595] This demonstrates that AIG's insurance subsidiaries incurred some loss even after the government's rescue, but the amount would likely have been much larger had a bankruptcy occurred. Third, it is unclear how the bankruptcy of the AIG parent would have affected the ratings of the insurance company subsidiaries.[596]

These effects could have been mitigated if the government stepped in to backstop or guarantee the insurance liabilities. Such a guarantee program (as opposed to a guarantee of any private rescue package), however, may have been impractical for several reasons. First, the amounts of AIG's insurance policies would have required a multi-trillion dollar government guarantee (and it is unclear whether AIG would have had sufficient collateral for the Federal Reserve to authorize such a guarantee).[597] Second, the lawyers for FRBNY did not believe that section 13(3) or any other provision of the Federal Reserve Act authorized the issuance of this type of guarantee (as opposed to other types of guarantees that might have been available, such as the guarantee of a private loan discussed earlier).[598] Third, there was the challenge of ensuring that all 50 state insurance regulators would have agreed not to seize their domiciled subsidiaries, and one seizure could have led to a cascading effect of other seizures. Finally, there would have been uncertainty as to who would ultimately be responsible for the guarantee's administration. Apart from the various business and legal issues associated with a potential multi-trillion dollar government guarantee of a private international company, it is not clear that such a program, which has not been used before, would work. Panel staff also asked the government if a guarantee for only certain of AIG's domestic insurance subsidiaries was considered, and the response was similar—that such a guarantee would likely not have been feasible given that AIG's domestic life and property & casualty insurance operations carried policies in the trillions of dollars.[599]

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[595] Panel staff conversation with Jay Wintrob, the CEO of the SunAmerica Financial Group (May 17, 2010).

[596] Written Testimony of Rodney Clark, *supra* note 80, at 6–8 (noting that while AIG's financial problems "have no direct effect on the solvency of its insurance subsidiaries, we believe the creditworthiness of those subsidiaries is nevertheless indirectly affected in two primary respects:" (1) financial pressures at AIG "generally make it less likely that AIG will be in a position to provide additional capital to its subsidiaries in the event the subsidiaries suffer investment losses of their own or otherwise require recapitalization;" and (2) "overall reputational risk resulting from the parent company's financial problems."

[597] In general, the Federal Reserve would only be able to issue a guarantee pursuant to Section 13(3) if the guarantee was fully secured. Therefore, the amount of the guarantee would be "capped" by the value of available or unencumbered assets that could be posted as collateral. For further detailed discussion of the Federal Reserve's Section 13(3) authority, see Section C.4, *supra*.

[598] FRBNY and Treasury briefing with Panel and Panel staff (May 11, 2010). In fact, based on further discussions with Scott Alvarez on May 28, 2010, it may have been possible to work out a guarantee of the insurance liabilities if adequate collateral could have been provided. Such a guarantee, however, would have required significant interaction with over 200 of AIG's domestic insurance regulators. These regulators may have been constrained by existing local or state law regarding the proper segregation of assets to satisfy outstanding insurance claims (potentially requiring the regulators to amend local/state law before they could agree to pledge the assets as collateral for a government guarantee). Further, any solution would have required a coordinated effort of all insurance regulators so that there would be uniform and consistent treatment for AIG policyholders across the United States. The Federal Reserve, FRBNY, and Treasury would have been further constrained by the limited amount of time available to accomplish the necessary tasks for a guarantee of the insurance liabilities.

[599] FRBNY conversations with Panel staff (May 4, 2010).

A possible alternative to a guarantee could have been direct lending to AIG's insurance company subsidiaries, which might have been possible (and might also have allowed the subsidiaries to maintain their credit ratings), but this would have been highly complex for a company like AIG.[600] According to Mr. Clark of S&P, "when you look at the literally hundreds, when you start looking globally, of regulated and unregulated subsidiaries of AIG, I think it would have been very difficult to get money to all of those. In addition, you had cross-guarantees between certain of the subsidiaries, both domestic and foreign, which most often went back to insurance companies regulated in New York or Pennsylvania, not always. It was a very complicated web of relationships really just necessitated by the complex global nature of the group."[601]

Given AIG's substantial issuance of commercial paper to money market mutual funds, there was a real possibility that an AIG bankruptcy could have had severe repercussions on both money market funds[602] and an already distressed commercial paper market. Once a bankruptcy filing by Lehman Brothers (which had $5 billion of commercial paper outstanding to money market funds) resulted in the "breaking of the buck" on September 16—the same day that the government rescued AIG—investors started withdrawing funds from money market mutual funds. As discussed above, however, AIG had issued $20 billion of commercial paper—four times the amount of Lehman's outstanding commercial paper. If a Lehman failure could cause these investment vehicles to begin trading at a discount and result in a wave of investor redemptions in prime funds and the reinvestment of capital into government funds, it seems quite plausible that an AIG failure would have further destabilized these investments, reduced or halted credit availability for corporations and financial institutions (even on a short-term basis), and caused higher lending rates.[603]

The Panel notes that in a bankruptcy filing, virtually all of the multi-sector CDO CDS counterparties would have terminated as of the petition date and would have been entitled to retain all previously posted cash collateral (which essentially means their unsecured claim would become secured to the extent of that collateral), hold onto the referenced CDOs (for those that were not holding naked positions), or continue the contract. Continuing collateral calls from the counterparties after a bankruptcy filing would have been unenforceable due to the automatic stay. Assuming that the counterparties could not cover their positions by obtaining a replacement derivative, they would have retained the right to assert an unsecured claim against AIGFP for unrecovered amounts, and these would have been resolved in bankruptcy court. For those counterparties that still held the underlying securities and were

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[600] Testimony of Rodney Clark, *supra* note 576.

[601] Testimony of Rodney Clark, *supra* note 576.

[602] A money market fund (MMF) is a type of mutual fund that invests only in highly-rated, short-term debt instruments. Government funds invest primarily in government securities like U.S. Treasuries, while prime funds invest primarily in non-government securities such as the commercial paper (i.e., short-term debt) of businesses. Investors use MMFs as a safe place to hold short-term funds that may pay higher interest rates than a bank account.

[603] The Panel notes, however, that any such fallout could have been prevented or mitigated by a government money market guarantee program, and this seems very possible given that Treasury ultimately announced such a program on September 19, 2008 (only three days after the AIG rescue), but this alternative would have also exposed the government to a substantial amount of risk.

not fully hedged, they would have likely faced the need to take the full risk of the reference securities onto their books.[604] This could have created a domino effect across AIG's counterparties and the capital markets, as those that had insufficient capital or liquidity to offset that risk could have faced significant distress.[605] While it is unclear whether this potentially substantial loss of capital on the part of many entities would have been destabilizing in itself, it is clear that a significant amount of liquidity had already been drained out of the system in September 2008, and the system would have had to dig itself out of a bigger hole had AIG gone bankrupt. As Secretary Geithner has noted, "[t]he risk to the system from AIG's collapse is not particularly reflected in the direct effects on its major counterparties, the banks that bought protection from AIG . . . What was significant for the system as a whole was the broader collateral damage that would've happened in the event of failure." [606]

The potential impact of an AIG bankruptcy can be guessed by examining how the markets continued to deteriorate even after AIG was rescued. As shown in Figure 22 below, the spread between the London Interbank Offered Rate (LIBOR) and the Overnight Index Spread Rate (OIS)—used as a proxy for fears of bank bankruptcy—dramatically increased in September 2008 amid the growing concerns of financial collapse. Former Federal Reserve Chairman Alan Greenspan stated that the "LIBOR-OIS spread remains a barometer of fears of bank insolvency." [607] In the immediate aftermath of the Lehman bankruptcy this spread spiked to a level indicating actual illiquidity in the interbank market—not merely a high cost for obtaining funds—meaning that banks were not willing to lend to one another.[608] Prior to the beginning of the credit market crisis in August 2007, the LIBOR-OIS spread was 10 basis points. Following the failure of Bear Stearns, the Libor-OIS spread increased to 83 basis points. The measure averaged 190.3 basis points through the final four months of 2008 and reached its peak of 365 basis points on October 10, 2008 following the collapse of Lehman Brothers. The LIBOR-OIS spread reflected the contraction of liquidity that crippled the financial markets in 2007 and 2008.[609]

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[604] The extent to which some of the CDS counterparties were actually at risk is discussed below at Section D.4, *infra*.

[605] Some of AIGFP's CDS counterparties assert that they were not at risk to the credit consequences of an AIG default. No one has asserted that they would not have been affected by the systemic impact of an AIG default.

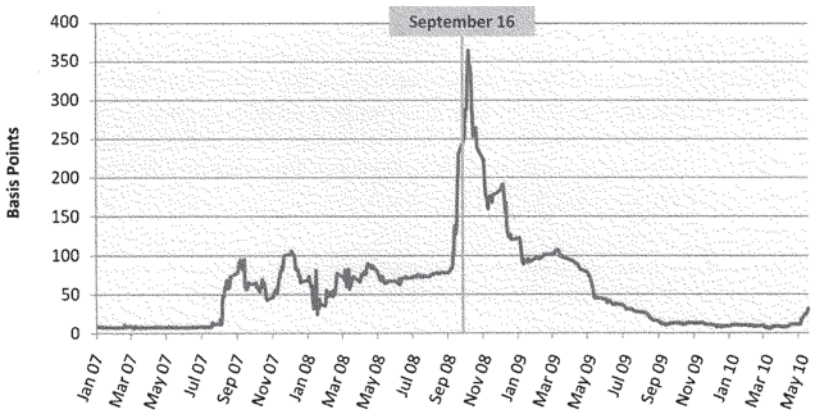
[606] COP Hearing with Secretary Geithner, *supra* note 86.

[607] Federal Reserve Bank of St. Louis, *What the LIBOR-OIS Spread Says* (2009) (online at www.research.stlouisfed.org/publications/es/09/ES0924.pdf).

[608] Federal Reserve Bank of St. Louis, *What the LIBOR-OIS Spread Says* (2009) (online at www.research.stlouisfed.org/publications/es/09/ES0924.pdf).

[609] Federal Reserve Bank of St. Louis, *The LIBOR-OIS Spread as a Summary Indicator* (2008) (online at www.research.stlouisfed.org/publications/es/08/ES0825.pdf).

FIGURE 22: SPREAD BETWEEN THREE-MONTH LIBOR AND OVERNIGHT INDEX SWAP RATE [610]



Furthermore, as discussed above, AIG was heavily reliant on commercial paper to fund its operations, a market that froze in the fall of 2008. As Figure 23 illustrates, the total amount of financial commercial paper outstanding declined by 16 percent in September 2008, a reflection of the market's uncertainty regarding financial companies.[611] Interest rates for overnight commercial paper shot up in September 2008. As Figure 24 shows, interest rates on relatively riskier investments such as A2/P2 and asset-backed commercial paper increased by 142 percent and 179 percent respectively in September 2008. The interest rates on comparatively less risky investments such as AA nonfinancial and AA financial commercial paper increased by 56 percent and 34 percent during the same period. As noted above, AIG had issued approximately $20 billion in commercial paper—roughly four times the amount Lehman issued.[612] Even after AIG's receipt of substantial government assistance, concerns regarding AIG's financial condition spread to the money market funds, which were owners of the paper.[613]

[610] 90-day LIBOR less the 90-day OIS rate. An OIS is an interest rate swap with the floating rate tied to an index of daily overnight rates, such as the effective federal funds rate. At maturity, two parties exchange, on the basis of the agreed notional amount, the difference between interest accrued at the fixed rate and interest accrued by averaging the floating, or index, rate. Investment Company Institute, Report of the Money Market Working Group (Mar. 17, 2009) (online at www.ici.org/pdf/ppr_09_mmwg.pdf).

[611] Federal Reserve Data Download Program, *supra* note 317 (accessed May 28, 2010).

[612] Federal Reserve Bank of New York, Presentation by Sandy Krieger, executive vice president, Credit, Investment and Payment Risk Group at the Federal Reserve Bank of New York, *Understanding the Response of the Federal Reserve to the Recent Financial Crisis,* at 34 (Apr. 14, 2010).

[613] Investment Company Institute, Report of the Money Market Working Group, at 103 (Mar. 17, 2009) (online at www.ici.org/pdf/ppr_09_mmwg.pdf) ("Concerns of money market fund investors about the risk exposure of their money market funds and the ability of sponsors of these funds to support them in the midst of a far-reaching financial crisis led some large institutional investors in money market funds to join the much broader run to Treasury securities, further overwhelming the financial system's ability to accommodate this sudden and broad-based change in the market outlook").

FIGURE 23: FINANCIAL COMMERCIAL PAPER OUTSTANDING, SEASONALLY ADJUSTED [614]

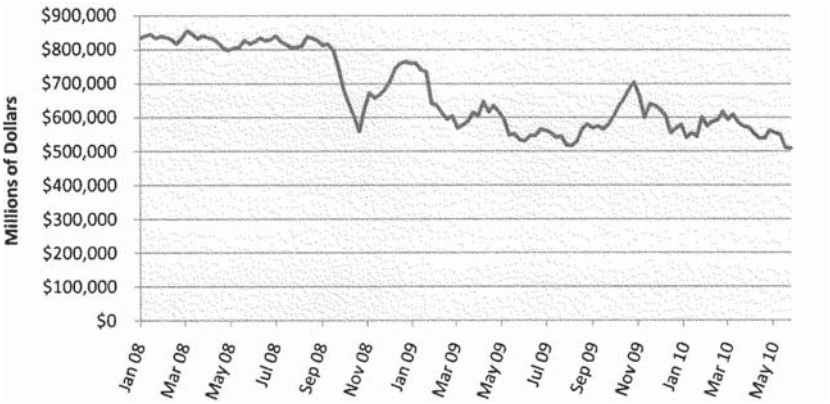
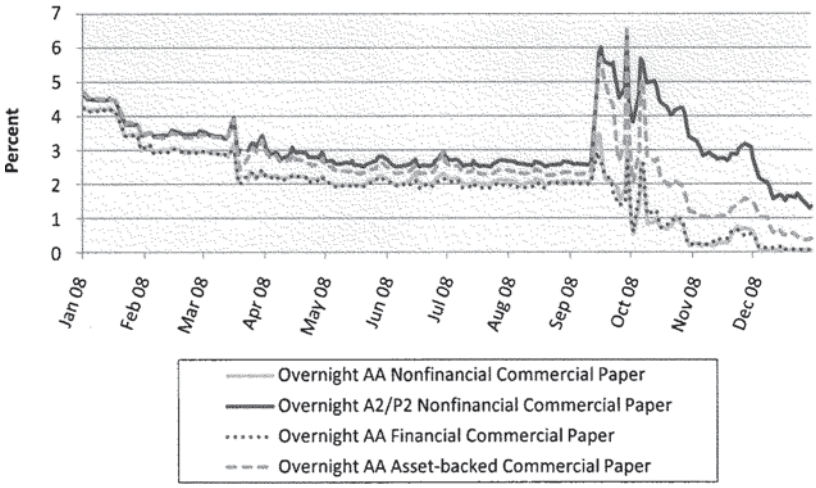


FIGURE 24: COMMERCIAL PAPER INTEREST RATES, 2008 [615]



As the financial crisis continued, spreads between yields on one-month commercial paper of financial companies and Treasury bills, an indicator of stress in money markets, widened significantly (and would have likely widened even more with an AIG bankruptcy), climbing to nearly 400 basis points at one time.[616]

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[614] Federal Reserve Data Download Program, *supra* note 317 (accessed May 28, 2010).
[615] Federal Reserve Data Download Program, *supra* note 317 (accessed May 28, 2010).
[616] This metric measures the spread between 30-day AA financial commercial paper rates and 1-month Treasury bonds. This spread reached its peak on October 9, 2008 at 382 basis points. This metric averaged 24 basis point between July 31, 2001—the earliest possible point of measurement—to January 1, 2008. Through the first nine months of 2008, the metric averaged 98 basis points until a spike in October, 2008 when the average for that month was 248 basis points. Federal Reserve Data Download Program, *supra* note 317 (accessed June 7, 2010); U.S. Department of the Treasury, *Daily Treasury Yield Curve Rates* (Instrument: 1-month security)

Continued

An AIG bankruptcy would likely have had significant international consequences. Several large European banks, which were exposed to AIG through CDSs that allowed them to hold less capital than they would have otherwise held, may have become undercapitalized as a result of a bankruptcy.[617] This could have led to serious regulatory consequences, including possible seizure by regulators,[618] and ripple effects on financial markets. In addition, if one foreign insurance regulator had decided to seize a foreign AIG insurance company, this could have set off a wave of additional seizures in other countries, because the likelihood that policyholders will be repaid decreases as more and more assets are frozen.

Even if it were possible to do a Lehman-type resolution for AIG by forcing the parent into bankruptcy and protecting the U.S. insurance subsidiaries (perhaps through a backstop), the vast reach and international aspects of this company would have made a filing extremely difficult without a sufficiently lengthy planning period.[619] Substantial time would have been needed to coordinate with the 200 foreign regulators and the large number of parties that had significant agreements with AIG,[620] and the likelihood of a quick response would have been slim.

Because of the FRBNY and Treasury decisions made on September 16, 2008, we can never really know what would have happened if AIG had filed for bankruptcy. The Panel concludes, however, that an AIG bankruptcy could have risked such severe financial disruptions that testing its consequences would have been inadvisable. In a time of crisis, FRBNY and Treasury's fundamental decision to provide support for AIG was probably necessary (or at least a reasonable enough conclusion made under great pressure); if that support had been provided in the context of a bankruptcy, the outcome for AIG and markets would have been very different.

v. Was Pre-Pack Bankruptcy an Alternative?

Finally, the Panel considered whether a pre-packaged bankruptcy or some other kind of arranged and controlled restructuring was possible on September 16, 2008 or contemplated at this time. A pre-pack is a plan for reorganization prepared in advance in cooperation with creditors that will be filed soon after the petition for relief under Chapter 11.[621] The advantages to a pre-pack are that the restructuring is not uncontrolled and there is an ability to distinguish among creditors and rearrange commercial contracts. For a number of reasons, this would not have been a feasible or prac-

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(online at www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield_historical_huge.shtml) (accessed June 7, 2010).

[617] See table of affected banks at Figure 21.

[618] For further discussion of the impact on regulatory capital swaps, see Sections B.3(a) and E.1 (Regulatory Capital Swap Counterparties), *supra*.

[619] Panel staff conversations with bankruptcy/restructuring experts.

[620] For example, there were at least 12 separate indentures (and the government would have had to talk to the trustees under those indentures) as well as a variety of other agreements. For further discussion of these and other agreements, see Section E, *supra*. Even if the government had started discussions with the regulators over the weekend, it is likely that that still would not have been enough time.

[621] Pre-packaged bankruptcies can take various forms. Debtors will often file prepackaged bankruptcies in order to shorten the traditional process of confirming a reorganization plan and save the company money for professional fees and other costs associated with bankruptcy. The sooner the restructuring under Chapter 11 is completed, the sooner the company can return focus to its core operations. Some of these pre-pack reorganizations are extremely large, but can nevertheless be accomplished in less than two months.

tical stand-alone alternative in September. First, there was only a matter of hours to arrange a pre-pack,[622] not even weeks. With AIG running out of cash quickly, the Reserve Primary Fund breaking the buck, and AIG's commercial paper being four times the size of Lehman's, it seems extremely unlikely that a pre-pack could have been arranged in such a short time period as to prevent AIG's immediate default and a complete run on the money market funds. Second, while arranging a pre-pack is easier and has traditionally worked well for debtors with a relatively small number of creditors (for example, those having one credit agreement or bonds issued under only one indenture), it is much more difficult to conduct when a debtor like AIG—a large worldwide enterprise—has a substantial number of creditors with different types of claims. Third, AIG had more than 400 separate regulators, and more than 200 of them were overseas in September 2008. From a logistical standpoint, trying to contact all of these players to coordinate an arranged and controlled bankruptcy in such a short amount of time was impracticable.

While a pre-pack around September 16, 2008 appears problematic assuming FRBNY and Treasury had insufficient notice of AIG's true financial health, in the event FRBNY and Treasury had been fully aware of the issues earlier, a pre-pack would have been a more workable option. It might have been possible to complete a pre-pack (combined with a government-sponsored bridge facility) over two or three months commencing in mid-September if it were combined with a government-sponsored bridge facility,[623] and the Panel notes that the following year pre-packs were effectively used in the support of the automotive companies.[624]

vi. Did the Government Recognize the Consequences of its Choice?

Senior officials of both the FRBNY and the Treasury have stated, however, that significant negative consequences resulted from their decision to rescue AIG. They have focused on the perception that their intervention would be perceived as a bailout of a "too big to fail" institution and, therefore, raise substantial moral hazard concerns, especially since these actions took place after the Federal Reserve had already provided assistance to Bear Stearns in March

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[622] Even including the weekend, there would have not have been enough time. Mr. Martin Bienenstock, partner and chair of the business solutions and government department at Dewey & LeBoeuf, does "not believe any prepackaged chapter 11 plan for AIG was remotely possible within the acutely short time available." Written Testimony of Martin Bienenstock, *supra* note 307, at 1. *See also* Testimony of Jim Millstein, *supra* note 44, at 4 (stating that "prepackaged plans only have a chance of success if there is sufficient time, before a company defaults, to organize creditors into a negotiating committee, and to negotiate and agree on a comprehensive restructuring plan which can be implemented in an expedited proceeding before bankruptcy court").

[623] According to Martin Bienenstock, chair of the Business Solutions and Governance Department at Dewey & LeBoeuf LLP, if on September 16, 2008, the government provided AIG with an $85 billion bridge loan and sought to work out a pre-pack bankruptcy of AIG, the odds of that being successful within 180 days would have been less than 10 percent. "On the prepack, the reason I'm saying less than a 10 percent likelihood is, as a matter of right, any creditor can ask for an examiner.. . . That can take months or years." Furthermore, if everyone was not going to get paid in full in the bankruptcy proceeding, then the chances of resolution within 180 days would have even been slim. Congressional Oversight Panel, Testimony of Martin Bienenstock, partner and chair of business solutions and government department, Dewey & LeBoeuf, *COP Hearing on TARP and Other Assistance to AIG* (May 26, 2010).

[624] September Oversight Report, *supra* note 389, at 49–50.

2008.[625] The government concluded, however, that such negative ramifications were outweighed by the countervailing concern that taking no action in the midst of a financial crisis might have served as the catalyst for the next Great Depression. According to Secretary Geithner, "[o]ur job was to make a set of choices among unpalatable, deeply offensive basic choices, and to do what was best, we thought, for the country at that stage."[626] The policymakers continue to emphasize that rescuing AIG was a "no brainer" in context due to their conclusion that the consequences of an AIG bankruptcy were far worse than those resulting from the provision of liquidity to AIG.[627] The Panel recognizes that FRBNY and Treasury realized they were making an unpalatable choice, but is not convinced they recognized just how unpalatable that choice was—that is, they had created a guarantee of the OTC derivatives market. The implications of this decision are discussed in the Conclusion.

The Panel also recognizes that the government was faced with a deepening financial crisis, and its attention was on a number of troubled institutions besides AIG in the course of just a few days. Given this context, the government took actions that it thought would facilitate rapid intervention in the midst of deteriorating economic conditions. Nonetheless, if the government concluded that it could not impose conditions on its assistance once it had decided to backstop AIG with taxpayer funds, or that other possible rescue alternatives were unattractive or impracticable, then it had an obligation to fully explain why it decided what it did, and especially why it was of the opinion that all AIG's creditors and counterparties would receive all amounts they were owed. In addition, while the Panel acknowledges the number of complex issues and troubled institutions that policymakers were concerned with at the time, it appears that the government was neither focused on nor prepared to deal with the AIG situation. By placing a tremendous amount of faith in the assumption that a private sector solution would succeed in resolving AIG, the government had no legitimate alternative on the table once that assumption turned out to be incorrect. In its assessment of government actions to deal with the current financial crisis, the Panel has regularly called for transparency, accountability, and clarity of goals. These obligations on the part of the government do not vanish in the midst of a financial crisis. In fact, it is during times of crisis, when difficult decisions must be made, that a full accounting of the government's actions is especially important.

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[625] FRBNY and Treasury briefing with Panel and Panel staff (May 11, 2010); Joint Written Testimony of Thomas C. Baxter and Sarah Dahlgren, *supra* note 255, at 3–4 (stating that the decision to lend "was difficult because of the collateral consequence, the moral hazard resulting from AIG's rescue."). While policymakers do not recall whether discussions took place concerning actions that could have mitigated the moral hazard concern during the decision-making that led up to the AIG rescue, they acknowledge the significance of the issue and do not pretend that the moral hazard price was not contemplated. According to at least one staff memo that was circulated on September 14, 2008, moral hazard was noted as a negative of lending to AIG. E-mail from Alejandro LaTorre, vice president, Federal Reserve Bank of New York, to Timothy F. Geithner, president, Federal Reserve Bank of New York, and other Federal Reserve Bank of New York officials (Sept. 14, 2008) (FRBNYAIG00496–499) (with attached memo).

[626] Congressional Oversight Panel, *Questions for the Record for Treasury Secretary Timothy Geithner* (Dec. 10, 2009) (online at www.cop.senate.gov/documents/testimony-121009-geithner-qfr.pdf).

[627] FRBNY and Treasury briefing with Panel and Panel staff (May 11, 2010).

2. Securities Borrowing Facility: October 2008

In the 15 days between September 16 and October 1, AIG drew down approximately $62 billion of the $85 billion RCF, and a substantial component of this amount was used to settle the redemptions arising from securities lending counterparties' return of those securities to AIG.[628] The fact that FRBNY had to resort to an additional credit facility so soon after the initial intervention (coupled with the facility's effect of allowing AIG to use the remaining amounts under the RCF for other purposes) suggests that none of the parties, including FRBNY, had a complete grasp of AIG's need for additional capital. Given the scope of the continued economic and market deterioration, however, it would have been very difficult for anyone to calculate with exact precision the impact of a worsening financial crisis on AIG's balance sheet.

As discussed above, credit rating agencies made early contact with FRBNY to emphasize that the $85 billion RCF was problematic because of the impact it had on AIG's balance sheet, and indicated that additional downgrades were likely if FRBNY did not address the continuing collateral calls stemming from AIG's securities lending and AIGFP CDS portfolios.[629] As a result, FRBNY spent a significant amount of time trying to develop alternative solutions to avoid further downgrades.[630] As discussed above, $62 billion of the RCF had been drawn down by October 1. While the drawdowns were expected, they also demonstrated the substantial liquidity pressures placed on AIG due to the ongoing withdrawal of counterparties from the securities lending program and the likelihood that additional securities borrowing counterparties would decide not to renew their positions with AIG. These concerns were compounded by the continued deterioration in the market. Given these circumstances, a primary benefit of the SBF was to reduce the pressure on AIG to liquidate the RMBS portfolio.[631]

By November 2008, AIG borrowed approximately $20 billion under the SBF. While the creation of this additional facility exposed FRBNY to further potential losses, advances made under the facility were with recourse to AIG. As discussed in more detail below, FRBNY received enhanced credit protection in these securities.[632]

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[628] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010); Federal Reserve Report on Restructuring, *supra* note 329, at 4; Board of Governors of the Federal Reserve System, *Minutes of Board Meeting on American International Group, Inc.—Proposal to Provide a Securities Lending Facility* (Oct. 6, 2008) (hereinafter "Minutes of Federal Reserve Board Meeting").

[629] House Committee on Oversight and Government Reform, Testimony of Timothy F. Geithner, secretary, U.S. Department of the Treasury, *The Federal Bailout of AIG* (Jan. 27, 2010) (publication forthcoming) (noting that while the initial $85 billion revolving credit facility "helped stem the bleeding for a time," "given the massive losses AIG faced, and given the force of the storm moving across the global financial system, it was not enough. And we had to work very quickly almost from the beginning to design and implement a broader, more permanent restructuring").

[630] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010).

[631] Given the financial crisis and the depressed real estate market, had AIG liquidated its RMBS portfolio at that time, the sales would have likely occurred at significantly depressed prices.

[632] Minutes of Federal Reserve Board Meeting, *supra* note 628. For further discussion of the ML2 facility and its current value, see Section D.3, *infra*.

As FRBNY has noted, the SBF was not designed to be a permanent solution.[633] While it may have made the company more leveraged temporarily, it was designed as a short term response to credit rating agency concerns about the liquidity pressures the AIG parent continued to face from its RMBS securities lending portfolio. It appears, therefore, to have achieved its immediate goals of helping stabilize AIG's liquidity situation in the near term and preserving the value of its insurance subsidiaries.

3. The TARP Investment and First Restructuring: November 2008

The period between late October and early November marked the first of several occasions in which the government had to weigh providing continued support for AIG against letting all or part of it fail. The enactment of EESA on October 3, 2008, provided government policymakers with a potentially more flexible set of tools for addressing AIG's problems in November than was available to them in the initial rescue of AIG in September. EESA created the TARP which included the ability to use equity and asset guarantees[634] to support troubled financial institutions and allowed for lending without the more restrictive collateral requirements that the Federal Reserve is required to meet under Section 13(3).

This was also a juncture at which the government considered whether there was a cheaper and more efficient resolution mechanism for AIG, including a surgical or partial bankruptcy such as a "pre-pack," but ultimately rejected any form of bankruptcy.[635] Between September and November, AIG continued to face liquidity pressures from its CDS and securities lending portfolios. As discussed above, AIG was expected to report a sizeable loss for the third quarter of 2008, and the four leading credit rating agencies had notified FRBNY of their concern that the RCF made the company overleveraged and did not adequately address its liquidity pressures. Given these concerns, the rating agencies suggested the strong likelihood of further downgrades if these issues were left unaddressed.

Having already provided AIG with the $85 billion line of credit as well as the subsequent SBF, the calculus of the government's decision-making focused on either the restructuring of the terms of its assistance or facing the risk of losing a part or the whole of its investment if AIG were to face downgrades and the renewed possibility of bankruptcy. AIG's earning statement was due to be released on November 10. Continuing to lend money to AIG so it

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[633] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010); Minutes of Federal Reserve Board Meeting, *supra* note 628; *RMBS Solution: AIG discussion document* (Oct. 30, 2008) (FRBNY–TOWNS–R1–205305) (stating that the "FRBNY $37.8 B sec lending program was initiated as a stop-gap liquidity measure to address the liquidity drain from sec lending terminations"). The primary reasoning offered by FRBNY for why this was not designed to be a permanent solution was that FRBNY could not continue to function as a "RMBS lender of last resort" on an indefinite basis.

[634] *See* November Oversight Report, *supra* note 411, at 40–43 (describing section 102 of EESA, which requires the Secretary, if he creates the TARP, also to "establish a program to guarantee troubled assets originated or issued prior to March 14, 2008, including mortgage-backed securities.").

[635] Testimony of Thomas C. Baxter, *supra* note 215; Testimony of Scott G. Alvarez, *supra* note 639. It is worth noting that since the prior AIG intervention had occurred before the passage of EESA, it was not until this time that TARP funds specifically, rather than government funds generally, became implicated.

could meet its obligations would have led to further downgrades and placed the company on the verge of bankruptcy. The government decided that November 10 had become the effective deadline for restructuring its assistance. The government has stated that its interactions with the rating agencies in the six weeks between September 16 and early November 2008 were an iterative process;[636] during regular conversations between the government and the rating agencies, the rating agencies evaluated the potential solutions offered by the government and offered feedback. Before the government announced the restructuring of its assistance, it ensured that the rating agencies had reviewed the set of solutions being offered.

The November restructuring of the AIG assistance illustrates how the government's initial decision to rescue AIG in September constrained all of its subsequent decision-making. In conversations with the Panel and its staff, government officials have emphasized their belief that it would be very poor policy and precedent for the government to vacillate in its decision-making, especially with respect to actions taken to avert economic collapse in the midst of a financial crisis. Later in the process, it was not just the credibility of the AIG investment that was at stake, but, in addition, all of TARP's Capital Purchase Program (CPP) and the implication that the large financial institutions that received government assistance were systemically important. A sudden change in course with respect to AIG would have called into question the government's intention to stand behind major TARP recipients.[637] In the government's view, then, the actions taken in September 2008 determined the trajectory of government policy: having decided to rescue AIG on September 16, 2008, the government concluded that it was very difficult and impracticable for it to reverse its course and let AIG fail.[638]

At this point, FRBNY and Treasury had enough time to collect information on AIG and reflect, on the basis of their due diligence, about the various ways to shape government assistance to AIG, that would have been more effective, efficient, and less costly than the course the government ultimately followed. The potential cost of delay depends on the value of the collateral provided to the government.

As indicated elsewhere, there was a difference of opinion between the private bankers and the government about the value of the collateral provided by the stock of AIG's insurance and related subsidiaries. The possible variance took several forms. First, there is a simple disagreement about what the subsidiaries were worth as going concerns. Second, a valuation could have reflected the fact

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[636] FRBNY conversations with Panel staff (May 4, 2010); Panel staff conversations with Standard & Poor's (May 19, 2010); Panel staff conversations with Moody's (May 19, 2010); Panel staff conversations with Fitch Ratings (May 20, 2010).

[637] *See* Congressional Oversight Panel, *January Oversight Report: Exiting TARP and Unwinding its Impact on the Financial Markets, at 5* (Jan. 14, 2010) (online at cop.senate.gov/documents/cop-011410-report.pdf) (hereinafter "January Oversight Report") (noting that "the TARP has raised the long-term challenge of how best to eliminate implicit guarantees. Belief remains widespread in the marketplace that, if the economy once again approaches the brink of collapse, the federal government will inevitably rush in to rescue financial institutions deemed too big to fail."); November Oversight Report, *supra* note 411, at 4 (noting that "the government's broader economic stabilization effort may have signaled an implicit guarantee to the marketplace: the American taxpayer would bear any price, and absorb any loss, to avert a financial meltdown").

[638] FRBNY and Treasury briefing with Panel and Panel staff (May 11, 2010).

that AIG's default—and conversion of the collateral—would have resulted in a probable bankruptcy of AIG, in turn causing seizure of the insurance companies by their respective regulators; even if that had not happened, a bankruptcy would have potentially placed the insurance subsidiaries in a "run-off" mode, when few new policies were purchased, policies that could be cashed in were cashed in, and assets were preserved simply to pay claims when due. Moreover, even if the collateral theoretically retained sufficient value to cover the loan, the bankruptcy process would have delayed realization of that value for some, perhaps a substantial, period of time, until conclusion of the bankruptcy process, and the value of the collateral could itself have changed during the interim. At each point in the timeline these considerations become more difficult to assess.

In any event, FRBNY and Treasury decided to continue on the course they had first elected in September. Mr. Alvarez of the Federal Reserve Board testified before the Panel that the RCF "did not prevent the private sector from subsequently coming in and restructuring AIG, making another loan, and taking us out of the position. That—that was always a possibility. Our loan did not remove that possibility."[639] It appears, however, FRBNY and Treasury did not make serious efforts to engage with private sector participants at this time (or any time post-September 2008) to assess the level of interest (if any) in a public-private hybrid or some other package of assistance that would have reduced the government's exposure and retained some private party discipline.

The Panel notes that the creation in November 2008 of a more durable capital structure for AIG had several practical consequences.[640] First, by avoiding bankruptcy and further downgrades, the government's restructuring provided AIG with more time and greater flexibility to sell assets. At a time when AIG likely could not have obtained anything other than fire sale prices for its assets, the restructuring protected the interests of the government and taxpayers by improving the company's negotiating position by allowing AIG to hold off on selling assets until market conditions improved. Second, once Treasury expended TARP funds, the government's calculus changed, since Treasury, in its role as the primary manager of TARP, is obligated to protect taxpayer interests, promote transparency, and foster accountability. Since the Federal Reserve is not as politically accountable as Treasury, it is likely that the Federal Reserve's goals are at least somewhat different from those of Treasury. Third, since Treasury's TARP investments are junior to the RCF and AIG's other senior debt, the return of the taxpayers' TARP investment (as well as its value) are dependent upon the company's viability going forward. While Treasury's direct involvement in AIG stemming from this first TARP investment did not by itself result in a transfer of risk to the public since the Federal Reserve's source for its $85 billion line of credit was the government's ability to print money, a primary implication of Treasury's preferred stock purchase in AIG was that

[639] Congressional Oversight Panel, Testimony of Scott G. Alvarez, general counsel, Board of Governors of the Federal Reserve System, *COP Hearing on TARP and Other Assistance to AIG* (May 26, 2010) (hereinafter "Testimony of Scott G. Alvarez").

[640] For a detailed discussion of tensions inherent in the capital structure, see Section G, *infra*.

the government acquired an increased interest in the viability and success of the institution in which it invested, which might color any future decisions concerning AIG.[641]

4. Maiden Lane II

The creation of the ML2 facility in combination with the creation of the ML3 facility (discussed below) allowed FRBNY to achieve the goal of avoiding rating downgrades and their negative consequences. As a result of the ML2 transaction, AIG's remaining exposure to losses from its U.S. securities lending program was limited to declines in market value prior to closing and its $1 billion of funding.[642] While the purchases transferred a substantial amount of risk to FRBNY, which is charged with managing those assets for the benefit of the U.S. taxpayer, the Panel notes that two factors combine to mitigate that risk.

First, while the possibility that these securities might decline in value below their purchase price (causing the asset pool to be "underwater" and for the government's stake to be "out of the money") and the portfolio exposes FRBNY to credit and concentration risk, these concerns are counterbalanced by FRBNY's substantially discounted purchase price[643] and FRBNY's right to share in 83 percent of the upside.[644] Further, the government believes there could be a significant upside on its holdings in ML2 (perhaps as much as $15–20 billion if securities return to par).[645] This upside potential also makes it more likely that AIG will repay the remainder of FRBNY's senior debt (RCF).

Second, FRBNY has the ability to hold the securities for some time; it does not face liquidity pressures to sell at fire sale prices. FRBNY engaged BlackRock to do a valuation analysis of the securities, including an investigation of cash flows under various scenarios, and BlackRock determined that the securities would realize more value if they could be held over a longer period of time.[646]

The ML2 transactions form a critical element of the larger AIG intervention and, therefore, play an instrumental role in the return on the government's investment. The government's stake in ML2 is currently "in the money."[647]

5. Maiden Lane III

As discussed above, even after the government's rescue in September 2008, collateral calls with respect to AIGFP's CDS portfolio were absorbing liquidity and threatening further ratings downgrades, which would have required even more collateral to be post-

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[641] See further discussion of the dynamics of Treasury equity positions and Federal Reserve loans to AIG in Section G. This stake is presumably greatest in a case like AIG—where the government has a lot to lose, since it committed to provide a total of $182.3 billion to the company since September 2008.

[642] BlackRock Financial Management, Inc., *Proposed Structure for Sec Lending RMBS Vehicle (Maiden Lane II)* (Nov. 2008) (FRBNY–TOWNS–R1–163661) (noting that the objectives of the ML2 transaction should include minimizing the cash drain on the AIG parent and minimizing the capital hit to AIG).

[643] FRBNY purchased RMBSs with a face value of $39.3 billion for a total price of $19.5 billion.

[644] See discussion of residual values for ML2 in Section D.3, *supra*.

[645] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010).

[646] FRBNY and Treasury briefing with Panel and Panel staff (Apr. 12, 2010).

[647] For further discussion please, see section D.3, *supra*.

ed.[648] AIG operated under the assumption that it had two potential courses of action: keep the CDSs (and keep making the collateral calls) or try to get rid of them; defaulting on them was not an option, since it would likely have led to bankruptcy.[649]

Continuing to pay out on the collateral calls, however, was not a workable option; only $24 billion remained undrawn on the RCF, and it was doubtful that that sum would cover anticipated further collateral calls prompted by the ratings downgrades that would have resulted from AIG's earnings release about to be published on November 10; moreover, this would have added to an already considerable debt burden.[650] In response, AIG attempted to negotiate cancellation of the CDSs in exchange for a cash payment, continuing to negotiate throughout October.[651] Since these negotiations were not succeeding, FRBNY asked BlackRock Solutions to develop options for disposing of the CDSs. In consultation with the government and its advisors, BlackRock presented three alternatives, two of which (discussed in more detail above) FRBNY felt would not work.[652]

At least one of the two alternatives that was rejected by the FRBNY is worth further exploration. As explained in Section D. 4., rather than purchasing the underlying CDOs, the FRBNY could have stepped into AIGFP's position and guaranteed the performance of the CDS contracts that AIGFP had written on the selected cash CDOs that ultimately were acquired by ML3. This could have been accomplished by using a special purpose vehicle like ML3 to purchase the CDSs written by AIGFP, rather than the underlying CDOs held by AIGFP's counterparties. The assumption by the government of AIG's obligations under their CDS contracts, and the consequent increased assurance of performance under the CDSs, would presumably have been very valuable to the counterparties and may have allowed FRBNY to obtain agreement to forego further collateral postings under those contracts.

Admittedly, government officials would have had to overcome several obstacles to achieve this result. One is the financing for the SPV. As discussed above, the Federal Reserve can only lend under section 13(3) if there is collateral sufficient to protect it from losses.[653] Collateral for an FRBNY loan to the SPV would have been an issue as the CDSs may have been seen as open-ended liabilities (even with the termination of further collateral postings) and too difficult to value as collateral under the Section 13(3) au-

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[648] The threat posed by the continuing collateral calls began immediately after the rescue. Briefing by Sara Dahlgren, executive vice president, Federal Bank of New York to Panel staff (May 11, 2010).

[649] Some of AIG's standard derivatives documentation—such as its Master Agreement with Goldman contained cross-default language providing that certain defaults between the counterparties (or certain of their affiliates) would cause amounts due and payable under the Master Agreement to become due and payable. Such provisions can have a cascade effect, and can complicate negotiations of individual contracts. Testimony of Jim Millstein, *supra* note 44 (stating: "Any creditor with the right to declare a cross-default could have brought the house of cards down."). See also Section G.1, *supra*.

[650] Briefing by Thomas C. Baxter, general counsel, Federal Reserve Bank of New York, to Congressional Oversight Panel (May 12, 2010) (noting some of the counterparties expressed a preference to continuing the position and continuing to take the collateral).

[651] Testimony of Thomas C. Baxter, *supra* note 319.

[652] See Section D, *supra*.

[653] For further discussion of collateral demands under Section 13(3) of the Federal Reserve Act, see Section C.4.b of this report.

thority.[654] Most of the other assets that AIG might have used as collateral had already been pledged in support of the Revolving Credit Facility. Nevertheless, it is possible that the Federal Reserve could have used some combination of the CDS contracts in the SPV and other unpledged holdings of AIG to provide the collateral needed for the Federal Reserve to authorize a Section 13(3) loan. Alternatively, it is possible that the Federal Reserve could have received expanded guarantee authority at the time TARP was passed or shortly thereafter if the proper groundwork had been laid. It appears that there was some consideration given to using TARP to provide a guarantee; in the end, TARP was not used for this purpose.

A further complication relates to the ability of AIGFP to assign its CDS contracts to a new legal entity. The argument that any assignment or assumption of the CDS contracts would have been very difficult in this instance is probably unlikely as standard language (often modified) in CDS contracts requires counterparties not to arbitrarily delay or withhold consent to such an assignment of interest.[655] Here again, in light of the superior credit position of the SPV that would be stepping in to take over the CDS contracts, the counterparties would likely have been agreeable to such assignment of their contracts. Had this alternative SPV been successfully put in place, then to the degree that prior collateral calls associated under the CDS contracts had resulted from downgrades in AIG's credit rating, the government would have been able to recapture that portion of the collateral postings as a result of the fact that the issuer of the CDS contracts—the SPV—would now be a AAA rated governmental entity.

As noted in Section D, the current value of the ML3 holdings is well in excess of the loan from the FRBNY and also exceeds the sum of the loan plus the AIG investment in ML3. Appreciation of the assets of ML3 produces income to the FRBNY and, in turn, to the Federal Reserve System. If, as in the alternative, an FRBNY owned SPV had assumed the issuer position of the CDS contracts, then appreciation of the underlying CDO's would likewise have been recaptured in the form of returned collateral from the CDS counterparties. In this respect, the government would have benefited from appreciation of the CDO's under either approach.

While acknowledging the difficulties involved in pursuing the government assumption of the contracts option, the Panel believes that the attention given to this alternative to ML3 was wholly inadequate, particularly in light of the advantages such an arrangement might have provided both with respect to avoiding any requirement to pay off CDO owners in full at the outset with government resources and with respect to the recapture of collateral by virtue of the government's superior credit rating.

The alternative, which FRBNY actually chose, was to create an SPV to purchase the CDOs at par from AIG's counterparties in exchange for cancelling the CDSs. These purchases could have been

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[654] *Id.*

[655] The International Swaps and Derivatives Association (ISDA) Master Agreement between Goldman Sachs International and AIGFP (GSI ISDA), dated as of August 19, 2003, provides for transfer without consent to affiliates of equivalent credit-worthiness; other assignments require the consent of the protected party.

effected at something less than the face value of the CDS less the collateral already received. This did not, however, happen. FRBNY has given a number of reasons for closing out the CDSs at their face value minus the collateral paid out:[656]

- After the government had made it clear in September that it was going to stand behind AIG, the threat of an imminent AIG bankruptcy had effectively been removed. Any threat of a default (anything less than payment of the full amount due on the CDSs) amounted to a threat of bankruptcy, which, once the government had indicated it would support AIG, would not be taken seriously.[657]
- FRBNY was concerned that threatening default would introduce doubt in the capital markets about the resolve of the government to stand behind its commitments, which would adversely affect the stability of the capital markets, reintroducing the systemic risk it had sought to quell.[658]
- FRBNY was also concerned about the reaction of the rating agencies to attempts to pay less than the full amount due on the CDSs, which could have led to further downgrades on AIG's credit rating.[659]
- There was little time, significant execution risk and the possibility of significant harm if the transaction was not affected by November 10.[660]

While by November the government had seriously undermined its own leverage, it may have had more leverage than it thought. The government believed that it could not threaten bankruptcy of AIG, because it had already decided against it in September. The markets, however, were not so sure. CDS spreads on AIG had widened, indicating that market participants were not convinced that the government was going to stand behind AIG.[661]

Any concessions had to be voluntary. This point is key—non-consensual payments at less than par would have triggered cross-defaults, causing a default under all agreements between AIG and the counterparty (and, in some circumstances, affiliates of AIG and the counterparty), and thus pushed AIG into the bankruptcy that the government had taken such great pains to avoid. The government's negotiating stance was that it had to treat all parties equally. At least one counterparty indicated that it would be open to a concession only if other counterparties would agree to the same concession.[662] Other counterparties, however, indicated in discussions with the Panel staff that they neither knew nor cared what

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[656] *See* Panel meeting with Federal Reserve Bank of New York officials (Apr. 12, 2008); SIGTARP Quarterly Report to Congress, *supra* note 369, at 30. *See also* Testimony of Thomas C. Baxter, *supra* note 319.

[657] *See* March Oversight Report, *supra* note 492, at 84–87.

[658] *See* March Oversight Report, *supra* note 492, at 84–87 (discussing Treasury's concerns that having committed to backstop the stress-tested banks, of which GMAC was one, it could not allow GMAC to file for bankruptcy without undermining its own credibility).

[659] See Section F.1(b)(iii), *supra* (discussing "selective default ratings"). *See also* Written Testimony of Rodney Clark, *supra* note 80.

[660] Briefing by Federal Reserve Bank of New York and the U.S. Department of the Treasury to the Congressional Oversight Panel and Panel staff (Apr. 12, 2010 and May 11, 2010).

[661] AIG's CDS spreads on September 12 and 16, and on November 7 were 858 basis points, 2413 basis points, and 2924 basis points, respectively, the last of which was an overall high. Data accessed through Bloomberg Data Service (accessed June 3, 2010).

[662] The counterparty was the Swiss bank UBS, which agreed to accept a 2 percent haircut provided the other counterparties did as well. SIGTARP Report on AIG Counterparties, *supra* note 246, at 15.

other counterparties had been offered or were willing to accept, and that they were negotiating for themselves alone.[663] This again suggests that FRBNY imposed unnecessary constraints on itself for public policy reasons. If other counterparties had separately agreed to varying degrees of concession, the holdouts could have been "named and shamed" as the only ones unwilling to make concessions and thus been more incentivized to come to an agreement.

FRBNY did make some attempts to negotiate with the CDS counterparties. It prepared talking points and briefing packages for the relatively low-level FRBNY officials who dealt with the counterparties.[664] These talking points emphasized the significant benefits that the counterparties had received by reason of the rescue of AIG and stabilization of the financial markets, and the moral obligations that the counterparties thus owed. The Panel staff has spoken to some of the counterparties about the nature of these negotiations. It seems that their nature varied. Some counterparties characterized them as genuine commercial negotiations in which they were forced to fight fiercely for their rights; others described more desultory attempts.[665]

Societe Generale was the largest counterparty and owned the reference securities.[666]

Goldman Sachs, the second largest counterparty, has stated, and has reaffirmed to the Panel, that it was not exposed to AIG counterparty credit risk—the risk that a protection seller will be unable to make a payment due under a CDS—in the event of an AIG bankruptcy.[667] This does not mean that Goldman had no exposure to AIG: for example, had Goldman agreed to make concessions on closing out its AIG CDSs, it would have experienced losses to the extent of those concessions, since those losses would not be covered by any of its hedges. A two percent concession on the notional value of Goldman's ML3 assets would have been $280 million.

Goldman's chief financial officer, David Viniar, stated that in purchasing CDS protection from AIG, "we served as an intermediary in assisting our clients to express a defined view on the market. The net risk we were exposed to is consistent with our role as a market intermediary rather than a proprietary market participant."[668] If true, however, this statement does not in and of itself

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[663] Panel staff discussions with CDS counterparties (May 10–16, 2010).

[664] Briefing by BlackRock Solutions, to Federal Reserve Bank of New York (Nov. 5, 2008) (FRBNYAIG–192338, 192382, 192392, 192402).

[665] Panel staff discussions with CDS counterparties (May 10–16, 2010).

[666] Some of the counterparties are reported to have "naked" CDS positions; i.e., they did not own (or have contracts with parties owning) the reference securities. The Panel has been unable to confirm the extent to which this assertion is correct, and the basis upon which those assertions are made are not entirely clear. To the extent this was true with respect to any particular counterparty, they would not have been at risk to a loss of value in those reference securities. Admittedly, upon termination of the contracts they would have lost out on the opportunity to make more money if there were a subsequent decrease in value of the reference securities. (The values of the reference securities could have gone in either direction, however, with consequent repayment of collateral received, and they have subsequently recovered some value; if the counterparty thought that valuations had bottomed out, it would be doubly happy to close out the contract and retain the collateral received.) The calculations and negotiating stance of a party that does not hold the underlying reference securities are necessarily different from those of a party that enters into the CDS as a hedge for securities it actually owns, and a party that is not at risk to the reference securities has more negotiating power.

[667] Panel correspondence with Goldman Sachs (May 14, 2010).

[668] *See* Thomson Street Events, *GS-Goldman Sachs Conference Call to Answer Questions from Journalists and Clarify Certain Misperceptions in the Press Regarding Goldman Sachs' Trading Relationship with AIG*, at 7 (Mar. 20, 2009) (hereinafter "Goldman Sachs Conference Call").

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mean that risk was completely mitigated, because the relationship between the contracts meant Goldman was still on the hook to its own clients. If AIG had failed, Goldman would have been exposed to its own clients to the entire extent of the notional amount of the CDSs it had written, and its ability to do so would have depended on the strength of its own hedges and its negotiating position vis-à-vis its own counterparties. The Panel notes that Goldman has declined to supply the Panel with the identities of its own counterparties or any documentation with respect to those relationships. It has similarly declined to provide information with respect to the providers of its own hedges on AIG.[669]

Goldman, however, had two types of protection against the failure of AIG.

The terms of the CDSs in effect with AIG provided that AIG had to put up cash collateral in the event of a downgrade in AIG's credit ratings, AIGFP's credit ratings, or a decrease in the market value of the reference CDOs.[670] On November 7, 2008, the amount of cash collateral posted with respect to Goldman's ML3 CDOs was approximately $8.2 billion (with an additional $1.2 billion claimed but not yet paid).[671]

Additionally, Goldman informed the Panel that it had purchased CDS protection against an AIG failure over the course of 2007 and 2008 from "all the large financial institutions around the U.S. and outside the U.S."[672] on AIG in amounts sufficient to cover Goldman's exposure to AIG.[673] According to Goldman, these CDS posi-

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However, since Goldman has declined to provide evidence of its relationships with its own counterparties, the Panel was unable to confirm this assertion. In the book, *The Big Short*, author Michael Lewis describes these counterparties as including Goldman Sachs itself (which sold bonds to its customers created by its own traders so that they could bet against them), hedge fund managers such as Steve Eisman of FrontPoint Partners, and stock market investor Michael Burry. *See* Michael Lewis, *The Big Short: Inside the Doomsday Machine,* at 76–77 (2010).

[669] Goldman has provided the Panel with quantitative data with respect to its hedges, but has provided no details with respect to the institutions that provided those hedges. Similarly Goldman has provided no details or documentation with respect to its own counterparties. The Panel does not presently have the ability to assess Goldman's negotiating position with respect to its counterparties. Data provided by Goldman to Panel (May 26, 2010).

[670] The International Swaps and Derivatives Association (ISDA) Master Agreement between Goldman Sachs International and AIGFP (GSI ISDA), dated as of August 19, 2003, provides for a variable threshold, which is essentially an amount of uncollateralized exposure provided for in the ISDA Master Agreement. (The ISDA Master Agreement and the Threshold are described in greater detail in Annex III.) The Threshold for each started at $125 million, and was reduced by $25 million (meaning that the counterparty would have to post collateral in the amount of $25 million) for each ratings downgrade. At BBB (S&P) or Baa2 (S&P), the agreement would terminate. AIG parent was AIGFP's credit support provider and Goldman Group was GSI's credit support provider. The GSI ISDA was amended in April, 2004 to provide that Goldman Group, GSI, and AIGFP would each have a threshold amount of $50 million, but AIG parent's threshold amount (meaning, the amount that GSI was willing to bear, uncollateralized, from AIG parent) was $250 million. However, these amounts could vary depending on the terms in the confirmation. For example, several transactions under the GSI ISDA calculated "exposure" as a function of the market value and outstanding principal balance of the reference obligation combined with a threshold that varied by a percentage based on the credit rating of the seller (AIGFP). Goldman's contract called for a calculation of "exposure" on each business day and concurrent collateral calls. According to Goldman, its MTM process was more rigorous than other counterparties', leading to collateral dispute with AIG.

[671] Data provided to the Panel by Goldman Sachs (May 24, 2010); *see also* SIGTARP Report on AIG Counterparties, *supra* note 246.

[672] *See* Goldman Sachs Conference Call, *supra* note 668, at 7.

[673] *See* Goldman Sachs Conference Call, *supra* note 668, at 2, 7, 16–17. Whether these hedges would, ultimately, have been successful in perfectly hedging Goldman dollar-for-dollar depends on the triggers—for a "plain vanilla" CDS, likely AIG's bankruptcy or default under various agreements—and the protection seller's role in the event of an AIG default. For a perfect hedge, the protection seller would have stepped into AIG's role, and provided identical protection to that provided under the defaulted AIG CDS. Even a less precise hedge, however, would have substantially reduced Goldman's exposure, and market participants confirmed to Panel staff that Goldman's hedges were consistent with market practice.

tions were collateralized, with collateral exchanged on a daily basis.[674] (Goldman was so well hedged, in fact, that the protection it bought on AIG netted it a gain over time, according to Mr. Viniar.)[675] The positions had termination dates ranging from 2008 and 2018, but the great majority of these positions terminated in 2012 or 2013.[676]

Goldman states that it had nothing to lose. Either AIG would close out its position at par as set forth in the contract, or it would default, and Goldman would keep the collateral that had already been posted by AIG and Goldman's AIG CDS counterparties.[677] As Mr. Viniar stated in March 2009:

> In the middle of September, it was clear that AIG would either be supported by the government and meet its obligations by making payments or posting collateral, or it would fail. In the case of the latter, we would have collected on our hedges and retained the collateral posted by AIG. That is why we are able to say that whether it failed or not, AIG would have had no material direct impact on Goldman Sachs.[678]

As regards to AIG credit risk, the position that Goldman describes is that of the classic "empty creditor"[679] (assuming the accuracy of its statements) indifferent between bankruptcy and bailout, but hostile to negotiated concessions. However, in light of the government's concerns with respect to the impact of AIG's failure, which Goldman must have shared, it would be slightly disingenuous for Goldman to say that it was truly neutral on this point.[680]

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[674] Senate Homeland Security, Permanent Subcommittee on Investigations, Testimony of David Viniar, chief financial officer, Goldman Sachs, *Wall Street and the Financial Crisis: The Role of Investment Banks.* (Apr. 27, 2010) (online at hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=f07ef2bf-914c-494c-aa66-27129f8e6282). As of November 6, 2008, Goldman held approximately $8.2 billion of cash collateral posted with respect to Goldman's ML3 CDOs (with an additional $1.2 billion claimed but not yet paid). Data provided by Goldman to Panel (May 26, 2010).

[675] *See* Goldman Sachs Conference Call, *supra* note 668, at 7. Mr. Viniar noted that the gain was "not particularly material."

[676] Data provided by Goldman to Panel (May 26, 2010).

[677] Goldman has provided data to the Panel which, assuming they are accurate, back up Goldman's claims that by reason of the collateral it held, it was not at credit risk to AIG in November 2008 and that the amount to which it was exposed by reason of an AIG failure was exceeded by the collateral already held from AIG and the providers of third party hedges. Data provided by Goldman to Panel (May 26, 2010).

[678] Goldman Sachs, *Overview of Goldman Sachs' Interaction with AIG and Goldman Sachs' Approach to Risk Management* (Mar. 20, 2009) (online at www2.goldmansachs.com/our-firm/on-the-issues/viewpoint/archive/aig-summary.html).

[679] The "Empty Creditor" theory posits that CDS may create so-called "empty creditors" whose interests are skewed in favor of bankruptcy rather than in the continuation of the debtor and who may accordingly push the debtor into inefficient bankruptcy or liquidation. *See* Patrick Bolton and Martin Oehmke, *Credit Default Swaps and the Empty Creditor Problem* at 1–2 (Nat'l Bureau of Econ. Research, Working Paper No 15999) (May 2010) (online at www.nber.org/papers/w15999.pdf) (citing Hu and Black, *Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications,* European Financial Management, 14, 663–709 (stating that "Even a creditor with zero, rather than negative, economic ownership may want to push a company into bankruptcy, because the bankruptcy filing will trigger a contractual payout on its credit default swap position") and *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions,* University of Pennsylvania Law Review, 156(3), 625–739).

[680] See Thomson Street Events, *GS-Goldman Sachs Conference Call to Answer Questions from Journalists and Clarify Certain Misperceptions in the Press Regarding Goldman Sachs' Trading Relationship with AIG,* at 7 (Mar. 20, 2009) (Viniar acknowledges disruption of AIG failure on the financial markets, conf call page 8, "quite dramatically"). Goldman states it had "no material credit exposure" to AIG; it does not argue that it would have been unaffected by AIG's failure. Goldman Sachs decline in equity value and increase in credit default swap spreads, while

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The point is, however, that Goldman believed that this would not happen. The government had signaled in September that AIG was too big to fail, and from that it could be inferred that AIG would be supported through its current liquidity crisis. On that basis, Goldman could refuse to make concessions until the clock ran out.[681]

It is unknowable whether if, instead of sending relatively junior people to negotiate, senior government officials could have used the government's bully pulpit to obtain a better result, either with the counterparties or with the credit rating agencies whose downgrades were anticipated. Certainly there was a significant time constraint, cited by Mr. Baxter of FRBNY.[682] But in light of concerns that these negotiations would themselves endanger AIG's credit rating, and the view expressed at the most senior levels of FRBNY that the attempt was likely doomed to failure,[683] it is hard to escape the conclusion that FRBNY was just "going through the motions."

The identities of the CDO CDS counterparties were not disclosed until several months after the event.[684] TARP Special Inspector General Neil Barofsky has referred to an ongoing inquiry with respect to the manner in which the decision to disclose was made, and in its most recent quarterly report to Congress, SIGTARP has made reference to ongoing investigations related to its audit of FRBNY's decision to pay certain AIG counterparties at par.[685] SIGTARP has indicated that if no charges result from its investigation, it intends to issue a report detailing its findings.[686]

6. Additional Assistance and Reorganization of Terms of Original Assistance: March and April 2009

While the additional restructuring of the government's assistance to AIG in March and April 2009 indicates that the company continued to be severely destabilized by capital and liquidity pressures, these actions also illustrate how the structure of the government's assistance had to be adjusted on a continuous basis due to changing circumstances. AIG's sizeable loss in the fourth quarter of 2008, coupled with the likelihood of additional rating downgrades, presented the government with another choice: whether to do nothing and face the risk of downgrades, bankruptcy, and the loss of a portion or the whole of its then outstanding investment, or restructure its assistance in order to stabilize AIG over the long term. As with the November restructuring, the government's decision-making re-

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marked, were not exceptional when compared to other financials, such as Morgan Stanley and Credit Suisse. Data accessed through Bloomberg Data Service (accessed June 3, 2010).

[681] Goldman has also raised the issue of its responsibilities to its shareholders which by then included the U.S. government not to make a loss. It is quite likely that any voluntary concessions would have triggered shareholder suits—on the grounds that the Goldman board's actions in agreeing to concessions in contracts for which they were theoretically fully hedged and collateralized would have improperly reduced the value of the CDSs for Goldman. *See* Jiong Deng, *Building an Investor-Friendly Shareholder Derivative System in China*, at 351 (Summer 2005) (online at www.harvardilj.org/attach.php?id=35). Whether the extraordinary circumstances under which Goldman would have agreed to such concessions would have affected the success of the shareholder suit is unknowable.

[682] Testimony of Thomas C. Baxter, *supra* note 319.

[683] COP Hearing with Secretary Geithner, *supra* note 86, at 81.

[684] SIGTARP Report on AIG Counterparties, *supra* note 246.

[685] SIGTARP Quarterly Report to Congress, *supra* note 369, at 19.

[686] Richard Teitelbaum, *Barofsky Says Criminal Charges Possible in Alleged AIG Coverup*, Bloomberg News (Apr. 28 2010) (online at www.bloomberg.com/apps/news?pid=20601208&sid=aVHMZwNcj2B0).

mained sharply constrained and influenced by its September decision to avert a bankruptcy (and its desire to not vacillate during a time of crisis), but was also shaped in part by a further consideration of whether there was a cheaper and more efficient mechanism to resolve AIG, including some kind of arranged and controlled bankruptcy.

The government's approach has largely remained focused on preventing the detrimental effect on market confidence that would result if it were to not deliver on its promise to provide financial assistance, as well as on preserving the value of its investment.[687] Treasury's commitment to provide total equity support to AIG of up to $69.8 billion exposed the taxpayers to additional risk, and the March 2009 restructuring (which likely benefitted AIG's existing common stockholders), deprived taxpayers of compulsory quarterly dividend payments, since Treasury exchanged its cumulative preferred stock for noncumulative preferred stock. On balance, it appears that the government made a calculation that the long-term benefits of restructuring its assistance in order to facilitate divestiture of its assets, maintain credit ratings, and maximize the likelihood of repayment outweighed any short-term monetary gains, such as those that would be acquired through the payment of dividends. While the government's public statements announcing the restructuring measures explicitly reference that an orderly restructuring would "take time and possibly further government support, if markets do not stabilize and improve,"[688] the terms and the amount of government assistance to AIG since March and April 2009 remain unchanged.

Instead of Treasury committing an additional $29.8 billion of TARP funds to AIG in March and April 2009, this also would have been another point when FRBNY and Treasury could have sought private sector financing, or some type of public-private hybrid form of assistance. While it does not appear that such efforts were made, it is important to recognize that this was another place when FRBNY and Treasury could have acted differently.

Perhaps most significantly, the Panel notes that the restructuring measures taken in March and April 2009 illustrate how the government, for the first time, began to prioritize an orderly restructuring process for AIG, as seen in the explicit separation of the major non-core businesses of the future AIG—AIA and ALICO. Together with the measures taken in September and November 2008, these actions provide tangible evidence of the government's commitment to the orderly restructuring of AIG over time. Given the scope of the government's assistance to AIG, the Panel finds that an orderly restructuring process is both a critical long-term solution for the company and a lynchpin of AIG's ability to repay its substantial government assistance.

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[687] Senate Committee on Banking, Housing, and Urban Affairs, Written Testimony of Donald Kohn, *supra* note 245, at 3 (stating that "[o]ur judgment has been and continues to be that, in this time of severe market and economic stress, the failure of AIG would impose unnecessary and burdensome losses on many individuals, households and businesses, disrupt financial markets, and greatly increase fear and uncertainty about the viability of our financial institutions. Thus, such a failure would deepen and extend market disruptions and asset price declines, further constrict the flow of credit to households and businesses in the United States and in many of our trading partners, and materially worsen the recession our economy is enduring").

[688] Treasury and the Federal Reserve Announce Participation in Restructuring, *supra* note 518.

7. Government's Ongoing Involvement in AIG

To repay its debt and reduce its degree of financial risk, AIG instituted a wind-down of AIGFP and a divestiture process to sell business units in September 2008. Since that time, AIGFP has been focused on unwinding its riskiest books and estimates that the majority of the wind-down will be completed by the end of 2010, provided the markets remain stable. In his December 2009 testimony before the Panel, Secretary Geithner asserted the company's new board and management are "working very hard and effectively" at strengthening AIG's core insurance business while reducing the AIGFP portfolio.[689] According to FRBNY, the entirety of AIG's restructuring is not at the government's behest, but is driven by the disposition plan in place when FRBNY rescued the company in September 2008.[690] This restructuring plan, which focuses on consolidating and downsizing AIG to focus on several core property & casualty and life insurance business units, has also guided the company's plans to repay gradually the government assistance through these asset sales and dispositions.

Since the Federal Reserve does not have statutory supervisory authority over AIG or its subsidiaries (as it does for bank holding companies or state chartered member banks), it functions as a creditor, and its rights are governed by the credit agreement for the RCF. As Chairman Bernanke has stated, "[h]aving lent AIG money to avert the risk of a global financial meltdown, we found ourselves in the uncomfortable situation of overseeing both the preservation of its value and its dismantling, a role quite different from our usual activities."[691] As creditor, FRBNY monitors the implementation of AIG's restructuring and divestiture plan and participates as an observer in the corporate governance of AIG.[692] FRBNY uses its rights as creditor to work with AIG management "to develop and oversee the implementation of the company's business strategy, its strategy for restructuring, and its new compensation policies, monitors the financial condition of AIG, and must approve certain major decisions that might reduce its ability to repay its loan."[693] As an ongoing condition of the RCF and to support its role as creditor, FRBNY established an on-site staff of approximately 25 people to monitor AIG's use of cash flows and its progress in pursuing its restructuring and divestiture plan. This internal team was supplemented by over 100 employees from the Bank of New York Mellon, investment bankers from Morgan Stanley, and outside legal counsel from Davis Polk & Wardwell LLP.[694] FRBNY has indicated that in the months since September 2008, the role and function of the on-site monitoring team has changed,

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[689] COP Hearing with Secretary Geithner, *supra* note 86, at 69.
[690] FRBNY conversations with Panel staff (May 4, 2010).
[691] Written Testimony of Ben Bernanke, *supra* note 481, at 4.
[692] While Federal Reserve banks have boards of directors which, by statutory construct, include bank executives and bank shareholders, they play a limited role in the Reserve bank's operations and function largely in an advisory capacity. The boards of directors of Reserve banks serve to make observations on the economy and markets, make recommendations on monetary policy, and ratify the Reserve bank's budget, internal controls, policies, procedures, and personnel matters. Consistent with the Federal Reserve Act, however, the boards do not exercise a role in the regulation, supervision, or oversight of banks, bank holding companies, or other financial institutions.
[693] Senate Committee on Banking, Housing, and Urban Affairs, Written Testimony of Donald Kohn, *supra* note 245, at 6.
[694] FRBNY conversations with Panel staff (May 6, 2010).

with separate teams having been established to monitor liquidity and the core business units that are central to AIG's operations going forward, and with regular ongoing communications between the teams.[695] FRBNY's on-site monitoring team works closely with Treasury's AIG team, and there are frequent meetings and regular communication between Treasury, FRBNY, and senior executives at AIG. While FRBNY's on-site team's size is approximately the same now as it was in September 2008, FRBNY's recruitment of individuals with investment banking and insurance expertise has allowed it to reduce the size of its external assistance.[696]

The Federal Reserve Board also oversees FRBNY's ongoing administration of the credit facilities for AIG authorized under section 13(3).[697] A team of Board staff regularly reviews developments affecting AIG with the FRBNY team charged with ensuring compliance with the terms of the credit agreements, monitoring AIG's liquidity and financial condition, and reviewing its restructuring plan. In turn, the Board staff team provides regular updates to Board members and senior agency staff about significant AIG developments. The Board staff also consults regularly with the Treasury team that oversees the TARP investments in AIG.

Together with the trustees of the Series C Trust, the Federal Reserve, FRBNY and Treasury have worked with AIG to recruit a substantially new board of directors and new senior management (including a new chief executive officer, a new chief risk officer, a new general counsel, and new chief administrative officer).[698]

The Panel also discusses the Special Master's involvement with respect to AIG, his rulings on executive compensation regarding AIG and the impact of those rulings on the company's competitive position in Section J.1.

8. Differences between the Treatment of AIG and Other Recipients of Exceptional Assistance

During Secretary Geithner's testimony before the Panel in April 2009, he said that where Treasury provides exceptional assistance,[699] "it will come with conditions to make sure there is restructuring, accountability, to make sure these firms emerge stronger in the future."[700] As with the automotive companies (but unlike Citigroup and Bank of America, other recipients of exceptional assistance), some of AIG's management has been replaced at the government's behest.[701] The government, and Treasury in particular, also seem to have taken on an active role with respect to planning and strategy at AIG, but not with respect to Citigroup and Bank

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[695] FRBNY conversations with Panel staff (May 6, 2010).
[696] FRBNY conversations with Panel staff (May 6, 2010).
[697] Testimony of Scott G. Alvarez, *supra* note 639, at 15–16.
[698] Testimony of Jim Millstein, *supra* note 44, at 2. The Series C Trustees have elected 11 of the 13 existing board members. The two remaining directors were nominated and elected by Treasury, pursuant to the terms of its Series E and Series F Preferred share holdings.
[699] Recipients of "exceptional assistance" are those companies receiving assistance under the SSFI, the TIP, the Asset Guarantee Program, the Automotive Industry Financing Program, and any future Treasury program designated by the Secretary as providing exceptional assistance. Recipients of exceptional assistance currently include AIG, Chrysler, Chrysler Financial, GM, and GMAC (since renamed Ally Financial).
[700] Congressional Oversight Panel, Testimony of Timothy F. Geithner, secretary, U.S. Department of the Treasury, *COP Hearing with Treasury Secretary Timothy F. Geithner*, at 40 (Apr. 21, 2009) (online at www.cop.senate.gov/documents/transcript-042109-geithner.pdf).
[701] The Panel recognizes that Citigroup and Bank of America have made significant changes in their management team on their own since early 2009.

of America. However, Treasury has not required AIG to submit a forward-looking viability plan, nor was AIG forced into bankruptcy. (This is why AIG's shareholders retain whatever value is left in their shares). Additionally, while Citigroup shareholders have been diluted, AIG shareholders have seen their positions severely diluted (if not nearly wiped out) by the government. This is also in contrast to the treatment of automotive company shareholders, who were wiped out completely.[702] While Treasury may have the power to dilute the other shareholders, it lost the power to eliminate them legally in the absence of bankruptcy proceedings. Because there was no bankruptcy, as discussed in Section E above, creditors of AIG were protected, unlike some creditors of the automotive companies. The parties that fared particularly well from the government's intervention in AIG include those stakeholders who would have lost everything or something on their position, but for the government's rescue. The government's actions, therefore, ensured that many parties that would have received nothing in a bankruptcy were not wiped out.

The perception that AIG received unique treatment is deepened by the fact that AIG was the sole recipient of TARP funding under Treasury's SSFI, which was later renamed the AIG Investment Program (AIGIP). During late 2008 and early 2009—the same period when AIG received substantial government assistance—Bank of America and Citigroup also received multiple rounds of government assistance against a backdrop of imminent insolvency. In addition to receiving $25 billion in funding under the TARP's CPP, Citigroup received $20 billion in TARP funds through the Targeted Investment Program (TIP); it also benefitted from a loss-sharing agreement on a pool of assets that Citigroup identified as some of its riskiest assets, and which was initially valued at up to $306 billion, under a TARP initiative known as the Asset Guarantee Program (AGP). For its part, Bank of America received $15 billion in CPP funds (which was supplemented by another $10 billion under the same program following the closing of its acquisition of Merrill Lynch in January 2009), $20 billion in TARP funds through the TIP, as well as a loss-sharing agreement on a pool of assets that was initially valued at approximately $118 billion but was never finalized.[703] It seems puzzling, however, that the SSFI program, which was established in the fall of 2008 "to provide stability and prevent disruptions to financial markets from the failure of institutions that are critical to the functioning of the nation's financial system," was not used to assist the other "systemically significant" institutions that were also placed on life support, including Bank of America and Citigroup. This also suggests that the government shied away from labeling some of the largest banks as "failing institutions" even as it was trying to prop them up.[704]

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[702] If Treasury were to convert its preferred shares in AIG (which looks increasingly possible), the other shareholders would be diluted beyond their already substantial dilution.

[703] The Panel notes that Bank of America repaid all of its TARP assistance and Citigroup repaid its $20 billion in TIP assistance and terminated the loss-sharing agreement in December 2009.

[704] With respect to the financial health of Citigroup in late October and November 2008, Treasury has stated "[d]ue to the deterioration in confidence, there was concern that, without government assistance, Citigroup would not be able to obtain sufficient funding in the market over the following days," and that "a failure to act to reestablish confidence in Citigroup by providing additional liquidity and an asset guarantee program would have had a significant ad-

But while there are some differences in treatment with respect to AIG and other recipients of exceptional assistance, the Panel also notes that there are some key similarities in the government's treatment of AIG and Citigroup.

As with Citigroup, AIG has undergone substantial corporate restructuring and consolidation, but these changes have been largely driven by internal corporate decision-making and have not occurred at the government's behest. It appears that at least some of AIG's asset disposition plan and focus on its core operations, including the significant wind-down of AIGFP and emphasis on property & casualty and life insurance businesses, preexisted the government's assistance to AIG.[705] Citigroup's asset sales and focus on its core operations, including worldwide retail banking, investment banking, and transaction services for institutional clients, resulted from its first quarter 2009 internal restructuring, when it reorganized itself into Citicorp and Citi Holdings.

In addition, there appear to be some similarities, at least preliminarily, with respect to how the government intends to dispose of its TARP investments in Citigroup and AIG. In February 2009, Treasury announced that it would convert up to $25 billion of its preferred stock holdings in Citigroup into common stock, which would provide additional tangible common equity for Citigroup. On June 9, 2009, Treasury agreed to terms to exchange its CPP preferred stock for 7.7 billion shares of common stock priced at $3.25 per share (for a total value of $25 billion) and also agreed to convert the form of its TIP and AGP holdings.[706] In addition, on July 30, Treasury exchanged its $20 billion of preferred stock in Citigroup under the TIP and its $5 billion investment in the AGP from preferred shares to trust preferred securities (TruPS). The conversion allowed Citigroup to strengthen its capital base by improving its tangible common equity ratio—a key measure of bank solvency—to 60 percent. Pursuant to a pre-arranged written trading plan, Treasury intends to fully dispose of its 7.7 billion common shares of Citigroup over the course of 2010, subject to market conditions.

In a similar fashion, during a recent interview, AIG Chief Executive Officer Robert Benmosche pointed to Treasury's conversion of preferred to common shares with respect to its Citigroup holdings as one possible government exit strategy from AIG.[707] Treasury will likely consider such a conversion as it plans and executes its AIG exit strategy.

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verse effect on U.S. and global financial markets." Congressional Oversight Panel, *Responses to Questions for the Record for Assistant Secretary Herbert M. Allison, Jr.*, at 3 (Mar. 4, 2010) (online at cop.senate.gov/documents/testimony-030410-allison-qfr.pdf).

[705] E-mail from Patricia Mosser, senior vice president, Federal Reserve Bank of New York, to Scott Alvarez of Federal Reserve Board of Governors, among others (Sept. 13, 2008) (FRBNYAIG00508) (referencing that AIG's medium-term plan was to sell approximately "$40 billion of high quality assets, largely life insurance subsidiaries in the US and abroad to raise capital/cash needed to fill the hole. Such a sale of assets would amount to AIG selling approximately 35 to 40% of the company").

[706] On July 23, 2009, Treasury, along with both public and private Citigroup debt holders, participated in a $58 billion exchange, which resulted in the conversion of Treasury's $25 billion CPP investment from preferred shares to interim securities to be converted to common shares upon shareholder approval of a new common stock issuance. The $25 billion exchange substantially diluted the equity holdings of existing Citigroup shareholders and was subject to shareholder approval on September 2, 2009.

[707] Jamie McGee, *AIG Less Reliant on U.S., on Path to Repaying Bailout, CEO Says*, Bloomberg News (Apr. 2, 2010) (online at www.bloomberg.com/apps/news?pid=20601109&sid=az0bouW0eHus).

G. Assessment of the Roles of Treasury and the Federal Reserve

Although Treasury had no regulatory authority to intervene, no failed financial institution resolution authority that might have provided an alternative to bankruptcy, and no fiscal capacity to finance a rescue of AIG in September 2008, Treasury clearly was closely involved in the discussions about the appropriate policy response to the unfolding AIG crisis. Notwithstanding their lack of formal authority to intervene, the Secretary and the President could be expected to be held accountable for the consequences of an AIG failure on the American economy. Likewise, the Federal Reserve Board Chairman and FRBNY President clearly would not have wanted to act without coordinating closely with Treasury and the White House. But in the absence of formal Treasury authority to act, the Federal Reserve Board and FRBNY, were necessarily the lead organizations in responding to the crisis.

FRBNY is owned by its member banks, not the federal government. It routinely acts as the agent of the Federal Reserve Board and System in financial market transactions. Although its purchases of securities are usually financed by the creation of money, not tax collections or borrowing, such money creation is undertaken by the government exercising its authority as sovereign. In that respect FRBNY was using the "taxpayer resources" of the federal government when it extended an $85 billion line of credit to AIG in September 2008. Although Treasury officials from the Bush Administration were unwilling to speak to the Panel in connection with this report, discussions with FRBNY officials confirm that policy officials negotiating with AIG at the time recognized that U.S. taxpayers and not the privately owned FRBNY should receive compensation for the value of the financial assistance being provided to AIG. Consequently, FRBNY required that convertible preferred stock with a value of 77.9 percent of the common stock of AIG be issued to "the United States Treasury," a reference to the general fund of the U.S. government, rather than Treasury.[708] A trust agreement was created to manage Treasury's equity holdings and address the U.S. government's corporate governance role created by this equity position.[709] This arrangement reflects both the absence of authority (at that time) for the Secretary or Treasury to hold the equity, and the inappropriateness of having the central bank of the United States owning and managing the majority of the equity in a very large financial institution.

Even with the enactment of EESA and Treasury's resulting ability to use TARP funds, Treasury continued to accede to a strong role for the Federal Reserve. The actions of FRBNY in using SPVs

[708] The Federal Reserve banks are separate legal entities which operate under the general supervision of the Board of Governors of the Federal Reserve System. Federal Reserve Act § 4, 12 U.S.C. 341 (2006). All banks in the United States are required to be stockholders of the Federal Reserve bank in the region in which the banks are located. 12 U.S.C. 282. The Board of Governors is authorized to exercise general supervision over the Federal Reserve banks. Federal Reserve Act § 11 , 12 U.S.C. 248(i) (2006). In addition, the Board is empowered to delegate functions other than those relating to establishing monetary and credit policies to the Federal Reserve banks. *Id.* at § 248(k).

[709] Panel staff interview with FRBNY General Counsel Thomas Baxter (May 7, 2010). For further discussion of the considerations involved in determining whether a trust arrangement would be advisable, *see* the Panel's September report. September Oversight Report, *supra* note 389, at 88–91.

(ML2 and ML3) to buy AIG's illiquid RMBS and to unwind derivative positions, when Treasury could have used TARP resources to accomplish the same objectives, seem particularly noteworthy. Part of the reason for this arrangement may have been that by this time FRBNY was in a far superior position to act, given its extensive ongoing involvement with resolving the AIG crisis from the outset, whereas Treasury was only beginning to get staff in place in early November. Treasury may also have been agreeable to FRBNY's lead role in light of the fear at that time that a $700 billion TARP could prove inadequate for the multitude of problems that might have needed to be addressed.

At the same time, the heavy reliance upon the Federal Reserve to take actions of an executive leadership and fiscal character raises questions as to what was lost in terms of accountability and transparency. The Federal Reserve's mission is to conduct monetary policy, and it is not well suited to incurring multi-billion dollar obligations of taxpayer resources. In fairness, the leadership of the Federal Reserve may rightly note that its actions in the case of the rescue of AIG were undertaken to fill a void in the government's ability to act, and it did not seek and would have gladly declined the role it played had the executive branch been able to play the role that circumstances demanded.

As discussed above, the Federal Reserve supported AIG through collateralized loans whereas Treasury made investments and loans for which it received preferred stock (convertible to common in most cases). This means that here, as with the "ring-fenced" assets guarantee to Citigroup and other TARP assistance transactions in which Treasury and the Federal Reserve have acted jointly, the Federal Reserve is in the senior or more protected position in the event of losses on the government's loans and investments in assisted institutions. Presumably use of this structure results from the combination of the Section 13(3) limitation on the Federal Reserve's form of assistance, the more flexible options available to Treasury using the TARP, and—at least in this instance—the fact that the Federal Reserve acted first. To avoid being in a lower repayment position, Treasury would have needed to extend secured loans to AIG—despite the adverse impact this would have had on AIG's balance sheet and its classifications by the ratings agencies. In that case, Treasury's exposure to losses in the event of default would have been a function of the quality of its collateral and not the higher priority of the Federal Reserve's position. In this respect, the fact that Treasury actually took a lower relative priority of repayment position means that Treasury's use of TARP resources has effectively protected the Federal Reserve. It also raises the prospect that Treasury may be more risk averse in its management direction and oversight of AIG than the Federal Reserve may be inclined to be. The Panel notes that Treasury and Federal Reserve staff acknowledge the potential differences in incentives here but insist that they in fact act in close coordination and that in practice their interests are completely aligned.

There is also the interesting question about what would happen if AIG fails despite the assistance of both the Federal Reserve and Treasury or had failed during the period when only the Federal Reserve had provided assistance to that firm. How would large losses

on the RCF, the SBF and the ML2 and ML3 have affected the Federal Reserve System's consolidated balance sheet? As the Congressional Budget Office (CBO) has recently noted, the Federal Reserve has generated sharply increased remittances to Treasury since the onset of the financial crisis as its expanded balance sheet and lending programs are producing a surge in earnings.[710] Nevertheless, the extraordinary size of the assistance provided to AIG means that there could have been losses large enough to have had wiped out the Federal Reserve's earnings for some period. The Federal Reserve has never run a loss and its capital surplus at the end of 2009 stood at over $50 billion. But its exposure to AIG and other financial rescue programs are unprecedented and policymakers may want to give more consideration as to how any possible losses should be managed in the current episode and any future financial crisis.

The actions of the Federal Reserve in the AIG rescue also serve to illustrate the importance of established procedures for executing financial transactions in the federal government. Such actions are made transparent through a formal budget process involving both the President and the Congress, which must explicitly authorize beforehand—and, in many cases, separately appropriate funds to cover—the fiscal transactions undertaken in the executive branch. Use of the Federal Reserve to undertake key transactions without such prior approval by the President and the Congress, as occurred in the case of AIG, while convenient to both the Federal Reserve and Treasury at the time, may have sacrificed longer-term accountability and transparency. Treasury's use of the TARP has been and continues to be held up to close scrutiny and subject to multiple oversight mechanisms, of which the Panel's reports and hearings are but one example. While the Federal Reserve has provided a large amount of reporting and information concerning its actions during the crisis, comparable oversight is not mandated by statute in the case of the actions of the Federal Reserve.[711]

H. Current Government Holdings and Their Value

AIG's outlook remains uncertain. While the potential for the Treasury to realize a positive return on its significant assistance to AIG has improved over the past 12 months, it still appears more likely than not that some loss is inevitable. The long-term horizon for a full government exit, with attendant equity market and company operating risks, further clouds this outlook. The size of any loss is unknowable at present and is, of course, dependent on a host of external factors. It is also dependent on the various inputs used to calculate the government's investment in the firm, such as the value of the Series C equity stake, forgone interest and dividend payments, and the ML2 and ML3 vehicles. Both AIG and Treasury, however, have generally expressed varying degrees of op-

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[710] Congressional Budget Office, *The Budgetary Impact and Subsidy Costs of the Federal Reserve's Actions During the Financial Crisis*, at 4–5 (May 2010) (online at cbo.gov/ftpdocs/115xx/doc11524/05-24-FederalReserve.pdf) (hereinafter "CBO Study").

[711] On May 20, 2009, subsequent to the major events discussed in this report, the Helping Families Save Their Homes Act was enacted. Among other provisions, this Act provides expanded authority to the Government Accountability Office to audit the actions taken by the Federal Reserve under Section 13(3) of the Federal Reserve Act during the financial crisis. *See* Helping Families Save Their Homes Act of 2009, Pub. L. No. 111–22, § 801(e).

timism on repayment prospects. AIG expects to fully repay its obligations to the government, while Treasury is generally hopeful that the government can ultimately recoup a significant portion of its investment.[712] In any case, both parties share an interest in bringing an end to the government's involvement with AIG as soon as possible.

While the Panel recognizes the danger in a prolonged investment strategy, political expediency should not trump the opportunity for taxpayers to realize as much value as possible from their investment.[713] Thus, the Panel cautions against a rapid exit in the absence of clearly defined parameters for achieving the maximum risk-adjusted return to the taxpayer. Nonetheless, given the significant equity market and company execution risks involved in a long-term, back-end-loaded exit strategy, the Panel believes that the government's exposure to AIG should be minimized (and shifted to private shareholders) where possible via accelerated sales of a small minority of the government's holdings, provided this can be done with limited harm to the share price. In this sense, the interests of AIG's government and private shareholders are aligned, as the taxpayer is best served by enhancing value before a broader exit strategy via the public markets can be executed.

This section and Section I below outline the value of the government's AIG holdings and potential scenarios for recovery. There is a debate in the marketplace about AIG's valuation, and thus the potential for taxpayers to see a return on their investment. The Panel's analysis outlines various valuation and exit scenarios, and their consequent impact on the recovery value of the government's investments. A rigorous valuation analysis of AIG is beyond the scope of the Panel's mandate, so this analysis focuses on the key factors informing the debate on AIG's valuation and the potential for the government to monetize its investment under various scenarios.

1. Market's View of AIG's Equity

Trading at $34.07 per share, the equity market currently values AIG at $22.8 billion.[714] While down considerably from the firm's peak split-adjusted share price of $1,456, the stock is trading above

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[712] Congressional Oversight Panel, Testimony of Jim Millstein, chief restructuring officer, U.S. Department of the Treasury, *Transcript: COP Hearing on TARP and Other Assistance to AIG* (May 26, 2010) (publication forthcoming) ("[I]t seems very likely that the $83 billion dollars of outstanding Fed support will be paid in full. Similarly, at current market prices, the common stock that the Series C represents has value. The Treasury Department has $49 billion dollars outstanding in Series E and F Preferred. And as I said in my testimony, the recovery on that will depend on the performance of the remaining businesses and how those businesses are valued in the market at the time"); Congressional Oversight Panel, Testimony of Robert Benmosche, president and chief executive officer, American International Group, Inc., *Transcript: COP Hearing on TARP and Other Assistance to AIG* (May 26, 2010) (publication forthcoming) ("I believe that we will pay back all that we owe the U.S. Government. And I believe at the end of the day, the U.S. Government will make an appropriate profit").

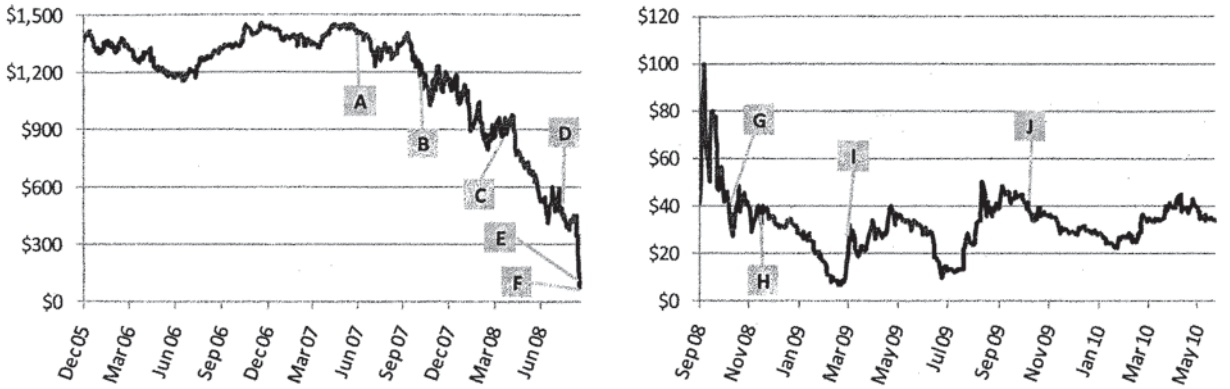
[713] Broader costs to the economy and the competitive landscape stemming from the protracted government ownership of a large for-profit company, while outside the scope of this report, should also be addressed in the government's risk/reward calculus, whenever possible.

[714] AIG's market capitalization is based on a total of 668 million common shares outstanding, which includes both the 135 million existing common shares and the government's Series C stock held in trust. These shares have not yet been converted into common stock, but conversion at some point is almost certain. Most analysts therefore include these shares in calculating AIG's equity market capitalization. AIG's closing stock price was $34.07 as of June 7, 2010. Bloomberg (accessed June 7, 2010).

the lows witnessed in late 2008 and early 2009.[715] AIG currently trades at almost five times its lowest closing price of $7 on March 9, 2009.[716] For the year-to-date period, the stock price is up approximately 14 percent.[717] Not surprisingly, this rebound over the prior 15 months or so has coincided with increased optimism concerning the potential for the government to recoup a significant portion of its investment. In the meantime, the share price remains volatile, befitting a stock with a limited public market floatation and elevated interest among short sellers.[718] Figure 25 illustrates the precipitous decline in AIG's stock price through early 2009, followed by its more recent improvement.

[715] Adjusted for 1 for 20 reverse stock split.
[716] Bloomberg (accessed June 7, 2010).
[717] Panel staff calculation from Bloomberg data (accessed June 7, 2010).
[718] The government's 79.8 percent stake of the diluted shares outstanding do not trade in the public market. According to Bloomberg, the float is 117.25 million shares (accessed June 7, 2010).

FIGURE 25: AIG STOCK PRICE: DECEMBER 30, 2005 TO AUGUST 16, 2008 (LEFT) AND AUGUST 17, 2008 TO JUNE 7, 2010 (RIGHT) [719]



KEY	
A June 2007: Two Bear Stearns hedge funds with CDO exposure suffer significant losses	**E** 9/15/08: Lehman Brothers collapse
B 10/9/07: Dow reaches all-time high; October 2007: Merrill Lynch and Citigroup report losses tied to CDO exposure	**F** 9/16/08: Fed offers AIG $85 billion credit facility
C 3/16/08: Bear Stearns sold to JPMorgan for $2/share	**G** 10/3/08: EESA passed, Moody's downgrades AIG
D 8/6/08: AIG reports loss of $14 billion on CDS	**H** 11/10/08: Maiden Lane III established by FRBNY
	I 3/2/09: Treasury restructures AIG agreement to offer a $30 billion capital facility
	J 8/7/09: AIG posts first profit since 2007

[719] SNL Financial. Price data updated through June 7, 2010.

According to market participants, many institutional investors believe that there is too much uncertainty to take a position on the outlook for AIG shares. The firm's limited public float and government ownership are additional complicating factors.[720] For those who are taking a position, the key debate focuses on the capacity for shareholders to realize any residual value should AIG succeed in repaying the government.[721]

In this context, some analysts have suggested that the government may choose to grant AIG concessions in order to mitigate potential losses on its investment. Although AIG claims that it does not need concessions to repay the government, this is not universally believed and in fact has not been the case to date. For example, the government has both formally (in agreeing to less onerous financing terms on three separate occasions)[722] and informally (by forgoing dividend payments on preferred shares) sought to mitigate the financial strain on AIG.

While one could argue that such moves amounted to "backdoor concessions," AIG's fragile financial position works against a hardline stance by the company's principal shareholder. The government's decision to forgo its right to non-cumulative dividends on its preferred equity stake equates to a nominal forfeiture of just under $5 billion annually.[723] Jim Millstein, chief restructuring officer at Treasury, asserted at the Panel's May 26, 2010 hearing that AIG's earnings are currently "insufficient to support a preferred dividend."[724] In any case, given that the government owns nearly 80 percent of the diluted shares outstanding (assuming conversion of the Series C)—or over 90 percent if the E and F preferred shares are exchanged for common stock—capital retained by AIG to sta-

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[720] Few actively-managed investment funds own sizable long positions in AIG shares. The top five shareholders, outside of the U.S. government are: Fairholme Capital Management, which holds a long investment on approximately 6 percent of AIG shares; Starr International, Hank Greenberg's company, which owns 2 percent; and two index funds, Vanguard Group Inc. and State Street Corp., which own 1.5 percent in the aggregate. Including the U.S. government's holdings, these six holders account for almost 90 percent ownership of outstanding AIG shares. Fairholme Capital Management, LLC, *Schedule 13G Statement of Acquisition of Beneficial Ownership by Individuals* (Apr. 12, 2010) (online at www.sec.gov/Archives/edgar/data/5272/000091957410002876/d1087362__13g.htm); Fairholme Capital Management, LLC, *Form 13F for Quarterly Period Ending March 31, 2010* (May 14, 2010) (online at www.sec.gov/Archives/edgar/data/1056831/ 000105683110000003/submisson.txt); Starr International Co., Inc., *Form 4 Statement of Changes in Beneficial Ownership of Securities* (Apr. 28, 2010) (online at www.sec.gov/Archives/edgar/data/5272/000114036110017797/ xslF345X03/doc1.xml); Vanguard Group Inc., *Form 13F for Quarterly Period Ending March 31, 2010* (May 6, 2010) (online at www.sec.gov/Archives/edgar/data/102909/ 000093247110002093/march2010vgi.txt); State Street Corp., *Form 13F for Quarterly Period Ending March 31, 2010* (May 17, 2010) (online at www.sec.gov/Archives/edgar/data/93751/ 000119312510121662/d13fhr.txt); Data accessed through Bloomberg Data Service.

[721] There are few recent publicly available valuation analyses of AIG. Citations are limited to publicly available analyst reports and do not include Panel staff conversations with a broader universe of market participants, including sell-side and buy-side analysts. For a published, relatively bullish analysis of this type, *see, e.g.*, UBS Investment Research, *Potential Pluses & Minuses = Neutral* (Apr. 28, 2010) (hereinafter "UBS Analysis"). For a published, relatively bearish analysis of this type, *see, e.g.*, Keefe, Bruyette & Woods, An Update on AIG (Apr. 27, 2010) (hereinafter "Keefe, Bruyette & Woods Analysis").

[722] The government restructured AIG's debt on three separate occasions: 1) November 10, 2008; 2) March 2, 2009; and 3) April 17, 2009. Generally these restructurings were conducted in order to mitigate the company's debt burden and prevent additional credit downgrades from the ratings agencies. For a detailed discussion of these debt restructurings, see Section D.2–5, *supra*.

[723] Treasury is entitled to non-cumulative cash dividends at a rate of 10 percent per annum on its $49.1 billion in Series E and F preferred shares.

[724] Testimony of Jim Millstein, *supra* note 44.

bilize its business should ultimately accrue to its largest shareholder.

Although the prospect of additional concessions has been openly debated by market participants, the Panel sees little evidence that the Administration, Congress, or the public would or should support such a strategy in the absence of compelling and clear-cut evidence that it was in the best interest of the taxpayer. Treasury officials have strongly asserted that additional concessions are unnecessary and not in the offing.[725]

Bullish investors take the view that AIG, provided it has the time to maximize the value of its core operations, can repay the government and have sufficient value to build a long-term franchise. These investors see the valuations offered for AIA and ALICO (albeit, in the case of AIA, ultimately withdrawn) as supportive of their outlook. They also believe that rising industry-wide valuations in the context of an improving economy will continue to support their investment strategy. A more measured pace to forthcoming asset sales—as opposed to a fire-sale approach—increases the value of the call option on AIG shares, according to one market participant.[726] This stance is to some extent backstopped by the belief among some market participants that the government will either forgive or restructure a portion of AIG's debt, to help facilitate its independence from government support.

Bearish investors, on the other hand, believe that the math simply does not work. They assert that the government is unlikely to offer concessions with respect to the company's outstanding debt and that, even if AIG succeeds in paying off the government, it does not have sufficient franchise value to support the current stock price. This view is reinforced by a more skeptical take on the underlying strength of AIG's operations, with most critical investors citing potential problems arising from legacy mismanagement, such as low reserve ratios and the potential for the unraveling of intercompany linkages, impacting the holding company's debt financing needs. Accordingly, many bearish investors believe that AIG has a negligible or negative net worth, a view that AIG contests (see footnote below for AIG rebuttal to claims of one bearish analyst).[727] The current 12-month price target consensus among analysts, including those with a relatively positive view, is $23,

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[725] Testimony of Jim Millstein, *supra* note 44. Mr. Millstein stated that the Panel "can be certain" that the government will not grant AIG any concessions, such as forgiving its debt, when the government exits its position in AIG. Panel staff briefing with Jim Millstein, chief restructuring officer, U.S. Department of the Treasury (May 17, 2010).

[726] Panel staff conversations with market participants.

[727] *See* Keefe, Bruyette & Woods Analysis, *supra* note 721; Congressional Oversight Panel, Testimony of Clifford Gallant, managing director of property and casualty insurance research, Keefe, Bruyette & Woods, *COP Hearing on TARP and Other Assistance to AIG* (May 26, 2010). In conversations with Panel staff on June 5, 2010, Brian Schreiber, AIG's senior vice president of strategic planning, disputed certain aspects of Mr. Gallant's April 27, 2010 report (and subsequent testimony). Among the items highlighted, AIG asserts that the report (1) understates the company's pro forma book value by excluding the value of the E/F preferred shares (on a converted basis); (2) overstates the company's leverage and debt load by including Treasury's E/F preferred shares in this category; (3) excludes the earnings of several AIG subsidiaries, including the Japan-based Star and Edison life insurance companies; and (4) calculates valuation based on assigning below-market multiples to Q4 2009 earnings streams, which AIG claims may not accurately represent the earnings power of the firm.

well below the stock's recent trading range of $30 to $45 per share.[728]

2. Residual Value of AIG: The Parameters of Debate

The key parameters of the debate regarding AIG's value reflect estimates regarding its residual value. As outlined in Figure 26 below, the company owes the government $100.8 billion:[729] $26.1 billion for the RCF,[730] $25.6 billion for FRBNY's interest in the AIA and ALICO SPVs, and $49.1 billion for the TARP preferred stock (which conceivably could be removed from the liabilities column if exchanged for common equity). AIG also has $43.9 billion of private debt outstanding. The company's total obligations are thus $144.7 billion.[731] AIG's announced asset sales are expected to yield about $55 billion in proceeds, reducing the company's obligations to the government to about $47 billion and its total obligations to roughly $90 billion.[732] Analysts estimate that Chartis, AIG's domestic property & casualty insurance group, and SunAmerica, its domestic life insurance group, together would command a valuation in the range of $45 billion-$60 billion, which would leave a gap of approximately $35 billion-$40 billion to reach par.[733] Thus, the value of AIG's core franchise, plus the remaining assets slated for sale, and AIG's stake in ML2 and ML3 must exceed the balance owed to the government and private bondholders to suggest any residual value to the company's equity. This is shown in Figure 26 below, which represents AIG's obligations less estimated asset sale proceeds. (This analysis excludes the Trust's Series C equity stake, which is currently valued at $18.2 billion. As these shares did not represent a direct outlay by the government, the value of this investment represents something of a wild card in calculating potential returns to the government.)

FIGURE 26: CALCULATION OF AIG RESIDUAL FRANCHISE VALUE

[Dollars in billions]

AIG Obligations	
FRBNY:	
FRBNY Revolving Credit Facility	$26.1
Preferred Interest in AIA and ALICO	25.6
Total	51.7
Treasury:*	
TARP Series E Preferred	41.6

[728] Bloomberg (accessed June 7, 2010). Trading range covers period of April 1, 2010 to June 7, 2010.

[729] This total reflects only the government's investment in AIG itself, and does not include FRBNY's investments in the Maiden Lane entities.

[730] Federal Reserve H.4.1 Statistical Release, *supra* note 342 (accessed June 4, 2010).

[731] American International Group, Inc., *Form 10–Q for the Quarterly Period Ended March 31, 2010*, at 5, 82 (May 7, 2010) (online at www.sec.gov/Archives/edgar/data/5272/000104746910004918/ a2198531z10-q.htm) (hereinafter "AIG Form 10–Q for the First Quarter 2010").

[732] AIG's President and CEO Robert Benmosche indicated that AIG intends to use the sale proceeds to repay FRBNY. Testimony of Robert Benmosche, *supra* note 28. The Panel assumes that AIG will use the sale proceeds to completely repay FRBNY for both its preferred interest in AIA and ALICO and the Revolving Credit Facility.

[733] *See, e.g.*, UBS Analysis, *supra* note 721, at 3; Keefe, Bruyette & Woods Analysis, *supra* note 721, at 2.

FIGURE 26: CALCULATION OF AIG RESIDUAL FRANCHISE VALUE—Continued

[Dollars in billions]

TARP Series F Preferred	7.5
Total	49.1
Total Obligations to Government	**100.8**
Other Debt:	
AIG Private Debt [734]	43.9
Total Obligations to Government & Private Sector	**144.7**
Assets Slated for Sale	
AIA	32.5
ALICO	16.2
Other Completed and Pending Asset Sales	6.1
Total Value of Assets Slated for Sale	**54.8**
Total Obligations of AIG	**144.7**
Total Value of Assets Slated for Sale	**−54.8**
Residual Franchise Value* (amount all other assets must be worth for AIG to have positive net worth)	**89.9**

*Note: TARP Series E/F Preferred could potentially be exchanged for equity, reducing AIG's obligations and producing a lower Residual Franchise Value.

[734] See Figure 32. Analyst estimates of AIG's private debt vary widely. Some analysts do not include the ''match funded'' debts of AIG's Matched Investment Program (MIP) or fully-collateralized debt within AIGFP, while other analysts include one or both of these instruments, in addition to certain debt within subsidiaries, including all or a portion of the debts of AIGFP that are guaranteed by the parent company. COP analysis includes the ''Debt Issued by AIG'' from AIG's financial statements, which includes the MIP and AIGFP match funded debts, but not the AIGFP debts guaranteed by AIG. This yields a figure of $43.9 billion for private debt, which is approximately in the middle of the range of recent analyst estimates.

Whether the company's remaining assets are worth more than $90 billion is an open question, although the role of the government in this process, and how it might seek to recoup its investment, which is discussed below, helps to inform this analysis.[735] The primary variables in calculating AIG's residual value are outlined below in Figure 27, which provides a baseline overview of three potential valuation scenarios for key AIG components. These scenarios—base, bull, and bear—reflect inputs with respect to the value of AIG's core and non-core operations and investments, conditions in the insurance industry, the health of the capital markets, legacy AIGFP asset valuations, and the company's potential return from its equity contribution to ML3. As the differing views in the market underscore and the scenarios below illustrate, there is significant room for debate on the value of AIG's core and non-core assets, and the company's corresponding ability to repay the government. It is likely that there are also fundamental differences in assumptions among investors, AIG, and the government about the company's core earnings potential (reflecting differences between current versus "expected" earnings assumptions) and the application of valuation multiples, since current industry multiples (in-

[735] However, the government will not likely play a role in collecting taxes from AIG for an extended period, given that as of March 31, 2010, AIG reported a net deferred tax asset of $8.2 billion, which can be used as an offset of future income tax expense and represents an amount deemed more likely than not to be realized. AIG's net deferred tax asset valuation incorporates the effect of deferred tax liabilities, the carryforward periods for any net operating loss carryforwards (of which AIG had $35.2 billion as of December 31, 2009 and which carryforward 20 years from the date incurred), and certain transactions expected to be completed in future periods. American International Group, Inc., *Form 10–Q for the Quarterly Period Ended March 31, 2010*, at 80–81 (May 7, 2010) (online at www.sec.gov/Archives/edgar/data/ 5272/ 000104746910004918/a2198531z10-q.htm). AIG Form 10–K for FY09, *supra* note 50.

cluding AIG's absolute and relative valuation) are meaningfully below historical averages.

The "Total vs. Residual Value" line in Figure 27 below compares the total value of AIG's core and non-core businesses to the Residual Franchise Value from Figure 26 above. Excluding the $49 billion from the Series E/F preferred, which may be exchanged for equity in the future, yields positive values in all three scenarios, versus a negative base scenario if the Treasury's preferreds are included in AIG's obligations.

FIGURE 27: BULL/BEAR/BASE SCENARIO FOR AIG VALUATION VS. RESIDUAL VALUE [736]

[Dollars in billions]

Assets	Base Scenario	Bull Scenario	Bear Scenario
AIG Core Operations (Chartis/SunAmerica)	$49	$61	$36
Non-Core Assets (ILFC, AGF, ML3, etc.)*	24	30	18
Total Value	**$72**	**$91**	**$54**
Total vs. Residual Value	(18)	(0)	(36)
Total vs. Residual Value (excl. Series E/F)	31	49	13

* Note: Excludes AIA and ALICO

[736] Inputs for base valuations reflect a compilation of sell-side and buy-side analysts' estimates. Base values for AIG Core Operations and Non-Core Potential Sales are the average of estimates provided by UBS, KBW, and two buy-side investors. UBS Analysis, *supra* note 721, at 3; Keefe, Bruyette & Woods Analysis, *supra* note 721, at 10. Bull and Bear scenarios illustrate base case scenarios by 25 percent in each direction.

This analysis yields a range of values from $(21) billion to $10 billion versus residual value. The exclusion of the preferred obligations produces positive values in the three scenarios, ranging from $13 billion to $49 billion.

3. Administration and CBO Subsidy Estimates

Market estimates of the residual value of AIG generally imply a more favorable recovery rate in comparison with the subsidy estimates published by the CBO and OMB. The CBO's current estimate of the subsidy cost for the AIG portion of the TARP is $36 billion.[737] The OMB's most recent estimate is $50 billion.[738] Treasury published a TARP financial update on May 21, 2010 showing that the Administration now estimates that TARP will lose $45.2 billion overall on its TARP investments, including its numerous non-AIG investments.[739] CBO, OMB and Treasury all assume that the full $69.8 billion in TARP funding that has been committed to AIG will fully be utilized, although only $49.1 billion has actually been disbursed to date. The Federal Reserve is not included in the federal budget, but CBO recently estimated a subsidy cost of $2 billion for the Federal Reserve's RCF for AIG at the time the loan was extended (September 16, 2008). While CBO did not produce a current subsidy estimate, the fact that they now estimate that the

[737] Congressional Budget Office, *Report on the Troubled Asset Relief Program—March 2010*, at 3 (Mar. 2010) (online at www.cbo.gov/ftpdocs/112xx/doc11227/03-17-TARP.pdf).

[738] Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2011*, Analytical Perspective, Chapter 4, at 39–40 (online at www.whitehouse.gov/omb/budget/fy2011/assets/budget.pdf) (accessed June 9, 2010).

[739] U.S. Department of the Treasury, *Summary Tables of Troubled Asset Relief Program* (TARP) Investments as of March 31, 2010, at 1 (May 21, 2010) (online at www.financialstability.gov/docs/TARP%20Cost%20Estimates%20-%20March%2031%202010.pdf). *See also* U.S. Department of the Treasury, Projected TARP Costs Reduced by $11.4 Billion (May 21, 2010) (online at www.financialstability.gov/latest/pr__05212010b.html).

RCF will produce $12 billion in interest income with minimal losses and that ML2 and ML3 investments will generate $4 billion in income implies that the government will realize a net gain from the Federal Reserve's financial transactions with AIG.[740] Consequently, it is possible that the Fed will make a profit on its support of AIG while Treasury endures a loss.

The TARP subsidy calculations of both agencies make use of market data for traded financial instruments of AIG, such as subordinated debt and preferred stock, to calculate market expectations and implied loss rates on the TARP investment. CBO's methodology involves analyzing preferred stock price data for AIG and the risk premium that appears to be reflected in that data. The risk premium is further analyzed to estimate an implied loss rate probability embedded in that premium. The resulting subsidy rate of 52 percent, which reflects potential losses as well as other factors, is then applied to the total funding available ($69.8 billion) to produce the subsidy estimate of $36 billion.

OMB's subsidy estimate is based upon a methodology developed in coordination with Treasury's Office of Financial Stability. It uses price data for AIG subordinated debt and adjusts that data to reflect the lower priority position of AIG preferred shares relative to subordinated debt. The adjustment used for the 2010 Budget was based upon the relative prices for subordinated debt and preferred stock of an institution that was in a similarly stressed situation at the time of the estimate, namely the CIT Group. For the 2011 Budget subsidy rate, the adjustment was based upon market data for Citigroup stock and debt. Similar to CBO, OMB used the resulting adjusted prices for AIG preferred stock to produce derived market implied loss rates and resulting credit subsidy rates of 83 percent for 2010 and 62 percent for 2011.

The Credit Reform Act of 1990 requires OMB to continue using its initial subsidy estimate—in this case from the 2010 Budget published in May 2009—for obligated funds until these funds have actually been disbursed.[741] Because most of the funds obligated for AIG Series F preferred stock purchases had not been disbursed by the time that the Administration's 2011 Budget was published in February 2010, OMB and Treasury were required to use their earlier 2009 estimates for a substantial portion of their latest subsidy estimate. Hence, OMB's most recent subsidy cost estimate of $50 billion incorporates a blend of the subsidy rate calculations over two years. This in large part accounts for the different subsidy estimates of the two agencies as they otherwise use similar methodologies based upon market data for AIG debt and preferred stock.

I. Exit Strategies

This section provides an overview of Treasury's exit strategy and the corresponding effort by AIG to improve its business operations, which will factor heavily in both the timing and amount of funds Treasury will recover from its investment. Section I.1 outlines the key challenges facing Treasury as it looks ahead to monetizing its investment in AIG. Section I.2 addresses AIG's current restruc-

[740] CBO Study, *supra* note 710, at 13–14.
[741] Federal Credit Reform Act of 1990 (FCRA), 2 U.S.C. 661 (1990).

turing efforts, the pace and success of which will weigh heavily on the outcome for the taxpayer. Section I.3 highlights Treasury's exit plan and its outlook on AIG's restructuring process, recent earnings, and near-term business risks that could delay the current timetable.

Despite some recent challenges, both AIG and Treasury believe that it is likely that the company will be able to fully repay FRBNY in 2010, which is senior to the company's TARP obligations. More significantly, both the company and Treasury have grown increasingly confident in recent months regarding the possibility (in the case of Treasury) or the expectation (in the case of AIG) of full repayment of Treasury's assistance.[742] Ultimately, the outlook for taxpayers is contingent on the long-term prospects for AIG, and the ability of the current management team to produce strong operating results ahead of the commencement of an expected exit strategy by Treasury in 2011.[743] Market observers and government officials generally agree that Mr. Benmosche's target for annualized earnings of approximately $8 billion would constitute sufficiently strong earnings (core earnings within AIG's primary ongoing P&C and Life Insurance businesses are currently approximately $6 billion, annualized for first quarter 2010 results).[744] In addition, a more transparent company structure would help facilitate access to the capital markets, allowing AIG to emerge as a stand-alone investment grade insurance company capable of repaying the government's investment.[745]

1. Overview

Figure 28 below outlines the current market value of the government assets to be unwound in conjunction with an exit from AIG. The government has expended $100.8 billion in total direct assistance to AIG (excluding investment in ML2 & ML3), but its current investment value is $119 billion, reflecting the additional value of the Series C shares. Assuming FRBNY is paid in full, Treasury's subordinate position represents $49.1 billion in preferred debt securities (Series E & F), and includes the value of the Series C shares (which fluctuates based on the share price of AIG), a $67.3 billion investment value.[746]

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[742] Although Treasury is clearly more confident versus the year-ago period, recent complications associated with the AIA transaction as well as a more challenging capital markets backdrop have perhaps justified a more calibrated assessment of the factors impacting the potential for full repayment. Testimony of Jim Millstein, *supra* note 44; Testimony of Robert Benmosche, *supra* note 28.

[743] Testimony of Jim Millstein, *supra* note 44 ("[T]he objective of the restructuring plan is to restructure AIG's balance sheet and business profile so that it can maintain this status on its own, thereby permitting the government to monetize the taxpayers' investment").

[744] Includes General Insurance (Chartis), Domestic Life Insurance & Retirement Services, and Foreign Life Insurance & Retirement Services. AIG Form 10–Q for the First Quarter 2010, *supra* note 731, at 114.

[745] Testimony of Robert Benmosche, *supra* note 28 ("[W]e have a company that can earn between $6 and $8 billion dollars after taxes * * * we want very clear discreet businesses that we can see what they are, where we can see their financials. And therefore, we can go to the capital markets for that insurance company"); Testimony of Jim Millstein, *supra* note 44 (Mr. Benmosche is an "experienced insurance executive...h[e] is confiden[t] that he can get Chartis and SunAmerica Financial to an $8 billion dollar net after tax earning. If he can do that, we're going to be paid in full").

[746] $67.3 billion assumes $49.1 billion for preferreds and $18.2 billion for Series C shares (based on conversion and sale at AIG's current market value of $34.07 per share as of June 7, 2010).

FIGURE 28: SUMMARY OF GOVERNMENT INVESTMENTS IN AIG [747]

[Dollars in billions]

Assets	Estimated Value
FRBNY:*	
FRBNY Revolving Credit Facility	$26.4
Preferred Interest in AIA and ALICO	25.6
Treasury:	
TARP Series E Preferred	41.6
TARP Series F Preferred	7.5
TARP Series E Warrants	0.0
TARP Series F Warrants	0.0
Series C Shares (Held in Trust):	
Series C Convertible Preferred	18.2

* Note: This table does not include ML2 and ML3.
[747] Value of FRBNY Revolving Credit Facility as of May 27, 2010. Series C valuation adjusted for equity market value as of June 7, 2010.

Until very recently, AIG had intended to repay FRBNY's investment with proceeds from the sale of its Asian subsidiaries, AIA and ALICO. On June 2, 2010, the announced sale of the larger of these two entities, AIA, to the British insurance giant Prudential for $35.5 billion,[748] was cancelled due to differences over price (discussed further in Section I.3). Nevertheless, Treasury officials have indicated to the Panel that they believe that AIG will be able to realize value equivalent to the $35.5 billion negotiated sale price through an alternate strategy, perhaps involving an IPO on the Hong Kong Stock Exchange.[749] However, there is a higher risk premium to this strategy given the potential for equity market and AIA operating risks (although operating results have improved in recent quarters) to weigh on an IPO valuation and subsequent secondary offerings to fully dispose of AIG's ownership interest.

Full repayment of Treasury's TARP investment and charting a course for a viable long-term strategy will demand additional actions that are not completely clear. Media reports and Treasury conversations with Panel staff affirm that the company intends to outline a more coherent strategy to repay its government assistance in the near future.[750] Assuming the ALICO sale is finalized and an IPO or other strategic action for AIA is clarified in the third or fourth quarter of 2010, it is probably fair to assume that an exit strategy will emerge before 2011. Treasury candidly acknowledged the necessity for AIG to move forward with unveiling a strategy in the coming months.[751] Working from the assumption that Treasury expects to recoup a substantial portion of its $49.1 billion cost basis (with full realization of its current investment value of $67.3 billion an aspirational target), it is likely that Treasury will seek to convert its preferred interest into common equity shares (consistent

[748] AIG Statement on $85 Billion Secured Revolving Credit Facility, *supra* note 501.
[749] Panel staff conversation with Jim Millstein, chief restructuring officer, U.S. Department of the Treasury (June 2, 2010). An AIA IPO was reportedly AIG's original divestiture strategy prior to the Prudential offer, and now appears to be the likely scenario since the planned sale to Prudential collapsed. *See* Andrew Peaple, *AIA Needs Polishing Before IPO,* Wall Street Journal (June 2, 2010) (online at online.wsj.com/article/SB10001424052748703561604575281771117418324.html?mod=WSJ_Heard_LEFTTopNews).
[750] Panel staff conversations with Jim Millstein, chief restructuring officer, U.S. Department of the Treasury (May 17, 2010 and June 2, 2010). *See also* Joann S. Lublin and Serena Ng, *Board Panel at AIG Hires Rothschild,* Wall Street Journal (May 12, 2010) (online at online.wsj.com/article/SB10001424052748703565804575238760116921430.html).
[751] Panel staff conversation with Jim Millstein, chief restructuring officer, U.S. Department of the Treasury (June 2, 2010).

with AIG boosting its balance sheet to support an investment grade credit rating), and then pursue a strategy aimed at selling the stake in the public markets over an extended time horizon. An exit that is perceived as overly hasty risks creating a run on the stock, as shareholders try to get out before the government converts its preferred stake to common equity, in order to avoid massive dilution.[752]

a. The Long Good-Bye

The baseline approach is for Treasury to seek to exit AIG over several years. The model for this approach will likely be Citigroup.[753] A conversion of the preferred shares into common equity may prove more difficult for Treasury to execute with AIG, though, given AIG's publicly traded float of $4 billion and a government equity stake that could conceivably amount to approximately $70 billion (full conversion of Series C, E & F at current market prices).[754] Thus, absent a capital raise by AIG to repay Treasury directly, a protracted wind-down of Treasury's stake seems inevitable.[755] Presumably, some amount of Series C sales will commence ahead of the exchange of Treasury's E and F preferred shares for common equity in order to improve liquidity and avoid the government's stake in AIG moving above 80 percent.[756]

Although neither AIG nor Treasury has announced a timeline for the government's exit, assuming Treasury converts its preferred

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[752] Panel staff discussions with Treasury officials, AIG executives, and stock analysts did not yield a consensus as to what extent the market is pricing in the potential for significant dilution in AIG shares. Market clarity on this front is hindered by the stock's very limited public float.

[753] The government's investment in Citigroup and the subsequent exit strategy is discussed in Section F.8, *supra*. The Panel's January 2010 report contains a discussion of the government's Citigroup exit strategy, including the monetization of the preferred shares under the TARP Capital Purchase Program (CPP). *See* January Oversight Report, *supra* note 637, at 34–64.

On December 22, 2009, Citigroup repaid $20 billion in TARP funds it received under the TIP. Citigroup issued $20.5 billion of new debt and equity to raise money to repurchase Treasury's $20 billion of TruPS through the selling of $17 billion of new common stock and issuing $3.5 billion of other debt and equity. Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress,* at 73 (Jan. 30, 2010) (online at www.sigtarp.gov/reports/congress/2010/January2010__Quarterly__Report__to__Congress.pdf) (hereinafter "SIGTARP Quarterly Report to Congress").

On July 30, 2009, Treasury agreed to exchange $25 billion in Citigroup preferred shares it had received under the Capital Purchase Program (CPP) for 7.7 billion shares of common stock priced at $3.25 per share. U.S. Department of the Treasury, *Exchange Agreement dated June 9, 2009 between Citigroup Inc. and United States Department of the Treasury,* at Schedule A (June 9, 2009) (online at www.financialstability.gov/docs/agreements/08282009/Citigroup%20Exchange%20Agreement.pdf). On March 29, 2010 Treasury announced its intention to sell the 7.7 billion in common shares in an "orderly and measured fashion" over the course of 2010, subject to market conditions. U.S. Department of the Treasury, *Treasury Announces Plan to Sell Citigroup Common Stock* (Mar. 29, 2010) (online at www.financialstability.gov/latest/pr__03282010.html).

On May 26, 2010, Treasury completed a sale of 19.5 percent of its holdings of Citigroup common stock. Treasury sold 1.5 billion shares for approximately $6.2 billion. U.S. Department of the Treasury, *Treasury Announces Plan to Continue to Sell Citigroup Common Stock* (May 26, 2010) (online at www.financialstability.gov/latest/pr__05262010b.html).

[754] As mentioned above, the Series C shares are convertible into common stock, while the E and F shares are not. Nevertheless, the exchange of the E and F shares for an equivalent dollar amount of common shares is a likely exit strategy. References to "conversion" hereafter refer both to the conversion of C shares and the exchange of E and F shares.

[755] On December 9, 2009, Bank of America repaid $45 billion in TARP funds ($25 billion from the Capital Purchase Program (CPP) and $20 billion from the TIP. Bank of America repurchased its preferred shares using capital it raised in a securities offering plus excess cash it generated through normal business operations. In the securities offering, Bank of America raised a total of $19.3 billion in the securities offering by selling 1.29 billion shares (equivalent to common equity) for $15 each. SIGTARP Quarterly Report to Congress, *supra* note 753, at 55.

[756] See note 265, *supra*, for an explanation of why the government chose an ownership percentage of just under 80 percent.

shares to common equity by early 2011, Treasury will likely remain a significant shareholder in AIG through 2012 as it sells down its stake over the next 12 months or so. This protracted timeline, of course, involves substantial equity market risk and will rely heavily on AIG building a sustainable franchise value over the medium term in order to support an increased supply of shares on the market (AIG's strategy and operations are examined in more detail in Section I.2 below).

b. The Mechanics and Key Variables of Treasury's Likely Baseline Exit Strategy

This baseline approach could conceivably yield a broad array of outcomes, depending on the equity market conditions and the residual value of the AIG franchise (as outlined in Section H.1 and H.2 above, with business outlook addressed in Section I.2 below). Mathematically, the key variable that will dictate the value realized by the government is not the price that Treasury converts its preferred stake into common equity, but rather the stock performance of the common shares subsequent to this conversion (although legacy shareholders are of course less diluted at a higher conversion price by the government). In order to recover its full investment, it is vital that Treasury be able to sell at or near the conversion price. By nature, this involves a period of considerable risk to Treasury's investment between conversion and sale.

Strictly speaking, aside from the impact of increased dilution for legacy shareholders, the price at which the E and F shares are converted is irrelevant, since the conversion is based on the dollar amount of Treasury's investment, $49.1 billion, rather than a fixed number of shares. For example, Treasury would receive twice as many new common shares at a conversion price of $18 as it would at $36. Similarly, the proceeds would be the same if the stock drops 50 percent after conversion at $36 versus a similar decline following conversion at $18.

A stable stock price over the next 18 months would yield $49 billion to the government from the E and F shares (equal to its $49 billion investment), assuming full conversion and the forthcoming sale of common shares at equivalent share prices. However, should AIG's share price subsequently collapse by 50 percent on the weight of dilution and uninspiring operating results from any price point following the conversion into common equity, Treasury would only see $25 billion in value from the E and F shares, $24 billion shy of its investment.

Importantly, these scenarios do not reflect the value of the Series C shares, which are fully tethered to the current value of the share price. Unlike the E and F shares, the C shares convert into a fixed number of common shares—approximately 533 million shares representing 79.8 percent ownership of AIG. In an ideal world, proceeds from the C shares, which were obtained at no cost to the taxpayer, will help Treasury recover its full investment and perhaps more. Thus, sales of the Series C shares at the conversion prices outlined below could conceivably yield anywhere from $3 billion to $20 billion in additional proceeds, helping mitigate the impact of a

potential decline in the post-conversion share price of the preferreds.[757]

Figure 29 shows the effects of three variables on the baseline exit strategy: (1) conversion of the E and F preferred shares to common at $36, $18, and $6 price points, (2) subsequent performance of the common shares following conversion (flat, down 50%, and down 75%), and (3) the exit value realized for the Series C shares ($36, $18, and $6).

FIGURE 29: GOVERNMENT EXIT STRATEGY RETURN POTENTIAL

[$ Billions except stock price data]

	E/F Stock Price at Conversion		
	$36.00	$18.00	$6.00
Stock Price at Sale:*			
Flat	$49	$49	$49
Down 50%	25	25	25
Down 75%	12	12	12
Memo: Series C Value	20	10	3

*Note: Data illustrates the impact on the government's investment from a change in the price of AIG common stock after the conversion of the E/F shares to common stock and sale of the resulting common.

Clearly, the manner in which the government exits these investments, and the market's reaction to this exit, will help determine the value that the government realizes. An investment horizon with an extended duration is probably the most conservative strategy, as it maintains optionality, while providing a clear path for recouping the government's investment. However, such an approach also entails significant market and operational risks over an extended period of time. Given these risks, the Panel believes that Treasury should explore options aimed at accelerated sales of smaller portions of its stake sooner rather than later, to help mitigate longer-term equity market risks, and transfer some of the risk from the taxpayer to the public markets.

c. Potential Fallback Options if Outlook Deteriorates

Alternatively, should Treasury's confidence in a full payback waver, other options could include (1) strategic actions aimed at breaking up the company and pursuing selective bankruptcies of non-core and cash-draining businesses as necessary, or (2) a restructuring of the government's assistance to AIG to expedite an exit and preserve a minimal amount of franchise value. These approaches would involve the realization that AIG does not offer a sufficient stable of assets to create the requisite value to repay Treasury's investment. While the Panel is not advocating either of these scenarios (as the underlying fundamentals of the company do not appear to warrant such an aggressive approach at this juncture), a break-up or a partial restructuring in bankruptcy or through congressionally mandated resolution authority should be revisited in the future should AIG prove to be effectively insolvent.

[757] Treasury is aware of the trade-offs and challenges involved in maximizing the value between the Series C and the E and F shares. *See* Testimony of Jim Millstein, *supra* note 44 ("[M]arket conditions may change before the trustees have the opportunity to sell that stock. And the very selling of that stock, given how much they have, will put significant downward selling pressure on the price of AIG's common stock").

Should equity market conditions or AIG's corporate performance substantially deteriorate, Treasury may conclude that the best approach involves a more aggressive break-up strategy and/or strategic bankruptcies of certain business lines. A separate or complementary approach could involve relegating unprofitable subsidiaries to bankruptcy in order to spare the holding company the cost of subsidizing their operations in the future. This would alleviate some of the financial pressures on the company (and by extension, the taxpayer), particularly for operations that require significant external funding and may have limited potential sale value. ILFC and AGF may fall into this category.[758] Under this approach, the government could avoid indirectly subsidizing money-losing subsidiaries and their creditors, as is currently the case, if the subsidiaries could be put into bankruptcy without affecting other operations or the holding company. This approach could not be applied to AIGFP and other subsidiaries whose obligations have been guaranteed by the holding company. One potential counterweight to this strategy is that selective bankruptcy for certain AIG subsidiaries might lead to a credit ratings downgrade of the holding company and key insurance subsidiaries, which would severely damage AIG's operations and its ability to raise capital to repay the government.[759] Accordingly, this strategy would require the acquiescence of the rating agencies, which could prove problematic, given the expectation that holding companies do not let downstream subsidiaries default on their debt.

If AIG appears to have a negative net worth, more drastic actions may make sense. AIG could spin off its valuable assets, such as Chartis and SunAmerica, by taking them public and seeding the companies with their own share bases. Proceeds from these transactions could then be used to pay off as much of the government investment as possible. Since this may not be enough to fully repay the government, the holding company, with the remaining bad assets and liabilities, could then be put through bankruptcy without affecting the policyholders or other clients of AIG. AIG's common equity, including anything left of the government's equity stake, would be made worthless. Private bondholders would likely take substantial losses, since most of the corporate value would have already been stripped away. If AIG is insolvent and the stock is worthless anyway, this strategy could salvage as much value as possible and place government interests before those of other creditors. It would also help motivate the employees of the spun-off firms, again helping to maximize value. This strategy would re-

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[758] See discussion in Section I(2)(d) below on outlook for key business units, including ILFC and AGF.

[759] "The credit rating of AIG is an essential factor in establishing the competitive position of its insurance subsidiaries because it provides a measure of the insurance subsidiaries' ability to meet obligations to policyholders, maintain public confidence in the insurance companies' products, facilitate marketing of products, and enhance the companies' competitive positions. AIG's credit rating is derived from the performance of all its subsidiaries. If one subsidiary files for bankruptcy, this would adversely impact AIG's rating and would ultimately impact the insurance subsidiaries' businesses and credit ratings as well. Selective bankruptcy would likely result in policyholders and potential customers losing confidence in the viability of AIG's insurance subsidiaries, leading to increased policy cancellations or termination of assumed reinsurance contracts, which would prevent the companies from new offering products and services. Moreover, a downgrade in AIG's credit ratings may, under credit rating agency policies concerning the relationship between parent and subsidiary ratings, result in a downgrade of the ratings of AIG's insurance subsidiaries." AIG Form 10–K for FY09, *supra* note 50, at 20. *See also* Standard & Poor's briefing with Panel staff (May 1, 2010).

quire a healthy market backdrop in order to facilitate investor interest in the spin-offs.

Another stop-gap option, but potentially many times more problematic for obvious reasons, is a reworking of the government's Series C equity stake.[760] The logic, according to several market participants, behind reducing the hurdle for paying back the government's investment is that—if losses are inevitable—a smaller piece of a bigger pie may be preferable to a bigger piece of a smaller pie. In practice, this approach would involve less dilution for non-government equity holders, which would in turn increase the value of the government's preferred stake when converted into equity. This higher equity price, however, would involve a substantial opportunity cost, as the government would forfeit its current holdings, representing a 79.8 percent stake in the company, with a value of approximately $18 billion, in the hope that this concession would drive a higher equity valuation following the conversion of its $49.1 billion preferred stake.

However, there are several complications to this approach beyond the front-loading of political and headline risks that would likely greet an announcement of this nature. For one, the conversion of the preferred shares would entail significantly higher execution risks vs. the potential break-up options discussed above. The longer duration of such a transaction and the uncertain outlook for AIG's equity market valuation could potentially magnify downside risks. Additionally, it is difficult to imagine that the AIG Credit Facility Trustees, who administer the Series C shares, would be keen to go along with such a strategy, unless a meaningful loss in their holdings was otherwise inevitable. That said, if such a transaction were to materialize, the endorsement of the Trustees, bound by a fiduciary duty to the taxpayer, could help counteract accusations that any concession amounted to a subsidy from the taxpayer to private sector equity and debt holders.

2. AIG's Plans for Return to Profitability

As the analysis above indicates, Treasury is unlikely to exit AIG until the company provides evidence to the market that it is capable of functioning as a standalone investment grade entity, absent government support. Accordingly, until such a date, the value of Treasury's investment is subject to significant and protracted operational risks, in addition to underlying equity market conditions.[761] A key variable in taxpayers recouping their investment pivots on the ability of AIG to execute on its strategy of maximizing the value of non-core assets and producing improved operating results

[760] Instead of giving up equity, the government could also restructure the entire basis of its involvement in AIG to something less onerous to the company. There is some precedent for this, since the Series D preferred was exchanged for Series E, which has terms that are more favorable to AIG. This would be less of a true exit strategy, than something akin to a bad debt workout, and would likely be influenced by the expectation that the government was poised to ultimately take a loss. This strategy would keep the government involved in AIG for some time to come.

[761] Testimony of Jim Millstein, *supra* note 44 ("Whether Treasury ultimately recovers all of its investment or makes a profit, will in large part depend on the company's operating performance and market multiples for insurance companies at the time the government sells its interest").

in its core businesses, paving the way for the firm to access the capital markets independent of government support.[762]

a. Evolving Strategy

The company's strategy is of course largely informed by the need to repay the government's $100.8 billion in assistance. AIG is seeking to balance asset sales and risk reduction with a credible and focused ongoing business strategy. This strategy has been some time in the making, as difficult market conditions and management turnover may have frustrated earlier efforts at charting a course for repaying the taxpayer prior to Mr. Benmosche's arrival at the firm in August of 2009.

In the wake of the government's rescue in the fall of 2008, the math simply did not provide a way forward for the company (and, as became evident in the subsequent months, for the government). The terms of the government's rescue and the market backdrop provided little hope of a full recovery, beyond seeking to mitigate the magnitude of expected losses on the government's assistance and to reduce the systemic risk posed by the company.[763] Potential buyers in the insurance sector suffered through significant valuation declines, dampening their appetite for acquisitions of AIG's most marketable assets. Cash purchases were of course problematic during this period, owing to the dearth of available funding, even to highly rated borrowers. Against this backdrop, core operating fundamentals of key insurance businesses suffered amidst the deteriorating market environment, further clouding the mergers and acquisitions outlook.

Thus, a greatly improved market backdrop and a longer-term investment mentality on the part of AIG's principal shareholder have facilitated a strategy aimed at repaying the government and cultivating a sustainable independent business strategy. The key components of AIG's recovery strategy are asset sales, risk reduction, and a renewed focus on longer-term business growth objectives. Specifically, in addition to asset sales, the firm is focused on strengthening its global property & casualty franchise and its domestic life insurance and retirement services operations, while continuing to manage down the firm's legacy exposure within AIGFP. In the meantime, there are currently many balls up in the air, given the pending sales of ALICO and other assets, the need for an alternate disposition plan for AIA, uncertain prospects and financing challenges for ILFC and AGF, and remaining residual AIGFP exposures in an adverse market backdrop. Additionally, the company must continue to make progress on streamlining its operations and untangling the cross-linkages throughout its vast operations. In turn, greater transparency into individual business lines will help facilitate more beneficial terms from the capital markets for financing core operations as well as facilitating the sale of noncore businesses at more attractive valuations. As noted, Treasury

[762] Testimony of Robert Benmosche, *supra* note 28.

[763] In this respect, the government was very much like a bank seeking to mitigate its losses on a mortgage foreclosure. In turn, a better market backdrop creates a pathway to value maximization as opposed to loss mitigation.

has stated that it expects the company to articulate an updated strategy in the next few months.[764]

As discussed in Section D.4, the fair value of the holdings of ML3 ($23.7 billion) is currently well in excess of the balance of the FRBNY loan outstanding to that SPV ($17.3 billion) and the underlying CDOs remaining in the SPV may well continue to appreciate. But it is important to recognize the economic value of the assistance provided to the counterparties at the time that the Maiden Lane acquisitions of the CDOs were completed. This assistance did not consist merely of the $24.3 billion share of the $29.3 billion that ML3 paid in November and December 2008 to acquire those CDOs. The terms of those sales to ML3 also provided the counterparties with the right to keep the $35 billion in collateral that AIGFP had posted up to that time under the CDS contracts that were extinguished when ML3 was created. Given the government's approximately 80 percent stake in AIG, it is at least arguable that the loss of AIG's $35 billion in collateral provided another $28 billion in government assistance to the ML3 counterparties.[765] Hence, from this perspective, more than $52 billion of the $62 billion par value received by those counterparties was direct or indirect government assistance, assistance which it is highly unlikely that ML3 will ever fully recover despite the rebound in the value of the CDOs since the time they were initially acquired by the SPV.

b. The Future AIG

Putting this all together, AIG—under management and the government's baseline scenario—is likely to be a much different company in 2011 or 2012, with a core business in property and casualty insurance, supported by a domestic life and retirement services operation. These businesses today produce approximately $53 billion in revenue and $6 billion in pre-tax earnings, annualized for first quarter 2010 results.[766] After the company's restructuring and asset sales are complete, the vast majority of AIG's businesses will be housed within its global property-casualty and commercial insurance operation, which has been rebranded as Chartis, and its domestic life insurance and retirement services segment, rebranded as SunAmerica. It is expected that Chartis and SunAmerica will constitute the vast majority of AIG's revenue going forward, with the balance of company revenue coming from certain non-core operations. Figure 30 below shows the expected future business structure of AIG.

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[764] Panel staff conversation with Jim Millstein, chief restructuring officer, U.S. Department of the Treasury (June 2, 2010).

[765] the government's power to unilaterally demand that CDS counterparties return collateral to AIG may have been limited, presumably the full backing of the government for these contracts would have backstopped AIG's credit rating at a higher level, providing a foundation for the company to recover some part of the posted collateral as the reference CDOs recovered in value. See discussion in Section F.5.

[766] Includes General Insurance (Chartis), Domestic Life Insurance & Retirement Services, and Foreign Life Insurance & Retirement Services. AIG Form 10–Q for the First Quarter 2010, *supra* note 731, at 114.

FIGURE 30: AIG FUTURE BUSINESS STRUCTURE

General Insurance (Chartis)	Life Insurance & Retirement Services (SunAmerica)	Financial Services	Asset Management
Function			
Property/casualty insurance Commercial/industrial insurance. Speciality insurance Reinsurance	Rebranded as Chartis Individual and group life insurance products. Retirement services Annuities Domestic operations rebranded as SunAmerica.	Capital markets Consumer finance Insurance premium finance Aircraft leasing	Investment advisory Brokerage Private banking Clients include AIG subsidiaries, institutional and individual investors
Key Subsidiaries to be Retained			
American Home Assurance Co. Chartis Overseas American International Underwriters Insurance Co. American International Reinsurance Co. (AIRCO).	Lexington Insurance Co American General Life Insurance Co. VALIC SunAmerica Annuity Western National American General Life and Annuity.	AIG Financial Products (AIGFP) (but in a largely in-house treasury/risk management function).	AIG Investments AIG SunAmerica Asset Management AIG Advisor Group
Asset Sales (Completed/Pending/Potential)			
Remaining Portion of Transatlantic Holdings.	American Life Insurance Co. (ALICO). American International Assurance Co. (AIA). Nan Shan Life	Most of AIGFP's assets AIG Consumer Finance Group (AIGCFG). International Lease Finance Corp.. American General Finance (AGF).	AIG Investments—international asset management operations AIG Private Bank

c. Which Businesses Are Being Continued or Sold and Why?

Since receiving government assistance, AIG has either completed or announced asset sales representing 29 percent of the firm's total assets, representing at $66 billion in gross proceeds.[767] Current management is targeting several smaller incremental sales or divestitures that could ultimately bring total asset sales to more than 35 percent of legacy operations, a reduction in comparison to the aims of the previous management team, which had targeted the sale of businesses constituting 65 percent of the company.[768]

For 2010, AIG is focused on executing the previously announced sales of its international life insurance operations, AIA and ALICO, often described as two of the company's crown jewels. The growth profile and strong profitability of these overseas life insurance businesses, in comparison with the more cyclical property & casualty arm, bolstered their attractiveness to potential buyers. Additionally, the property & casualty business was viewed as a better

[767] Although these figures include the announced but since withdrawn sale of AIA to Prudential, an alternative disposition plan for this asset is likely to be announced in the coming months.

[768] GAO Report, *supra* note 18, at 42.

source of cash flow to the parent, given the annual payment streams generated by its customer base.[769]

Barring a shift in the company's strategy, additional asset sales by AIG are unlikely to raise significant new sums of money, given that the company has already announced the sales of the big ticket items. Among businesses that are either in run-off mode, considered non-core, or may be slated for sale, ILFC and AGF appear to be the more prominent—although any sale is unlikely to move the needle meaningfully in terms of generating incremental cash to repay the government. Valuations for these two assets are likely to be tempered by the challenges within the aircraft leasing and low-income consumer credit market, respectively. Not coincidentally, these businesses are also the most reliant on the wholesale funding market, which is difficult for AIG to access under present circumstances. Additionally, some smaller properties, such as Star/Edison in Japan, may be put back on the market after failing to attract a buyer the first time around.

AIG's aircraft leasing business, ILFC, continues to be hampered by broader economic conditions as well as a meaningful increase in financing costs. In the near term, AIG is seeking to sell aircraft portfolios to raise needed cash, although these sales often entail relinquishing the desirable aircraft within the fleet, which increases the remaining portfolio's average fleet age and lowers operating margins.[770] AIG will likely exit this business when doing so is practical. In the meantime, there are few potential buyers for the entire fleet, necessitating piecemeal portfolio sales. Similar to ILFC, AGF is battling a challenging macroeconomic environment, exacerbated by rising funding costs. Given this backdrop, one could probably fairly characterize these businesses in their current state as depreciating assets.

FIGURE 31: AIG ASSET SALES AS OF JUNE 7, 2010[771]

[Dollars in millions]

Buyer	Target Name	Announcement Date	Announced Deal Value
Public Shareholders[772]	AIA Group Ltd.	TBA	$32,500
MetLife Inc.	American Life Insurance Company	3/7/2010	15,545
Investor group	Nan Shan Life Insurance Co. Ltd.	10/12/2009	2,150
Zurich Financial Services AG	21st Century Insurance Group (U.S. personal lines automobile insurance business).	4/16/2009	1,900
Wintrust Financial Corp.	Assets of A.I. Credit Corp.	7/28/2009	747
Münchener Rückversicherungs	HSB Group, Inc.	12/21/2008	666
Pacific Century Group	Portion of investment advisory and asset management business.	9/5/2009	500
BMO Financial Group	AIG Life Holdings (Canada), ULC	1/13/2009	311
Aabar Investments PJSC	AIG Private Bank Ltd.	12/1/2008	254
UBS AG	Commodity index business of AIG Financial Products Corp..	1/19/2009	150

[769] Panel staff conversation with Brian Schreiber, senior vice president, AIG Strategic Planning (Apr. 23, 2010). Life insurance policies are generally long-term contracts whereas many property and casualty policies are renewed on an annual basis.

[770] In April 2010, ILFC entered into an agreement with Macquarie Aerospace Limited to sell 53 aircraft with an aggregate book value of approximately $2.3 billion, which is expected to generate approximately $2 billion in gross proceeds during 2010. AIG Form 10–Q for the First Quarter 2010, *supra* note 731, at 12. In May 2010, AIG announced that it hired Mr. Henri Courpron as the new ILFC chief executive officer. AIG Statement on $85 Billion Secured Revolving Credit Facility, *supra* note 501.

FIGURE 31: AIG ASSET SALES AS OF JUNE 7, 2010[771]—Continued

[Dollars in millions]

Buyer	Target Name	Announcement Date	Announced Deal Value
Top Ten Total			54,722
Others			590
Total			**$55,313**

[771] SNL Financial; AIG Form 10–Q for the First Quarter 2010, *supra* note 731, at 19; AIG Form 10–K for FY09, *supra* note 50, at 40, 47, 119; AIG Form 10–K for FY08, *supra* note 47, at 6, 63.
[772] Recent press reports indicate the likely disposition strategy for AIA Group is now an IPO. $32.5 billion figure represents the mid-range estimate of the possible value.

d. Key Business Challenges

For the most part, market observers with whom the Panel staff spoke were quick to stress the positive attributes of many of AIG's insurance assets.[773] While it is unclear to what extent AIG has compromised underwriting quality and pricing to help mitigate the unique challenges faced by the company in the current competitive environment, recent data support the resiliency of the firm's market share in core operations, particularly within Chartis (outlined in more detail below).[774] AIG's management asserts that rebranding efforts and enhanced distribution platforms for its products should begin to contribute positively to the company's growth.[775]

There is some debate, however, among analysts with respect to the health of AIG's core franchise, with under-reserving for insurance claims most often cited as a potential drag on future earnings.[776] Loss provisioning across the industry was described by one market participant as "more art than science." In particular, several market observers raised questions regarding AIG's long-term provisioning practices across its core businesses.[777] AIG has assured the Panel that its insurance subsidiaries have adequate reserves, and stated that its auditors and insurance regulators would not allow it to under-reserve.[778] Several market experts were also quick to note that market share and revenue growth within the insurance industry can be finessed on a near-term basis by more lenient underwriting standards and generous pricing initiatives, the evidence of which may take several years to materialize in financial results. One market observer relayed complaints he has heard that AIG may be undercutting competitors by as much as 30 percent on the price of property & casualty insurance, though AIG, Treasury, and GAO have disputed this allegation.[779] These alleged

[773] Panel staff conversations with sell-side and buy-side investors.
[774] Panel staff briefing with Robert Schimek, chief financial officer, Chartis (Apr. 23, 2010).
[775] Panel staff briefing with Robert Schimek, chief financial officer, Chartis (Apr. 23, 2010).
[776] For further discussion of the financial condition of the insurance company subsidiaries at the time of the government's intervention in AIG, see Section E.2 (AIG Insurance Company Subsidiaries), *supra*.
[777] For a detailed discussion, see Section B.4, *supra*.
[778] Panel and staff briefing with AIG CFO David Herzog, chief financial officer, AIG (May 17, 2010 and June 4, 2010).
[779] *See* Testimony of Jim Millstein, *supra* note 44; House Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Written Testimony of Orice M. Williams, director, Financial Markets and Community Investment, Government Accountability Office, *American International Group's Impact on the Global Economy: Before, During, and After Federal Intervention*, at 16 (Mar. 18, 2009) (online at www.house.gov/apps/list/hearing/financialsvcs__dem/gao__-__williams.pdf) ("[S]ome of AIG's competitors claim that AIG's

Continued

pricing practices raise questions about the impact of government backing on both risk taking within AIG and on the business dynamics facing AIG's competitors.

More broadly, some investors voiced skepticism that the current management team is capable of overcoming what they viewed as significant legacy institutional practices that cultivated an array of cross-linkages throughout the firm. In particular, a legacy of intercompany funding arrangements (discussed in greater detail in Section B.4(d)), and how the unwinding of these arrangements may impact the holding company's debt load, is another area that skeptical analysts contend could impact value realization. Accordingly, AIG's outstanding debt load and certain valuation assumptions could be subject to potential revision given that AIG may need to borrow more from FRBNY's loan facility, particularly as cross-segment lending arrangements expire, and private sector debt matures.

The table below highlights a conservative estimate of the company's current obligations. Given that AIG has provided financial assistance to subsidiaries whose debt is not guaranteed by the parent company, such as AGF and International Lease Finance Corporation (ILFC), the full liability could be greater. Since the start of 2010, AIG has drawn down more than $5.3 billion in additional funds from the RCF, raising concerns among some market participants about the scope of the holding company's debt obligations, given that some of these funds were used to renew expiring subsidiary credit lines.[780]

FIGURE 32: TOTAL DEBT OUTSTANDING[781]

[Dollars in millions]

	03/31/10	12/31/2009	03/31/09
Debt Issued by AIG:			
FRBNY Credit Facility (secured)	$27,400	$23,435	$47,405
Notes and bonds payable	9,457	10,419	11,221
Junior subordinated debt	11,699	12,001	11,520
Junior subordinated debt attributed to equity units[782]	5,880	5,880	5,880
Loans and mortgages payable	427	438	370
MIP matched notes and bonds payable[783]	12,642	13,371	13,953
Series AIGFP matched notes and bonds payable[784]	3,868	3,913	4,296
Total AIG Debt	71,373	69,457	94,645
Total AIG Private Debt	43,973	46,022	47,240
Debt Guaranteed by AIG:.			
Commercial paper and other short-term debt	2,285	2,742	6,747
GIA	8,353	8,257	10,716
Notes and bonds payable	1,916	2,029	3,538
Loans and mortgages payable	825	1,022	1,981
Hybrid financial instruments	1,706	1,887	1,257
Total AIGFP Debt	15,085	15,937	24,239
AIG Funding commercial paper	—	1,997	5,509
AIGLH notes and bonds payable	798	798	798
Liabilities connected to trust preferred stock	1,339	1,339	1,299

commercial insurance pricing is out of line with its risks but other insurance industry participants and observers disagree. At this time, we have not drawn any final conclusions about how the assistance has impacted the overall competitiveness of the commercial property/casualty market").

[780] Federal Reserve H.4.1 Statistical Release, *supra* note 2. Federal Reserve H.4.1 Statistical Release, *supra* note 342.

FIGURE 32: TOTAL DEBT OUTSTANDING [781]—Continued

[Dollars in millions]

	03/31/10	12/31/2009	03/31/09
Total debt issued or guaranteed by AIG	**$88,595**	**$89,528**	**$126,490**

[781] AIG Form 10–Q for the First Quarter 2010, *supra* note 731, at 103; AIG Form 10–Q for the First Quarter 2009, *supra* note 367, at 64.
[782] Upon each of the stock purchase dates of AIG's mandatory convertibles, AIG's obligations will be met with through a successful remarketing of the debt portion of the equity units, or upon a failed remarketing, through the surrendering of the outstanding debentures to satisfy the stock purchase contract portion of the equity units.
[783] Debt maturities for the MIP are expected to be funded through cash flows generated from invested assets, as well as the sale or financing of the asset portfolio's in the program. However, mismatches and the timing of cash flows of the MIP, as well as any short falls do to impairments of MIP assets, would need to be funded by AIG parent. In addition, as a result of AIG's restructuring activities, AIG expects to utilize assets from its non-core businesses and subsidiaries to provide future cash flow enhancements and help the MIP meet its maturing debt obligations.
[784] Approximately $813 million of AIGFP debt maturities through March 31, 2011 are fully collateralized, with assets backing the corresponding liabilities; however mismatches in the timing of cash inflows on the assets and outflows with respect to the liabilities may require assets to be sold to satisfy maturing liabilities.

For his part, Mr. Benmosche asserts that near-term fluctuations in AIG's borrowing from the RCF reflect short-term variances in the company's cash flows and are not indicative of an underlying appetite for increased government assistance. While he predicted further ups and downs in the firm's RCF balance as AIG taps its government credit line to meet its funding needs as legacy debt matures, he believes AIG's cash flows will eventually stabilize, allowing the firm to begin to repay its obligations. That said, the key yardstick for progress on this front will be when the firm is able to raise funding from private sources at attractive and sustainable levels of interest.[785]

e. Overview of Core Insurance Businesses

Based on core operating data in the lead-up to the crisis, AIG's life insurance and property & casualty subsidiaries—as measured by Return on Equity (ROE)—either performed on par or exceeded key industry benchmarks.

• **Life Insurance.** AIG has historically produced ROEs of 15 percent in its life insurance business. This compares favorably to 13–14 percent ROEs for the industry, though recent returns have been impacted by a more challenging market backdrop, with AIG underperforming the industry's 10–12 percent ROE during the 2008–2009 period. AIG's global life insurance returns have traditionally benefitted from its leading foothold in overseas markets, particularly in Asia (although these businesses are now in the process of being sold), where pricing and growth were considered more favorable than in the U.S. market. Within the United States, AIG's life insurance operations benefited from its vast scale, which helped the company offset less favorable growth and pricing trends in comparison to its overseas operations.

• **Property & Casualty.** Percentage returns for AIG's property & casualty business, historically in the mid-teens, have also declined in recent years (less than 10 percent in 2008–2009). According to market participants, AIG's relative historic outperformance in this business was boosted by its product diversity and innovative underwriting, which provided a pipeline of higher-margin contracts. And consistent with the size of its platform, AIG benefited from better cost leverage in its operations. As noted above, several critics claim that AIG's returns, particularly in recent years, have

[785] Testimony of Robert Benmosche, *supra* note 28.

benefitted from underreserving for future payouts, a practice that would presumably lower future returns when loss rates on legacy contracts exceed the reserve cushion.

Figure 33 below outlines trailing 5-year ROEs for AIG's legacy U.S. life and P&C businesses. (Note that returns are lower than the historical results outlined above, given the absence of AIG's more profitable overseas operations, including its Asian life businesses (which are being sold) and the company's overseas P&C business lines (which will remain under the Chartis umbrella).

FIGURE 33: AIG U.S. LIFE INSURANCE AND PROPERTY & CASUALTY ROE, 2005–2009 [786]

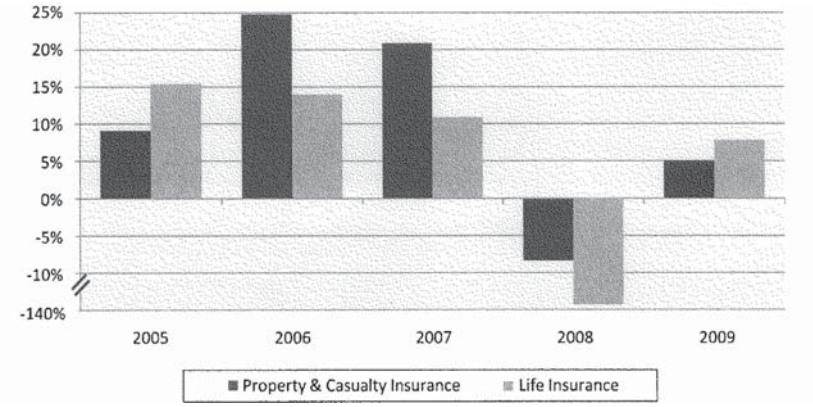
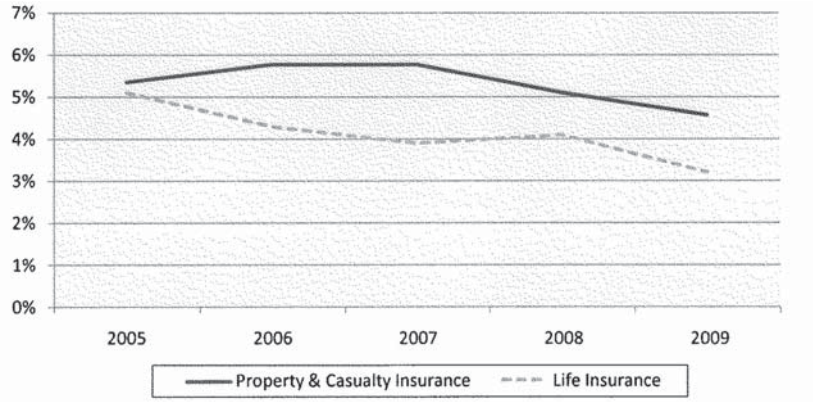


Figure 34 below outlines market share data for the core U.S. life and P&C business. While AIG's U.S. P&C market share has remained fairly stable during the 2008–2009 period, life insurance has declined measurably. The relative performance disparity is not necessarily surprising given the variance in contract terms. P&C contracts are generally renewed annually, whereas life customers can terminate their policies at will, making the life business more sensitive (at least on a short-term basis) to AIG's recent challenges.[787]

[786] The underlying data for this graph pertains to return on equity (ROE) for AIG's U.S. Life and Property & Casualty insurance subsidiaries. The historical ROEs for the Property & Casualty subsidiary was provided by A.M. Best. The historical ROEs for the Life Insurance subsidiary was accessed through SNL Financial data service.

[787] AIG Form 10–K for FY09, *supra* note 50, at 109 ("AIG expects that negative publicity about AIG during the fourth quarter of 2008 and the first nine months of 2009, AIG's previously announced asset disposition plan and the uncertainties related to AIG will continue to adversely affect Life Insurance & Retirement Services operations for the remainder of 2009, especially in the domestic businesses. In addition, AIG's issues have affected certain operations through higher surrender activity, primarily in the U.S. domestic retirement fixed annuity business and foreign investment-oriented and retirement products. Surrender levels have declined from their peaks in mid-September of 2008 and have begun to stabilize and return to pre-September 2008 levels for most products and countries").

FIGURE 34: AIG U.S. LIFE INSURANCE AND PROPERTY & CASUALTY MARKET SHARE, 2005–2009 [788]



However, business retention and growth trends have improved in recent quarters for AIG's U.S. life insurance operations, with business retention for the first quarter of 2010 the best since September 2008 (although, given the depth of AIG's problems in the aftermath of initial government assistance, it would be surprising if retention *did not* begin to improve in recent quarters).[789]

In the context of AIG's strategic outlook, the near-term operating environment for its core ongoing insurance businesses remains challenging. Summarizing from AIG's 2009 10–K.[790]

• Domestic Life Insurance & Retirement Services: Closely levered to improving economic and market backdrop, these businesses are expected to benefit from rebranding and improved distribution channels, as well as a reduction in low-yielding excess liquidity as a result of a more stable market backdrop.

• General Insurance (Chartis): Pricing and ratable exposures (value and number of policies outstanding, influenced by asset values and economic growth) are both expected to decline in 2010, consistent with industry-wide expectations.

Figure 35 below shows the ratios of payments to policyholders and operating expenses compared to premiums earned by AIG's property & casualty insurance business. This "Combined Ratio" highlights the total of these costs compared to premiums (i.e., the lower the ratio the better). This ratio, which excludes investment activities, is a good barometer of the absolute and relative health of the business, although trends vary based on the underlying business cycle. With a few exceptions, AIG has generally reported a Combined Ratio below its peer group average. In 2009, however, AIG's Combined Ratio of 108 percent compared to an industry av-

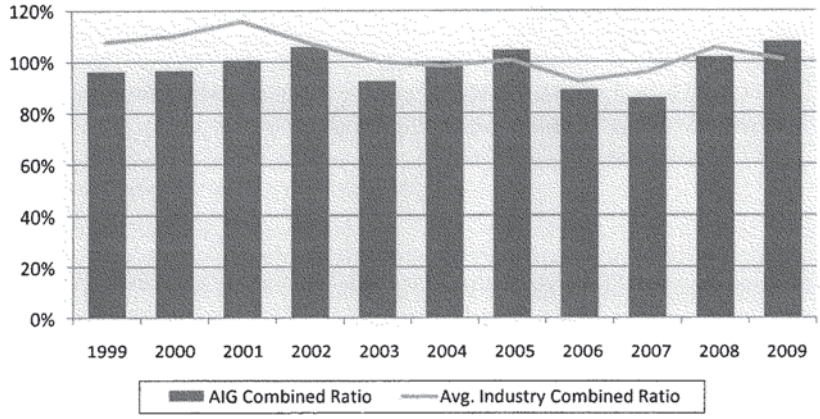
[788] The underlying data for this graph pertains to the consolidated market share of AIG's U.S. Life and Property & Casualty insurance subsidiaries in their respective markets. Data accessed through SNL Financial data service.

[789] Congressional Oversight Panel, Written Testimony of Robert Benmosche, president and chief executive officer, American International Group, Inc., *COP Hearing on TARP and Other Assistance to AIG*, at 12 (May 26, 2010) (online at cop.senate.gov/documents/testimony-052610-benmosche.pdf).

[790] AIG Form 10–K for FY09, *supra* note 50, at 39–40.

erage of 101 percent. This increase could be partially a cyclical reserve build, exacerbated by recent challenges unique to AIG.

FIGURE 35: UNDERWRITING COST RATIOS [791]



f. Success in Winding Down AIGFP Positions; how much of AIGFP's Operations will be Continued?

AIG plans to exit the "vast majority of the risk" within AIGFP by year-end 2010. Public disclosure regarding the unit's holdings and Panel staff conversations with management indicate that this wind-down process has moved ahead at a rapid pace.[792] The process has been aided by the improved market backdrop, with higher asset values and a healing credit market helping to maintain—and in some cases increase—the portfolio's value, in addition to facilitating sales. Further, given the current management team's desire to avoid disposing of assets at fire-sale prices, the economics from this process have also benefited from a longer time horizon (in the context of a recovery in many asset classes) and strengthened negotiating position.[793]

AIG's outstanding trade positions declined by 54 percent in 2009. The notional amount of non-credit derivatives exposure fell by 49 percent in 2009, while credit derivatives declined 39 percent during the year; overall, the firm's derivatives portfolio declined by 41 percent, from $1.6 trillion to $941 billion. The pace of declines continued in the first quarter of 2010, with notional amounts in the credit book down an incremental 26 percent, and overall trade positions declining by 11 percent.

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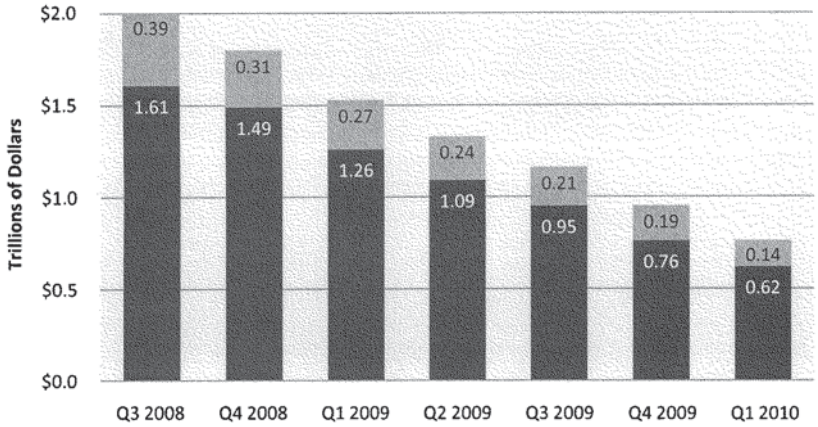
[791] AIG Form 10–K for FY09, *supra* note 50, at 74. AIG combined ratios prior to 2007 and average industry combined ratios accessed through SNL Financial data service.

[792] AIGFP Chief Operating Officer Gerry Pasciucco briefing with Panel staff (Apr. 23, 2010).

[793] Testimony of Robert Benmosche, *supra* note 28; AIGFP Chief Operating Officer Gerry Pasciucco briefing with Panel staff (Apr. 23, 2010).

FIGURE 36: WIND-DOWN OF AIGFP'S PORTFOLIO, THIRD QUARTER 2008 TO FIRST QUARTER 2010 [794]



While the company has sought to balance overly hasty exits from certain positions with a desire to reduce significantly AIGFP's risk exposures in an expedited manner, the underlying bias has been to dispose of assets as quickly as possible whenever possible. While difficult to verify (beyond the reduced volatility in quarter-over-quarter results), management asserted to Panel staff that this process has targeted the most complex risk first, which would suggest that its remaining exposures are not tainted by a "survivor's bias." [795] And from a systemic risk standpoint, as exposures have been sold or otherwise hedged, the capital markets portfolio's exposure to market volatility has declined approximately 80 percent since year-end 2008.[796] The number of trading counterparties has declined approximately 43 percent during this period.

Accordingly, this reduction in exposure and counterparties, as well as the improved market backdrop, has significantly diminished—but not yet eliminated—AIGFP's vulnerability to a severe market disruption.[797] The company noted that AIGFP's exposure to cash calls from counterparties due to a downgrade of its credit ratings declined from $20 to $22 billion at the beginning of 2009 to approximately $4 billion today.[798]

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[794] American International Group, Inc., *The Restructuring Plan: AIG Financial Products Corp. Unwind Progress* (online at www.aigcorporate.com/restructuring/windownofFP.html) (accessed June 9, 2010). Due to FAS 161, FP is changing its methodology for computing notional, leading to a slight increase of previously reported values for Q3 (actual $1.9b) and Q4 2009 (actual $1.6b). The notional amount of derivatives outstanding for the first quarter of 2010 is $755.4 billion.

[795] AIGFP Chief Operating Officer Gerry Pasciucco briefing with Panel staff (Apr. 23, 2010).

[796] AIG presentation to COP, "AIG Financial Products Corp. Unwind Progress." AIGFP's "Gross Vega", the sum of all individual positions' absolute exposures as if each position is not hedged, has declined from $1.30 billion to $0.22 billion, as of the first quarter of 2010.

[797] Jim Millstein described the goal in his May 26, 2010 testimony before the Panel: AIGFP's "risk profile will need to be reduced to the level where potential losses are inconsequential to the parent company's financial condition. More specifically, investors must be satisfied that AIGFP does not pose a substantial threat to the Company's liquidity position, even in times of stress." Testimony of Jim Millstein, *supra* note 44, at 9–10.

[798] Testimony of Robert Benmosche, *supra* note 28; AIG Form 10–Q for the First Quarter 2010, *supra* note 731, at 158.

Figure 37 below provides a more detailed view of the evolution of AIGFP's CDS portfolio, outlining the composition and losses from 2007 through the first quarter of 2010. AIGFP recorded a positive valuation gain in 2009 of $1.4 billion vs. a loss of $28.6 billion in 2008. Tighter credit spreads were no doubt a key factor in the modest gain, although the size of AIGFP's book declined dramatically following the cancelation of multi-sector CDS contracts associated with the ML3 transaction.[799] Even so, these results reflected losses within the legacy remnants of the much reduced multi-sector CDS portfolio ($669 million in 2009 vs. $25.7 billion in 2008). The negative impact of these legacy exposures was offset, however, by a positive swing in AIGFP's corporate CDO book ($1.9 billion gain in 2009 vs. $2.3 billion loss in 2008). First quarter 2010 results reflected a modest valuation gain of $119 million across the entire credit portfolio.[800] Since 2008, the biggest reductions have been achieved in the firm's regulatory capital swap portfolio, as would be expected given the relative size of this portfolio and the nature of the underlying contracts.[801]

[799] AIG Form 10–K for FY09, *supra* note 50, at 38.
[800] AIG Form 10–Q for the First Quarter 2010, *supra* note 731.
[801] See the discussion of regulatory capital swaps in Section B.3.

FIGURE 37: AIGFP CDS PORTFOLIO, 2007 TO FIRST QUARTER OF 2010 [802]

[Dollars in millions]

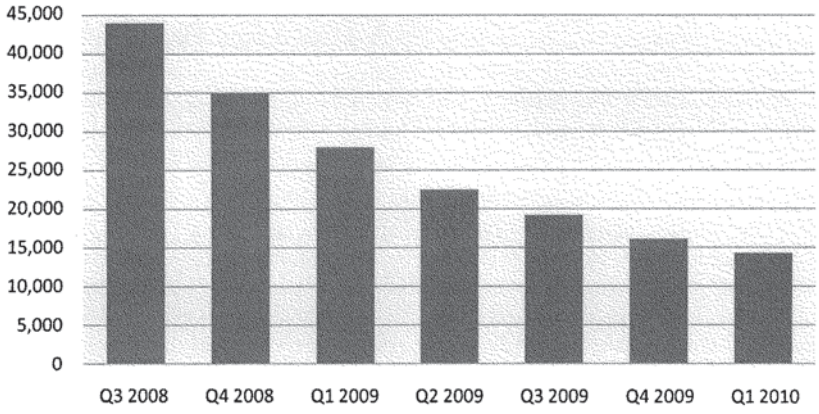
	Net Notional Amount				Unrealized Valuation Gain (Loss)			
	FY Ending 12/31			Q1 (3/31)	FY Ending 12/31			Q1 (3/31)
	2007	2008	2009	2010	2007	2008	2009	2010
Regulatory Capital:								
Corporate loans	$229,313	$125,628	$55,010	$41,993	—	—	—	—
Prime residential mortgages	149,430	107,246	93,276	65,844	—	—	$137	$33
Other	—	1,575	1,760	1,552	—	$(379)	35	6
Total	**378,743**	**234,449**	**150,046**	**109,389**	—	**(379)**	**172**	**39**
Arbitrage:								
Multi-sector CDOs	78,205	12,556	7,926	7,574	(11,246)	(25,700)	(669)	158
Corporate debt/CLOs	70,425	50,495	22,076	16,367	(226)	(2,328)	1,863	(7)
Total	**148,630**	**63,051**	**30,002**	**23,941**	**(11,472)**	**(28,028)**	**1,194**	**151**
Mezzanine Tranches	5,770	4,701	3,478	3,104	—	(195)	52	(71)
Grand Total	**$533,143**	**$302,201**	**$183,526**	**$136,434**	**$(11,472)**	**$(28,602)**	**$1,418**	**$119**

[802] Form 10–K for FY09, *supra* note 50, at 130; AIG Form 10–K for FY07, *supra* note 41; AIG Form 10–Q for the First Quarter 2010, *supra* note 731.

Looking ahead, AIG is not anticipating a swift exit from the balance of its positions within AIGFP, given that in many instances the risk/reward calculus favors holding certain assets to maturity.[803] For example, AIGFP's regulatory capital book is expected to substantially roll off in the next 12 months, as European financial institutions transition from the Basel I regulatory capital framework. AIG is confident that it will not have to make any payments associated with potential triggers or the expiration of these contracts.[804] Additionally, other assets and hedges are byproducts of the insurance operations of the firm, and will not be wound down, absent a change in the underlying nature of AIG's insurance business.

AIG's management asserts that AIGFP is effectively on the verge of entering run-off mode status in 2010, a phase that will require significantly less expertise to manage what is expected to be a portfolio across credit and non-credit asset classes of several thousand positions, in comparison to about 14,000 today and 44,000 at the end of September 2008.[805] Ultimately, the aim is to absorb the remaining portfolio into AIG. Ultimately, this business is expected to evolve into the treasury function of a financial company, a cost center (as opposed to a profit center) tasked with managing the capital markets exposures and funding needs of the overall business.

FIGURE 38: NUMBER OF AIGFP'S TRADE POSITIONS, THIRD QUARTER 2008 TO FIRST QUARTER 2010



3. Treasury's Plan for Exit

Consistent with other investments in financial institutions, Treasury describes itself as a "reluctant shareholder" in AIG, forgoing its ability to become involved in the company's day-to-day op-

[803] Panel conversation with AIGFP COO Gerry Pasciucco briefing with Panel staff (04/23/10);
[804] AIG Form 10–K for FY09, *supra* note 50, at 27 ("Given the current performance of the underlying portfolios, the level of subordination and AIGFP's own assessment of the credit quality of the underlying portfolio, as well as the risk mitigants inherent in the transaction structures, AIGFP does not expect that it will be required to make payments pursuant to the contractual terms of those transactions providing regulatory capital relief").
[805] AIGFP COO Gerry Pasciucco briefing with Panel staff (Apr. 23, 2010); Testimony of Jim Millstein, *supra* note 44.

erations.[806] Further, Treasury maintains that it will divest its holdings as soon as practicable;[807] in its view, monetizing the investments in AIG on behalf of the taxpayer will take time. In addition, Treasury has a junior preference—below FRBNY—in recouping funds from AIG; thus, while recent news surrounding the sale of AIA and ALICO increases the likelihood of the FRBNY credit facility being paid back in full, some uncertainty continues to surround Treasury's investment.[808] As of May 27, 2010, AIG and its affiliated entities' total obligations to FRBNY and Treasury were as follows:

FIGURE 39: OUTSTANDING GOVERNMENT ASSISTANCE TO AIG (AS OF MAY 27, 2010)[809]

[Dollars in billions]

Fed Revolving Credit Facility (outstanding principal)	$26.1
Treasury Investment (SSFI)/AIGIP	41.6
Total	67.7
Maiden Lane III (amount outstanding and accrued interest)	16.6
Maiden Lane II (amount outstanding and accrued interest)	14.9
Total	31.5
Subtotal	99.2
Equity Capital Facility (drawdown)	7.5
Current Exposure	106.7
Preferred Interest in AIA and ALICO SPVs	25.6
Total Exposure	132.3
Fed	83.2
Treasury	49.1
Total	132.3
	(31.5)
Assistance on AIG's Balance Sheet	$100.8

[809] Treasury Transactions Report, *supra* note 2, at 18; Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances* (*H.4.1*) (online at www.federalreserve.gov/Releases/H41/Current/) (hereinafter ''Federal Reserve H.4.1 Statistical Release'') (accessed June 2, 2010).

As illustrated above, certain investments in AIG do not require the company to either repurchase preferred shares at a particular liquidation preference or pay back drawdowns of capital facilities. These vehicles include both ML2 and ML3, as well as Series C convertible preferred stock, which is being held in the AIG Credit Facility Trust for the benefit of the U.S. Treasury. Loans extended to ML2 and ML3 are secured by the underlying assets in the portfolio and do not represent a direct obligation of AIG. The preferred stock, which is convertible into approximately 80 percent of AIG's

[806] *See* Testimony of Jim Millstein, *supra* note 44, at 1; House Oversight and Government Reform Committee, Joint Written Testimony of Jill M. Considine, Chester B. Feldberg, and Douglas L. Foshee, trustees, AIG Credit Facility Trust, AIG: *Where is the Taxpayer Money Going*, at 5 (online at oversight.house.gov/images/stories/documents/20090512165555.pdf); Written Testimony of Herb Allison, *supra* note 396, at 5.

[807] *See* Testimony of Jim Millstein, *supra* note 44, at 1; AIG Credit Facility Trust Agreement, *supra* note 377. *See also* January Oversight Report, *supra* note 637, at 28–32 (discussing Treasury's exit strategy for the disposal of assets held in relation to TARP). Written Testimony of Herb Allison, *supra* note 396, at 5.

[808] See further discussion of the relationship between Treasury and FRBNY in Section G.

common shares outstanding, is managed through a trust, as discussed above.[810]

The government's current plan, a "hold" strategy, which appears to be the objective of Treasury and the Federal Reserve, may have several advantages.[811] First, realizing the intrinsic value of CDOs and RMBS purchased by ML2 and ML3 will likely take time, given the difficulties in obtaining reasonable prices for these types of assets.[812] Second, a more patient approach may increase AIG's ability to repay its obligations to the federal government as economic conditions continue to improve. "The slower approach to restructuring could help AIG to generate more favorable values from its business portfolio than would be the case under rushed asset sales," Moody's Investors Service has noted.[813] Third, in early 2010 Mr. Benmosche cautioned that corporate earnings will likely remain subject to "continued volatility" as the company continues its restructuring process. While 2010 first quarter earnings were much improved, it may be somewhat premature to conclude that the earnings volatility that occurred in 2009 is no longer a concern because claims relating to catastrophes such as the ones that the company faces from the earthquake in Chile, the explosion of an oil rig in the Gulf of Mexico and unrealized gains (losses) from its securities portfolios present near-term risks. This point is highlighted by the fact that the net loss attributable to AIG in the fourth quarter of 2009 was $8.9 billion. This came after the company posted net income of $1.8 billion and $455 million in the previous two quarters. As Figure 40 below shows, a true earnings trend has yet to emerge.

FIGURE 40: AIG NET INCOME/(LOSS)

[Dollars in millions]

Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010
$(7,805)	$(5,357)	$(24,468)	$(61,659)	$(4,353)	$1,822	$455	$(8,873)	$1,451

While the restructuring process is under way, it remains to be seen if this is the best course of action for AIG and U.S. taxpayers. In a recent interview, Mr. Benmosche stated that "the most important thing is to raise enough money so that we can pay back the Federal Reserve."[814] He goes on to suggest after the closing of the AIA and ALICO sales, formal talks could begin with the government over an exit, and cited the next 12 to 18 months as the period in which many issues would be addressed.[815] As discussed above, the withdrawal of Prudential's offer to purchase AIA delays this timetable.

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[810] See Section D.6(b), *supra*.

[811] A "hold" strategy does not necessarily imply that the government intends to hold its investments over the long-term but rather that the Federal Reserve and Treasury will dispose of these assets as soon as practical.

[812] FRBNY stated that this equity interest "has the potential to provide a substantial financial return to the American people should the $85 billion loan, as anticipated, provide AIG with the intended breathing room to execute a value-maximizing strategic plan." Federal Reserve Bank of New York, *Statement by the Federal Reserve Bank of New York Regarding AIG Transaction* (Sept. 29, 2008) (online at www.newyorkfed.org/newsevents/news/markets/2008/an080929.html).

[813] *See* Moody's Investors Service, *Issuer Comment: Moody's Sees AIG Holding its Ground Through 3Q09* (Nov. 9, 2009).

[814] Karan Iyer, *Report: Benmosche Says AIG on Track to Repay Government*, SNL Financial (Apr. 3, 2010) (online at www.snl.com/interactivex/article.aspx?Id=10978787&KPLT=2).

[815] *Id.*

When other goals that the company set forward for 2010 have been reached, such as closing the sales of Nan Shan and ALICO, the rate at which the government can decrease its exposure may become clearer, but will continue to depend upon the future profitability of AIG's core property & casualty insurance, and to a lesser extent, its domestic life and retirement services businesses. As discussed in Section I.2(d), AIG's property & casualty insurance business is in the midst of a soft market, and questions persist with respect to the adequacy of its reserves.

In 2009, broad market and credit conditions prevented Treasury and AIG's management from articulating a credible government exit strategy from AIG. That may be changing, however. In total, Treasury has invested approximately $49 billion in the insurer. Recent comments by the CEO and government officials indicate that a framework for Treasury to divest its holdings in the company could come later this year. This would be consistent with recent reports indicating that a board panel has hired Rothschild as an independent financial advisor, in addition to the advisors management has hired to aid in the restructuring efforts. Treasury also owns warrants in AIG; and although Treasury has not articulated how those warrants would be disposed of, one option would be the approach taken with financial institutions under the CPP.

It remains to be seen whether the failure to close the AIA sale with Prudential diminishes the underlying value of the asset—investment banks advising AIG maintain that an IPO would result in an enterprise value greater than Prudential's revised offer of $30.4 billion—but the failure to close does delay the timing in which FRBNY is paid back. In turn, the timetable by which Treasury is paid back is pushed further into the future.

J. Executive Compensation

1. General [816]

It is not surprising that the large group of companies that AIG owned (with an employee complement of over 100,000) [817] would have many different compensation arrangements. The company told SIGTARP that, as of March 2009, it had "approximately 630 compensation plans," [818] involving bonuses, retention awards, and deferred compensation schemes. Some plans covered employees of AIG itself and others covered employees of the subsidiaries.[819]

Historically, the structure and management of AIG's compensation plans were decentralized, and no approval of plan grants or terms at the company's subsidiaries was required at the holding company level. That fact made it hard for government officials, and for AIG officials themselves, initially to comprehend the scope, on-

[816] Parts a and b of this discussion are based upon a SIGTARP report released in October 2009. Office of the Inspector General for the Troubled Asset Relief Program, *Extent of Federal Agencies' Oversight of AIG Compensation: Varied and Important Challenges Remain* (Oct. 14, 2009) (SIGTARP–10–002) (online at www.sigtarp.gov/reports/audit/2009/Extent__of__Federal__Agencies%27__Oversight__of__AIG__Compensation__Varied__and__Important__Challenges__Remain__10__14__09.pdf) (hereinafter "SIGTARP Report on Oversight of AIG Compensation").

[817] Data indicate that the AIG group of companies had 106,000 employees as of June 30, 2009. SIGTARP Report on Oversight of AIG Compensation, *supra* note 816, at 7 note 7.

[818] SIGTARP Report on Oversight of AIG Compensation, *supra* note 816, at 7.

[819] SIGTARP Report on Oversight of AIG Compensation, *supra* note 816, at 7.

going cost, coverage, and, even more important, the amounts payable under those plans. The difficulties were compounded by the incompatibility of AIG's information systems.

2. Initial Government Involvement

The FRBNY review of AIG's financial and management issues, which started in early October 2008, led to its concern about AIG's pending and future compensation plans, especially liabilities for payments of $1 billion in the nearly nine months following the installation of the RCF. That concern led to the reduction of the company's 2008 bonus pool by 30 percent compared to 2007. FRBNY has played a continuing role in working with the company on its overall compensation programs, and has become the most informed of those agencies involved in the rescue on AIG compensation issues.

Treasury imposed specific compensation restrictions as part of its TARP investment. These restrictions applied to 57 then-senior employees. They limited golden parachute payments, placed a ceiling on 2009 incentive compensation of 3.5 percent of 2008 base salary plus bonus, placed a ceiling on the size of senior executive bonus pools based on 2006–07 pools, and restricted payments of bonuses or cash awards out of TARP funds.[820] SIGTARP found, however, that "Treasury essentially relied on what it was told [about AIG's compensation arrangements] . . . and did not conduct direct oversight of AIG's executive compensation prior to March 19, 2009."[821]

FRBNY, on the other hand, even in the formal credit agreement creating the RCF, made no effort to condition future assistance on compensation restrictions for AIG senior management. Although such restrictions were arguably unnecessary after June 2009—when Treasury's executive compensation rules were placed in effect—no effort comparable to that undertaken by Treasury was made beforehand, despite the Reserve bank's superior knowledge of AIG's compensation arrangements. Whether or not the agreements were legally binding, it is not uncommon to renegotiate compensation packages as a condition of providing financing for a company.

3. The AIGFP Retention Payments

In 2007 and 2008, AIGFP changed some of its compensation arrangements to create retention award agreements for employees whose deferred compensation had lost value because of AIG's financial reversals. According to AIG, the agreements, which provided for a total of approximately $475 million to be distributed over two years, were designed not to reward employees for their performance, but instead to keep employees in place so that they could "wind down the complex trades and/or continue AIGFP's general operations."[822]

In March 2009 AIG paid approximately $168 million in retention awards payments to roughly 400 AIGFP employees. (The remaining amounts are payable in 2010.) The payments, not surprisingly,

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[820] *See* American International Group, Inc., *Fixed Rate Cumulative Perpetual Preferred Stock Offering*, at section 4.10 (Nov. 25, 2008) (online at www.financialstability.gov/docs/agreements/AIG_Agreement_11252008.pdf) (outlining the securities purchase agreement between AIG and Treasury).

[821] SIGTARP Report on Oversight of AIG Compensation, *supra* note 816, at 22.

[822] SIGTARP Report on Oversight of AIG Compensation, *supra* note 816, at 12.

generated much public criticism, both in Congress and the Administration. (Apparently, FRBNY learned of the AIGFP retention programs in November 2008, but did not tell Treasury about them until the end of February 2009.) SIGTARP concluded that "Treasury's failure to discover the scope and scale of AIG's executive compensation obligations, in particular at AIGFP, potentially resulted in a missed opportunity to avoid the explosively controversial events and created considerable public and Congressional concern over the retention payments."[823] At the same time, however, SIGTARP found that government and private lawyers—who reviewed the employment contracts on behalf of AIG, the FRBNY, and the Treasury Department—had concluded that the contracts were binding and that AIG was required by law to make the retention payments. But one of the conditions of Treasury's Equity Capital Facility was an agreement by AIG to pay a $165 million commitment fee within five years to Treasury on account of the retention agreement awards.[824]

The retention payments raise three difficult issues. The first is one of policy, namely whether the need to retain employees who understood and could unwind AIGFP's CDS trades to reduce AIG's continuing liabilities, outweighed the need to clean house at AIGFP. The second is why FRBNY did not push AIGFP to renegotiate the agreements, especially since AIGFP was the company whose operations had led to the crisis at the company. The third is the failure of FRBNY to tell Treasury about the retention program for more than three months and to consider the way to deal with the payments.

4. The Special Master

Like all recipients of TARP assistance, AIG is subject to both statutory[825] and regulatory[826] executive compensation standards. In general, the rules apply to AIG's "top 5 most highly paid execu-

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[823] *See, e.g.*, Testimony of Edward Liddy, *supra* note 91, at 3 ("[I]t is regrettable that we have even reached this point. When the press first reported about the AIG Financial Products retention bonuses in late January, I called Mr. Liddy to express my concerns that paying out such sums to the very division that engaged in the risky behavior that warranted the government's bailout would rightly incite a public outcry * * * Unfortunately, my sound advice went unheeded, the company hid behind legal technicalities, and the public outcry that I predicted happened: AIG has become the subject of considerable public scorn, and the public's interest in providing ongoing, sustainable support to repair our struggling financial system has plummeted.").

[824] U.S. Department of the Treasury, *Securities Purchase Agreement, Dated as of April 17, 2009, Between American International Group, Inc. and United States Department of the Treasury*, at Section 1.2 (Apr. 17, 2009) (online at www.financialstability.gov/docs/agreements/Series.F.Securities.Purchase.Agreement.pdf).

[825] The statutory standards are found in EESA section 111. The text of section 111 in force after February 17, 2009 is contained in section 7001 of the American Recovery and Reinvestment Act, Pub. L. No. 111–5 (Feb. 17, 2009) ("ARRA"), which almost completely recast, and toughened, the original EESA language, EESA § 111(a)(5). The fact that an institution's stock warrants remain outstanding does not in itself require continuation of the compensation restrictions. However, section 111 also applies during the period of the actual federal "ownership" of the common stock of a TARP recipient. *See* 31 CFR § 30.2.

[826] The regulatory standards are found in the Interim Final Rule, entitled "TARP Standards for Compensation and Corporate Governance." 31 CFR §§ 30.0–30.17 (June 15, 2009) (online at ecfr.gpoaccess.gov/cgi/t/text/text-dx?c=ecfr;sid=00de395363b27bcc941de94d3b128136;rgn=div5;view=text;node=31%3A1.1.1.1.28;idno=31;cc=ecfr).

tives"[827] and various other employees.[828] The rules (and the rules relating to the Special Master, discussed immediately below) apply until the date "no obligation arising from the . . . assistance . . . remains outstanding."[829]

Under Treasury's implementing regulations, AIG's compensation arrangements are subject to an additional set of more restrictive rules. Because AIG is one of the companies deemed to have received "exceptional financial assistance,"[830] it is one of the companies subject to the jurisdiction of the Special Master for TARP Executive Compensation, Kenneth R. Feinberg, for the same period as that in which the general rules apply.[831] The Special Master, who is appointed by the Treasury Secretary,[832] must (i) agree to the amount and type of compensation to be paid to AIG's 25 most senior executives, and (ii) fix parameters for setting compensation for other individuals whom relevant SEC rules classify as AIG execu-

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[827] EESA § 111(a)(1). The five executives, called "senior executive employees," must each be an individual "whose compensation is required to be disclosed under the Securities Exchange Act, "and non-public company counterparts." *Id*.

[828] As set out in EESA section 111(b)(3)(A–F), they include: exclusion, for senior executive officers of compensation incentives to take "unnecessary risks"; a required ability by the institution to recover (or "clawback") "bonus, retention, or incentive compensation, for senior executive officers and the institution's 20 next most highly-compensated employees, "based on statements of earnings, revenues, gains, or other criteria . . . later found to be materially inaccurate;" prohibition of any plan whose terms would "encourage manipulation of earnings . . . to enhance the compensation of *any* of its employees;) of compensation; a prohibition on golden parachute payments to a senior executive officer and any of the institution's next 5 most highly-compensated employees; a requirement that bonuses, incentive awards, or incentive compensation, for, in the case of an institution of AIG's size, senior executive officers and the next 20 most highly-compensated employees, except through "long-term restricted stock" that (i) cannot "fully vest" while obligations arising from TARP assistance are outstanding, and (ii) has a value no greater than one-third of the individual's total annual compensation. ; and creation of an independent compensation committee of the institution's board of directors to review compliance with the foregoing standards. (As a company listed on the New York Stock Exchange, AIG was already required to have an independent compensation committee of its board of directors.) An institution's board is also required to adopt a strict policy limiting "perquisites," EESA section 111(d). Finally, Treasury must review any bonuses and other compensation paid to the senior executive officers and the next most highly paid employees of each entity that receives TARP assistance before February 17, 2009, to determine if the bonuses are (i) inconsistent with the purposes of section 111, (ii) inconsistent with the TARP, or (iii) contrary to the public interest. In any case in which Treasury makes that determination, it must "seek to negotiate" with both the institution and the recipient of the compensation for "appropriate reimbursements to the government." EESA section 111(f).

[829] EESA section 111(a)(5). The fact that an institution's stock warrants remain outstanding does not in itself require continuation of the compensation restrictions. *Id.* However, section 111 also applies during the period of the actual federal "ownership" of the common stock of a TARP recipient. *See* 31 CFR § 30.2.

[830] The term "exceptional financial assistance" means any financial assistance provided under the SSFI, the TIP, the Automotive Industry Financing Program, and any new program designated by the Secretary as providing exceptional financial assistance. 31 CFR § 30.1.

[831] For 2009, AIG was one of seven companies subject to the approval requirement; Bank of America, Chrysler, Chrysler Financial, Citigroup, General Motors, and GMAC were the others. The number shrunk to five for 2010, because Bank of America and Citigroup repaid the TARP assistance that had placed them in the group of institutions subject to the mandatory approval rules. On May 17, 2010, Treasury announced that Chrysler Financial had exited the TARP after its parent company, Chrysler Holding, repaid an outstanding loan of $1.9 billion. On May 14, 2010. As a result, that company is also no longer required to comply with the TARP executive compensation restrictions, for periods after May 14; Treasury staff has indicated that the rules do not permit the company to adjust its post-repayment compensation to make up for amounts that might have been paid or earned, but for the relevant caps, for the period before repayment.

[832] Mr. Feinberg is a Washington lawyer whose specialty is mediation, resolution of multiparty claims, and administration of settlement funds. He was, for example, Special Master of the September 11th Victims Compensation Fund, Special Master in the Agent Orange, asbestos, Dalkon shield and DES (pregnancy medication) cases, administrator for the Memorial Fund created after the shootings at Virginia Tech and the fund created by the settlement of SEC claims against AIG (arising from pre-2008 conduct), and, on behalf of several insurance companies, manager of resolution of claims disputes arising from Hurricane Katrina claims. Feinberg was appointed Special Master in June 2009.

tive officers, and for the company's next 100 most highly-paid employees.

The Special Master reviewed the company's compensation proposals and made a determination of appropriate compensation levels (i.e., those levels that he would approve). In his review, he applied the following standards:[833] (i) base cash salary should not exceed $500,000 except in "appropriate cases for good cause shown," (ii) executives should receive the bulk of their compensation in the form of units of "restricted stock," (iii) total compensation should be comparable to total compensation for similarly situated employees in similar companies, (iv) employees could be eligible for long-term incentive awards if they achieve certain performance objectives, and (iv) all incentive compensation had to be subject to a "clawback" if it were subsequently discovered that it was paid on the basis of materially inaccurate information.[834]

Due to employee turnover, the Special Master set the compensation of only 13 senior AIG executives for 2009 and 22 such executives for 2010. For 2009, the highest compensation figure approved for the "Top 25" employees was $10.5 million and the lowest was $100,000. For 2010, the highest was $10.5 million, and the lowest was $312,500.[835] In addition, the Special Master sought to recoup a portion of March 2009 retention awards. After AIGFP employees satisfied their pledge to return $45 million of the retention payments they received in 2009, the Special Master permitted AIG to pay these employees "non-cash compensation" in 2010. He also determined that with only one exception, all AIGFP executives who received retention awards in 2010 would have their 2010 salaries frozen at the levels he set in 2009.[836]

An illustration of the Special Master's approach is provided by the level of compensation he approved for Mr. Benmosche, who became AIG's CEO in mid-2009. Staff of the Special Master's office has cited several factors to support that figure: (i) Mr. Benmosche was new to the company and had in no way been involved in the conditions that led to the company's difficulties, (ii) Mr. Benmosche was an experienced insurance executive, (iii) a certain compensation level was necessary to attract the sort of experienced individual willing to tackle a situation such as AIG's, (iv) that level was in the range of what is paid to individuals holding comparable positions at comparable companies, and, perhaps most important,

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[833] Letter from Kenneth R. Feinberg, special master for TARP executive compensation, U.S. Department of the Treasury, to Robert Benmosche, president and chief executive officer, American International Group, Inc., *Proposed Compensation Payments and Structures for Senior Executive Officers and Most Highly Compensated Employees* (Oct. 22, 2009) (online at www.treas.gov/press/releases/docs/20091022%20AIG%20Letter.pdf). He also applied similar standards in reviewing the compensation structures of covered employees 26–100 in both 2009 and 2010. The standards are consistent with those applied to the other institutions within the Special Master's jurisdiction.

[834] The general executive compensation rules limit executive compensation to no more than 1/3 of an employee's total compensation and require that it be paid in restricted stock, that is, stock whose vesting and ultimate sale are extended over time. The "clawback" provision is also part of the general rules.

[835] FRBNY has worked with Treasury and the Special Master, to some extent, especially by providing information based on its knowledge of AIG's compensation arrangements and practices.

[836] U.S. Department of the Treasury, Letter from Kenneth R. Feinberg, Proposed Compensation Payments and Structures for Senior Executive Officers and Most Highly Compensated Employees, at A10 ("Covered Employees 1–25") (Mar. 23, 2010) (online at www.financialstability.gov/docs/
20100323%20AIG%202010%20Top%2025%20Determination%20(3-23-10).pdf).

(v) $7.5 of the $10.5 million in Mr. Benmosche's package was composed of long-term equity that will have value only if his efforts were successful.

The company allegedly has chafed against the determinations of the Special Master in some cases, and a few senior executives have left the company because of proposed limits on their compensation.[837] The Chairman's Message at the beginning of the 2009 AIG Annual Report notes that:

> The Board has been intently focused on . . . dealing with the pay guidelines and restrictions imposed by the Special Master, who has ultimate authority over a number of major compensation decisions. While we can pay the vast majority of people competitively, on occasion, these restrictions and his decisions have yielded outcomes that make little business sense. *For example, in some cases, we are prevented from providing market competitive compensation to retain some of our own most experienced and best executives. This hurts the business and makes it harder to repay the taxpayers*.[838]

The SIGTARP Executive Compensation Report reports that "AIG documents indicate that dozens of Directors and Officers have resigned across the Commercial Insurance, Worldwide Life Insurance, Investments, and Financial Products businesses."[839] The losses are apparently "especially acute" at AIGFP, but the Report does not indicate how many of the affected individuals were subject to the Special Master's determinations.[840]

The Special Master has generally rejected such assertions from the companies under his jurisdiction. In testimony before the House Committee on Financial Services on February 25, 2010, he stated:

> I'm dubious about that claim. Now, I will say this, first, the determinations we have made were only made last October, last December. We don't see any exit of individuals from these companies.
>
> Whatever individuals were exiting these companies, I suggest exited long before compensation determinations were made by this office. There were quite a few vacancies when I took over this assignment. But I don't see exiting. We have to take that into account. It certainly impacts our decisions on compensation. But I'm rather dubious about that claim.[841]

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[837] On December 11, 2009, The New York Times reported that five of AIG's top executives, including general counsel Anastasia Kelly, had exercised a "right to severance" afforded to them by a company executive plan that permitted them to claim severance if their pay and responsibilities were reduced. At least three of the five subsequently withdrew their claims. Mary Williams Walsh and Louise Story, *A.I.G. General Counsel Set to Depart Over Pay*, The New York Times (Dec. 10, 2009) (online at dealbook.blogs.nytimes.com/2009/12/11/aig-general-counsel-is-set-to-depart-amid-talks-on-pay/).

[838] American International Group, Inc., *AIG 2009 Annual Report*, at 2 (Feb. 26, 2009) (online at www.aigcorporate.com/investors/2010__April/2009AnnualReport.pdf) (emphasis added).

[839] SIGTARP Report on Oversight of AIG Compensation, *supra* note 816, at 19.

[840] SIGTARP Report on Oversight of AIG Compensation, *supra* note 816, at 20.

[841] House Committee on Financial Services, Testimony of Kenneth R. Feinberg, special master for TARP executive compensation, U.S. Department of Treasury, *Compensation in the Financial Industry—Government Perspectives* (Feb. 25, 2010) (online at www.house.gov/apps/list/hearing/financialsvcs__dem/hr__021810.shtml). One of the principles governing the Special Master's work is to the need to retain competitiveness to permit repayment of TARP assistance. 31 CFR § 30.16(b)(1)(ii) ("The compensation structure, and amount payable where applicable, should re-

5. Effect on AIG's Future

Analysts and rating agencies have cited executive turnover as one cause for concern about the future strength of AIG. FRBNY apparently shares this concern.[842]

AIG divisional management, in conversations with Staff, has provided a mixed assessment of government compensation constraints, indicating that this is more of an issue at the firm-wide or holding company level. A firm-wide manager described the issue as a "huge time sink" for senior managers and asserted that there is no question that the company has seen executives depart as a result of the compensation constraints. Another firmwide manager acknowledged that AIG had lost some people but had also managed to hold on to a lot more. And, again, only the most senior and well-paid employees of AIG are subject to the Special Master's jurisdiction. Chartis, for example, has very few such employees. In any case, retention of key employees is likely to pivot on the perceived long-term direction of the firm.

The fixing of salary levels at a company in AIG's situation is not easy. Still, AIG is supported largely by public funds. The Panel continues to hold the view, expressed in its GMAC report, that the appropriate and necessary levels of compensation for executives of companies that depend on federal assistance for their operation raises significant unanswered questions.

K. Conclusion

1. AIG Changed a Fundamental Market Relationship

By providing a complete bailout that called for no shared sacrifice among AIG and its creditors, FRBNY and Treasury fundamentally changed the rules of America's financial marketplace.

U.S. policy has long drawn a distinction between two different types of investments. The first type is "safe" products, such as checking accounts, which are highly regulated and are intended to be accessible to even unsophisticated investors. Banks that offer checking accounts must accept a substantial degree of regulatory scrutiny, offer standardized features, and pay for FDIC insurance on their deposits. In return, the bank and its customers benefit from an explicit government guarantee: within certain limitations, no checking account in the United States will be allowed to lose even a penny of value.

By contrast, "risky" products, which are more loosely regulated, are aimed at more sophisticated players. These products often offer much higher profit margins for banks and much higher potential returns to investors, but they have never benefited from any government guarantee. The risks—and the rewards—have always been borne solely by private parties.

Before the AIG bailout, the derivatives market appeared to fall cleanly in the second category. Yet by bailing out AIG and its counterparties, the federal government signaled that the entire derivatives market—which had been explicitly and completely deregu-

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flect the need for the TARP recipient to remain a competitive enterprise, to retain and recruit talented employees who will contribute to the TARP recipient's future success, and ultimately to be able to repay TARP obligations.").

[842] SIGTARP Report on Oversight of AIG Compensation, *supra* note 816, at 19.

lated by Congress through the Commodities Futures Modernization Act[843]—would now benefit from the same government safety net provided to fully regulated financial products. In essence, the government distorted the marketplace by transforming highly risky derivative bets into fully guaranteed transactions, with the American taxpayer standing as guarantor.

The Panel believes that the moral hazard problem unleashed by making whole AIG's counterparties in unregulated, unguaranteed transactions has turned out to be a key act in undermining the credibility of America's system of financial regulation and the credibility of the specific efforts at addressing the financial crisis that followed, including the entirety of the TARP program.

2. The Powerful Role of Credit Rating Agencies

It is clear from the analysis in this report that considerations about credit rating agencies were central to FRBNY's, and later Treasury's, decisions to assist AIG, and shaped many of the decisions that had to be made during the course of the rescue. Indeed, it is no exaggeration to say that concerns about rating downgrades drove government policy in regard to AIG.

As the market's most widely followed judges of financial soundness, credit rating agencies wield immense power, whether they consciously use it or not. In this case, government decisionmakers felt compelled to follow a particular course of action out of a justifiable fear of what credit rating agencies might do if they acted otherwise. The fact that this small group of private firms was able to command such deference from the federal government raises questions about their role within the marketplace and how effectively and accountably they have wielded their power.

3. The Options Available to the Government

FRBNY and Treasury justify AIG's extraordinary bailout by saying that they faced a "binary choice" between allowing AIG to fail, which would have resulted in chaos, or rescuing the entire institution, including all of its business partners. The Panel rejects this reasoning. The evidence suggests that government had more than two options at its disposal, and that some of the alternatives would not have resulted in the payment in full of the counterparties and other AIG creditors.

In interviews and meetings with participants on all sides in these events, the Panel has identified a key decision point: the period between Sunday afternoon, September 14, 2008, and Tuesday morning, September 16, 2008. This was the period during which FRBNY sought to encourage a private effort to lend sufficient funds to AIG to address its liquidity crisis, while at the same time trying to determine what the consequences would be of the bankruptcy of AIG's holding company. Secretary Geithner characterized the decision as to whether or not to press JPMorgan and Goldman Sachs further to support AIG as an existential decision, showing both the importance and the difficulty of that moment.

The key events in this effort at a private sector solution began with the convening of a meeting at FRBNY at 11 a.m on Monday,

[843] For a further discussion of AIG's regulatory scheme, see Section B.2, *supra*.

September 15, 2008, led on the lender side by representatives of JPMorgan Chase and Goldman Sachs. Representatives from Morgan Stanley, who was retained to assist the government, were also present. President Geithner helped open the meeting and indicated that FRBNY expected the parties to find a private sector solution for AIG, which at that point involved lending AIG approximately $75 billion. While the meeting continued for some time, and the parties to the meeting left with a commitment to keep working, by late afternoon President Geithner had concluded the chances of their putting together a private sector rescue package were slipping.

Early in the morning on September 16, 2008, an attorney for JPMorgan Chase contacted FRBNY and informed FRBNY that JPMorgan Chase and Goldman Sachs would be unable to put together a rescue plan for AIG. It appears no further efforts were made to pursue a private sector solution, or to pursue a mixed FRBNY-private sector solution. In particular, there were no efforts by FRBNY to speak to the CEOs of JPMorgan Chase or Goldman Sachs about the urgency of crafting a private sector solution for AIG.

The Panel is concerned that the government put the effort to organize a private AIG rescue in the hands of only two banks—banks with severe conflicts of interest as they would have been among the largest beneficiaries of a taxpayer bailout. By failing to bring in other players, the government neglected to use all of its negotiating leverage. There is no doubt that a private rescue would have been difficult, perhaps impossible, to arrange, but if the effort had succeeded, the impact on market confidence would have been extraordinary, and the savings to taxpayers would have been immense.

Further, even after the Federal Reserve and Treasury had decided that a public rescue was the only choice, they still could have pursued options other than paying every creditor and every counterparty at 100 cents on the dollar. Arrangements in which different creditors accept varying degrees of loss are common in bankruptcy proceedings or other negotiations when a distressed company is involved, and in this case the government failed to use its significant negotiating leverage to extract such compromises. As Mr. Bienenstock of Dewey & LeBoeuf testified to the Panel, "FRBNY was saving AIG with taxpayer funds due to the losses sustained by the business divisions transacting business with these creditor groups, and a fundamental principle of workouts is shared sacrifice, especially when creditors are being made better off than they would be if AIG were left to file bankruptcy." As such, "it was very plausible to have obtained material creditor discounts from some creditor groups as part of that process without undermining its overarching goal of preventing systemic impairment of the financial system and without compromising the Federal Reserve Board's principles."

The Panel believes that FRBNY's approach was driven by three considerations.

The first consideration was a matter of central banking philosophy: was it the role of FRBNY to attempt to use all the tools at its disposal to induce entities it regulated to do something they did not want to do in the interests of systemic stability? The Panel be-

lieves that FRBNY at that moment did not see such inducement as its role. The Panel believes that in such a crisis, with the stability of the financial system and the integrity of the regulatory system in jeopardy, that FRBNY's role was to do just that: to ensure that those private parties that benefited from the stability of the financial system would contribute to its preservation.

The second consideration was moral hazard. The key actors in FRBNY, as well as Chairman Bernanke, have all expressed their sense that AIG deserved to fail, that rescuing AIG created a moral hazard problem for other large firms. The Panel believes the Federal Reserve System fully and properly considered this downside to rescuing AIG. However, AIG was not the only financial market participant rescued by the AIG bailout. As noted above, however, the Federal Reserve's rescue of AIG also rescued AIG's counterparties, and the Panel does not believe that this aspect of the moral hazard problem was given proper weight.

The third consideration, and a potentially decisive one all by itself, was the question of whether there was enough time to work further on a private sector solution or a mixed public-private solution, as well as a related question as to whether any private sector institution or group of institutions was strong enough in the midst of an accelerating crisis to participate on the scale necessary. The record appears to be clear that in the absence of outside funding AIG would have been insolvent by the end of the day on September 16, 2008. In the end, FRBNY provided immediate funding that night.

Ultimately, it is impossible to stand in the shoes of those who had to make decisions during those hours, to weigh the risks of accelerated systemic collapse against the profound need for the financial firms that FRBNY was rescuing along with AIG to share in the costs and the risks of that rescue, and to weigh those considerations not today in an atmosphere of relative calm, but in the middle of the night in the midst of a financial collapse. All the Panel can do is observe the costs to the public's confidence in our public institutions from the failure to share the burden of the AIG rescue with AIG's counterparties in the financial sector.

4. The Government's Authorities in a Financial Crisis

The Federal Reserve and Treasury have explained the haphazard nature of the AIG rescue by noting that they lacked specific tools to handle the collapse of such a complex, multisector, multinational financial corporation. To some extent this argument is a red herring: the relevant authorities should have monitored AIG more closely, discovered its vulnerability earlier, and sought any needed new authorities from Congress in advance of the crisis. Even after AIG began to unravel, the Federal Reserve and Treasury could have used their existing authority more effectively.

Even so, it is worth noting that the government has no well-defined legal process to wind down a company like AIG in the same way that it winds down banks through the FDIC resolution process or nonfinancial companies through bankruptcy. As a result, the Federal Reserve and Treasury had to repurpose powers that were originally intended for other circumstances, leading to a bailout that was improvised, imperfect, and in many ways deeply unfair.

It is similarly worth noting that OTS approached AIG from a bottom-up perspective, focused primarily on ensuring that no harm would be done to the thrift, as opposed to taking a top-down approach that reviewed the overall safety and soundness of the holding company. Given that AIG's thrift represented well under 1 percent of the holding company's assets, this approach seems misguided at best and raises questions about whether this is the most effective way to review complex companies and their systemic risks.

5. Conflicts

The rescue of AIG illustrates the tangled nature of relationships on Wall Street. People from the same small group of law firms, investment banks, and regulators appear in the AIG saga (and many other aspects of the financial crisis) in many roles, and sometimes representing different and conflicting interests. The lawyers who represented banks trying to put together a rescue package for AIG became the lawyers to FRBNY, shifting sides in a matter of minutes. Those same banks appear first as advisors, then potential rescuers, then as counterparties to several different kinds of agreements with AIG, and ultimately as the direct and indirect beneficiaries of the government rescue. Many of the regulators and government officials (in both Administrations) are former employees of the entities they oversee or that benefited from the rescue.

These links have led to many allegations that the rescue was orchestrated in order to assist friends and former colleagues of those leading the rescue. Although Panel staff has spent significant time reviewing hundreds of thousands of pages of documents from the time of the rescue, to date they have found no evidence of any such concerted effort. It is nonetheless indisputable that the friends and former colleagues of those who directed the AIG rescue are among the many beneficiaries of the rescue.

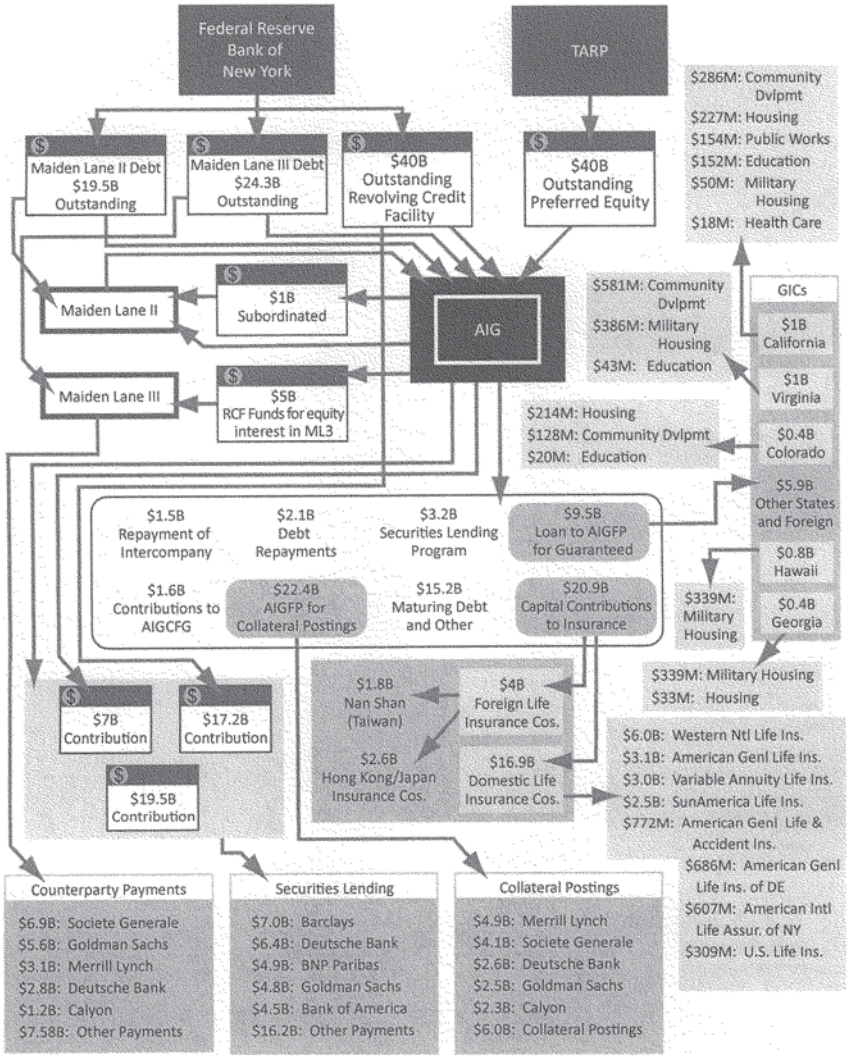
The government has justified its decision to draw from a limited pool of lawyers and advisors by citing the need for expertise from Wall Street insiders familiar with AIG. Even so, the government entities should have recognized that at a time when the American taxpayers were being asked to bear extraordinary burdens, they had a special responsibility to ensure that their actions did not undermine public trust by failing to address all potential conflicts and the appearance of conflicts that could arise. The need to address conflicts and the appearance of conflicts, by government actors, counterparties, lawyers and all other agents involved in this drama, was treated largely as a detail that could be subjugated to the primary goal of keeping the financial system up and running. This was wrong.

Even setting aside concerns about actual or apparent conflicts of interest, the limited pool of people involved in AIG's rescue raises a broader concern. Everyone involved in AIG's rescue had the mindset of either a banker or a banking regulator. The discussions did not include other voices that might have brought different ideas and a broader view of the national interest. It is unsurprising, then, that the American public remains convinced that the rescue was designed by Wall Street to help fellow Wall Streeters, with less emphasis given to protecting the public trust.

The Panel recognizes that government officials were confronting an immediate crisis and had to act in haste. Yet it is at moments of crisis that the government has its most acute obligation to protect the public interest by avoiding even the appearance of impropriety. As Mr. Baxter of FRBNY told the Panel, "If we should go through this again, we [would] need to be more mindful of how our actions can be perceived. The lesson learned for me personally here is that we need to be mindful of that and perhaps change our behavior as a result of the perception, not the actuality."

ANNEXES

ANNEX I: WHERE THE MONEY WENT



ANNEX II: DETAILED TIMELINE OF EVENTS LEADING UP TO THE RESCUE OF AIG

Mid to late 2007:

AIG:

• Texas Department of Insurance discovers during an examination that AIG's life insurance subsidiaries' securities lending program had been purchasing RMBS with the cash collateral. The insurance regulators instruct AIG to unwind the program. They inform the regulators of AIG's other life insurance subsidiaries.

• In November 2007, at the AIG Supervisory College, the Texas Department of Insurance informs OTS and the other non-insurance regulators of the securities lending issue.

Mid-July through August 2008:

AIG:

• AIG CEO Robert Willumstad reviews AIG's businesses and measures to address the liquidity concerns in AIG's securities lending portfolio and the ongoing collateral calls with respect to AIGFP's CDS portfolio.

—AIG asks a number of investment banking firms to discuss possible solutions to these issues.

—In late August, AIG engages JP Morgan to assist in developing alternatives, including a potential additional capital raise.

• FRBNY records reflect that Mr. Willumstad has one conversation with FRBNY President Geithner regarding possible access to the Federal Reserve's discount window.

• On August 11, OTS holds an introductory meeting with FRBNY at FRBNY's request. FRBNY examiners had long sought such a meeting with the OTS to open a dialogue with them about AIG and its operations, and to discuss issues that the FRBNY examiners had seen with respect to the monoline financial guarantors. An OTS examiner attends on behalf of OTS.

• Mr. Willumstad announces plans to hold an investor meeting on September 25, 2008 to present the results of his review.

• At the end of August, the credit rating agencies advise Mr. Willumstad of their plans to reassess AIG's ratings (even though they had previously agreed to wait).

Early September 2008:

AIG:

• AIG faces increasing stress on its liquidity due to securities lending requirements and cash collateral demands from its AIGFP CDS portfolio.

• AIG meets with representatives of the major rating agencies to discuss Mr. Willumstad's strategic review as well as the liquidity issues arising from AIG's securities lending program and AIGFP's CDS portfolio.

September 7, 2008: Fannie Mae and Freddie Mac are placed into government conservatorship.

September 8–12, 2008: AIG

• AIG's common stock price declines from $22.76 to $12.14.
• The company reports that as of July 31, 2008, S&P, Moody's, and Fitch had placed its senior long-term debt on negative outlook.
• Mr. Willumstad meets with S&P, Moody's, and Fitch, and they all but announce that they would be downgrading AIG in the very near future.

September 9, 2008: Mr. Willumstad calls President Geithner and asks to meet with him. In a short meeting, they discuss the potential for AIG to become a primary dealer in order to gain access to the Federal Reserve's discount window. President Geithner tells Mr. Willumstad that AIG does not meet the requirements to be a primary dealer and that he will get back to him.

September 11, 2008: President Geithner notifies Secretary Paulson and Chairman Bernanke that Lehman Brothers is unlikely to open for business on Monday, September 15, 2008.

September 12, 2008: AIG
• S&P places AIG on CreditWatch with negative implications and notes that upon completion of its review, it could affirm the company's current rating of AA- or lower the rating by one to three notches.
• AIG understands that both S&P and Moody's would re-evaluate AIG's ratings early in the week of September 15.
• AIG's subsidiaries, ILFC and AGF, are unable to replace all of their maturing commercial paper with new issuances of commercial paper. Therefore, the AIG parent advances loans to them to meet their commercial paper obligations.
• Mr. Willumstad and other senior AIG officials meet with some private equity investors over lunch to discuss the serious challenges AIG is facing.
• Mr. Willumstad calls President Geithner at FRBNY to inform him that the company is facing potentially fatal liquidity problems. Mr. Willumstad's concerns are two-fold:

(1) AIG had lent out investment-grade securities for cash collateral, which was invested in illiquid MBSs. Consequently, AIG would not be able to liquidate its assets to meet the demands of its counterparties.

(2) AIG is facing a downgrade in its credit rating the next week, perhaps coming as soon as Monday, September 15. Depending on the severity of the downgrade, it would prompt additional collateral calls ranging between $13 billion to $18 billion.

• Mr. Willumstad meets with private equity investors and investment bankers during the course of the day.
• AIG's common stock price falls from $22.76 on September 8 to $12.14 on September 12.
• AIG's general counsel and CFO call the New York Insurance Department to inform it of its liquidity problem, and to ask for assistance.
• Later that day, FRBNY analysts come to AIG to look into, discuss, and ask questions about liquidity issues arising from the AIGFP portfolio.
• Mr. Willumstad informs President Geithner that he needs to raise $20 billion, and with the advice of its financial advisor JPMorgan Chase, the company sets out to raise $20 billion over the

weekend (in order to allow AIG to meet its obligations as they came due in anticipation of collateral calls related to looming downgrades).

• Mr. Willumstad calls Warren Buffett during the evening, who apparently expresses some interest in some of AIG's businesses if they were for sale, but does not want to invest in the AIG parent because it is "too complicated."

• During the evening an FRBNY employee emails William Dudley and others at FRBNY about "panic" at hedge funds about AIG: "I am hearing worse than [Lehman.] Every bank and dealer has exposure to them . . . People I heard from worry they can't roll over their funding. . . . Estimate I hear is 2 trillion balance sheet."

• Staff from FRBNY (along with staff from the Federal Reserve Board of Governors who participated by telephone) met with AIG senior executives on Friday. At this meeting, AIG stated that it had $8 billion cash in its holding company, and if there was no downgrade, enough liquidity to last for the next two weeks. AIG estimated that it might have to pay out $18.6 billion over the next week if, as expected, its ratings were downgraded the following week. A description of this meeting was sent to President Geithner, Dudley, and others, late Friday night.

• On Friday, AIG informed Treasury and the New York state insurance regulators of its severe liquidity problems, principally due to increasing demands to return cash collateral under its securities lending program and collateral calls on AIGFP's CDS portfolio.

• On Friday, President Geithner called together representatives of 12 major financial institutions to participate in discussions regarding a private-sector consortium rescue for Lehman Brothers at a meeting that began at 6:45 p.m. and continued through the weekend. On Friday, the financial institutions discussed committing funds to finance $40 billion of Lehman's real estate assets. Over the course of the weekend, the institutions did commit to financing. Barclays, however, was no longer prepared to complete the purchase.

September 13–14, 2008: AIG

• Mr. Willumstad, along with his CFO, Vice Chairman, and JPMorgan Chase bankers held a call with FRBNY staff and BOG staff to update them on the status of the company's efforts to address its liquidity needs. At this point, Mr. Willumstad is fairly optimistic that assistance from New York State is forthcoming (in the form of New York State authorization for AIG to transfer $20 billion in liquid assets from its subsidiaries to use as collateral for daily operations). AIG said it had a plan over the next six to 12 months to sell approximately $40 billion in assets, including domestic and foreign life insurance subsidiaries; these assets equaled 35–40 percent of the company. AIG said that in addition to the aforementioned assistance from the New York State Insurance Department, it needed bridge financing, and was interested in tapping Federal Reserve lending facilities. Federal Reserve officials who were on the call got the impression that AIG had not approached private financial institutions about obtaining this financing, likely because AIG felt that it would be turned down. The phone call also included a discussion of the Federal Reserve's emergency lending authority under Section 13(3) of the Federal Reserve Act. The Fed-

eral Reserve officials stated that 13(3) lending would send a negative signal to the market, and told AIG that they "should not be particularly optimistic," given the history and hurdles of 13(3) lending.

• Treasury, Federal Reserve, New York State Insurance Department and other experts meet to consider how to respond to AIG's problems and determine if it is systemically important (while aware that the private sector was already working on a solution to AIG's liquidity problems). State insurance regulators provide information on the condition of AIG's insurance subsidiaries, including the potential impact of RMBS portfolio losses on the subsidiaries' capital base.

• The New York Insurance Department has a conference call with AIG on Saturday morning, and then goes to AIG's offices where they spend the remainder of the weekend where they can provide assistance and expedite any needed regulatory actions.

• AIG accelerates the process of attempting to raise additional capital and discusses capital injections and other liquidity measures with private equity firms, sovereign wealth funds, and other potential investors. AIG also meets with Blackstone Advisory Services LP to assist in developing alternatives, including a potential additional capital raise. However, once AIG concludes that it needs $40 billion by Saturday evening (the increased estimate is partly based on the increasing likelihood of a Lehman bankruptcy, which would substantially increase the pressure on AIG due to additional collateral calls and a likely decline in the value of its investment portfolio), investors lose interest because they do not think it would be a sound investment given AIG's financial condition.

• By Saturday evening, Mr. Willumstad concludes that the only solution is for the government to guarantee AIG's balance sheet through a loan or line of credit. Mr. Willumstad calls President Geithner at FRBNY during the evening and estimates that AIG needs $40 billion, twice the amount he had mentioned earlier.

—To raise this amount, Mr. Willumstad notes that he needs government support. Geithner says that this would not be possible.

• On Sunday, Christopher Flowers, founder of the private equity firm J.C. Flowers & Company proposes that his firm and Allianz (the German insurance company) buy AIG for $2 a share (they propose to acquire the assets of the subsidiaries but seek to be insulated from the liabilities of the parent). Flowers and Allianz would each contribute $5 billion in new capital, but Flowers' offer is conditioned on receiving government support, New York State authorization for AIG to transfer $20 billion in assets from its subsidiaries to use as collateral for daily operations, and the replacement of AIG's top management with Allianz executives.

—Mr. Willumstad does not believe the proposal is credible.

• Sunday mid-day, staffers at FRBNY were preparing to brief President Geithner on the pros and cons of providing AIG access to the Federal Reserve's Discount Window, "this is to inform [Geithner] in his discussions with Chairman Bernanke w/r/t the option and impact of lending to AIG."

• At 3:49 p.m. on Sunday, President Geithner (and other FRBNY officials) receive a staff memo describing the pros and cons of lend-

ing to AIG, a spreadsheet provided by AIG detailing the firms with the largest exposures to AIG (that was not complete as it dealt only with derivatives and lending exposures), and a presentation describing what FRBNY knows on AIG subsidiaries based on publicly available information.

• On Sunday afternoon/evening, Mr. Willumstad returns to FRBNY and tells the regulators that he is out of ideas and that without government support, the company would not survive.

• Also on Sunday evening, FRBNY officials meet with JPMorgan Chase, AIG's financial advisor, and no AIG representatives are present.

• Late Sunday night, President Geithner felt that "it still seemed inconceivable that the Federal Reserve could or should play any role in preventing AIG's collapse."

September 15, 2008:

Bank of America/Merrill Lynch: Bank of America announces its intent to purchase Merrill Lynch for $50 billion

Lehman Brothers: Lehman Brothers files for Chapter 11 bankruptcy protection

Money Market Mutual Funds:

• According to Secretary Geithner's 1/27/10 House Oversight testimony, an escalating bank run and broad withdrawal of funds from money market funds starts on Sunday evening, September 14–15, 2008, severely disrupting the commercial paper market.

• Reserve Primary Fund (which had increased its purchases of Lehman securities from November 2007 through the summer of 2008 and held $785 million in Lehman short-term debt, meaning that 1.2 percent of its assets were in Lehman debt, by September 2008) contacts FRBNY to express concern about Lehman's effect on the money market industry and on the Primary Fund.

—That morning, the Primary Fund faces $5.2 billion in redemption requests, and these increase to $16.5 billion by the early afternoon.

—By the end of the day, redemption orders for the Reserve Primary Fund total $25 billion.

• By early afternoon, State Street, the fund's custodian bank, calls to report that the huge number of redemptions caused the Primary Fund's account to be overdrawn, and the bank is suspending overdraft privileges. Investors seeking to withdraw funds could not immediately access their money.

AIG:

• Just after midnight and into the early morning, FRBNY staff consider whether AIG could receive support from the FHLB as a backstop for the insurance subsidiaries.

• During the morning, President Geithner calls Mr. Willumstad to advise him that he has asked JPMorgan Chase and Goldman Sachs to lead a private consortium effort to assist AIG.

• FRBNY staff meets and discusses systemic risks posed by the possible bankruptcy of AIG (bank exposures, implications for the insurance subsidiaries, and wider economic knock-on effects).

• As of Monday morning, FRBNY staff was pushing a private sector solution.

• At 11:30 a.m., Mr. Willumstad and other AIG officials, at the request of President Geithner, meets with representatives of Goldman Sachs, JPMorgan, Morgan Stanley, the New York State Insurance Department, FRBNY, and Treasury at FRBNY to discuss the creation of a $75 billion secured lending facility to be syndicated among a number of large financial institutions. President Geithner says that there would be no government help, meaning that there has to be an industry and private solution.

—Goldman Sachs and JPMorgan immediately begin the financing attempt.

—Mr. Willumstad, along with Dan Jester from Treasury, calls the credit rating agencies to ask them to delay downgrading AIG, to no avail.

—After the meeting, Mr. Willumstad and other AIG officials return to AIG and prepare for a bankruptcy filing.

• AIG is again unable to access the commercial paper market for its primary commercial paper programs, AIG Funding, ILCF, and AGF. AIG advances loans to ILFC and AGF to meet their funding obligations.

• AIG experiences returns under its securities lending programs which lead to cash payments of $5.2 billion to securities lending counterparties.

• In the late afternoon, S&P downgrades AIG's long-term debt rating by three notches, and Moody's and Fitch downgrade AIG's long-term debt rating by two notches, causing AIG to need to post additional collateral.

—As a result, AIGFP estimates that it needs more than $20 billion to fund additional collateral demands and transaction termination payments in a short period of time.

—Due to the downgrades, AIG has 48 hours under its contracts to post collateral. This means that AIG would run out of cash by Wednesday, September 17, default on its obligations, and be placed into bankruptcy.

—(By the end of September, AIG had drawn down $61 billion on the Federal Reserve's RCF, due to the impact of the downgrades, changes in market levels, and other factors).

• Traders, aware of AIG's mounting collateral calls and the ongoing meetings at FRBNY, unload their stock. AIG's common stock price falls to $4.76 per share (a 61 percent drop in one day).

• New York Governor David Paterson (acting on the recommendation of New York State Superintendent of Insurance Eric Dinallo) authorizes AIG to transfer $20 billion in assets from its subsidiaries to use as collateral for daily operations. In exchange, the parent company will give the subsidiaries less-liquid assets.

• According to Mr. Willumstad, AIG is largely out of business by the evening.

September 16, 2008:

AIG:

• At 1:44 a.m., President Geithner receives a staff memo weighing the pros and cons of a proposal to temporarily reinsure AIGFP's stable value wraps so that AIGFP could be unwound in a manner that contains the negative economic and psychological impact on plan participants. This would require an act of Congress.

• At 2 a.m., FRBNY officials receive word that AIG's plans for the secured lending facility with Goldman Sachs and JPMorgan fail. The FRBNY knew as of this time that there was no viable private sector solution to AIG's liquidity problems.

• At 3:13 a.m., FRBNY staff forward to President Geithner and other FRBNY officials receive a memo that assesses the systemic impact of an AIG bankruptcy, how the bankruptcy process might unfold, and the impact of an AIG failure on financial counterparties, market liquidity, and related spillover effects. The memo concludes that it "could be more systemic in nature than Lehman due to the retail dimension of its business . . . [that] intervention needs to insulate the retail activities (inc. those in the parent, like stable value wraps) in a way that inspires confidence among the public to avoid a potential crisis of confidence. Coordination issues among state regulators could make this difficult."

• FRBNY, Treasury, and Federal Reserve officials present their assessment of the AIG situation to the Federal Reserve Board at a meeting that began at 8 a.m., which authorizes FRBNY to provide liquidity to AIG in the form of an $85 billion revolving credit facility under Section 13(3) of the Federal Reserve Act.

• Mr. Willumstad calls President Geithner during the morning to inform him of his plans to draw down the remaining AIG credit lines that morning (because it could not make the required representations to its lenders), but President Geithner advises him not to do so. Nonetheless, Mr. Willumstad authorizes the draw-downs.

• The downgrades coupled with the sharp decline in AIG's common stock price to $4.76 on the previous day (and the fear of an anticipated AIG bankruptcy) result in counterparties withholding payments from AIG and refusing to transact with AIG even on a secured short-term basis, resulting in AIG being unable to borrow in the short-term lending markets.

• To provide liquidity, both ILFC and AGF draw down on their existing revolving credit facilities, resulting in borrowings of approximately $6.5 billion and $4.6 billion, respectively.

• At 11 a.m., President Geithner calls Mr. Willumstad and tells him that he is working on a solution and will get back to him.

• Insurance regulators notify AIG that it will no longer be permitted to borrow funds from its insurance company subsidiaries under a revolving credit facility that AIG maintains with certain of its insurance subsidiaries acting as lenders. Subsequently, the insurance regulators require AIG to repay any outstanding loans under that facility and to terminate it. (The intercompany facility is terminated effective September 22, 2008).

• AIG requests to draw on its $15 billion line of credit. JPMorgan was the lead agent on the line and held approximately $800 million of exposure. FRBNY staff following whether line is funded, if other participant banks invoke MAC clause, and how it affects other exposures and collateral requirements for AIG.

• At 2 p.m., FRBNY calls Mr. Willumstad and asks him to send a group of AIG attorneys over to FRBNY.

• At approximately 3:30 p.m., the FRBNY sends AIG the terms of a secured lending agreement that it is prepared to provide. AIG anticipates an immediate need for cash in excess of its available resources. (Those liquidity problems (and AIG's actual draws on the

Federal Reserve's RCF) went from $0 to $14 billion on September 16th, to $28 billion by the end of the next day, and to almost $40 billion by the end of the week).

• At 4:42 p.m., President Geithner and Secretary Paulson call Mr. Willumstad and outline the terms of FRBNY's secured lending agreement. Mr. Geithner advises him that he has two choices: accept the terms or file for bankruptcy. Secretary Paulson tells Mr. Willumstad that there is "no negotiation" and that "this is the only offer."

• Secretary Paulson also notes that another condition is that Mr. Willumstad would be replaced (AIG subsequently elects Edward M. Liddy as chairman and CEO). While President Geithner and Secretary Paulson push Mr. Willumstad to get an answer quickly (largely because of the impact on the capital markets), Mr. Willumstad tells them the AIG Board will have to review and make a decision on its own.

• At Board meeting that starts at 5 p.m. and lasts several hours, AIG's Board of Directors approves borrowing from FRBNY based on a term sheet that sets forth the terms of the secured credit agreement and related equity participation.

• At 6 p.m., Secretary Paulson and Chairman Bernanke conduct a briefing on the AIG rescue for House and Senate leadership in Senator Majority Leader Reid's conference room.

• Mr. Willumstad calls FRBNY at 8 p.m. to notify them of the AIG Board's acceptance.

Money Market Mutual Funds:

• Redemption requests at the Reserve Primary Fund reach $24.6 billion by 9 a.m.

• By 3:45 p.m., total redemption requests reach about $40 billion, and FRBNY declines to provide assistance in meeting shareholder redemptions.

• The net asset value of shares in the Reserve Primary Money Fund falls below $1 as of 4 p.m., primarily due to losses on Lehman Brothers commercial paper and medium-term notes.

• Money market redemption requests reach $33.8 billion (compared with a total of $4.9 billion for the entire previous week).

September 17, 2008:

Secretary Paulson has a conversation with Jeffrey Immelt, CEO of General Electric, who tells him that the capital markets are "very bad" and that the commercial paper markets are under significant stress.

The cost of buying default protection against Morgan Stanley and Goldman Sachs had soared overnight.

Money Market Mutual Funds:

• Putnam announces that it would close and liquidate the $12.3 billion Institutional Prime Money Market Fund, even though it does not own any Lehman or AIG securities and maintains its one dollar share value.

• Investors liquidate $169 billion from prime funds and reinvest $89 billion into government funds between September 15 and September 17.

Yields on 3-month Treasury notes dip below zero as investors seek the safety of short-term Treasury bonds.

Dow Jones average drops 449 points, falling 7 percent in only 3 days of trading.

At 6 p.m., Chairman Bernanke meets with Federal Reserve Vice Chairman Donald Kohn and Federal Reserve Governor Kevin Warsh, Mr. Alvarez of the Federal Reserve Board, and Spokesperson Michelle Smith (with President Geithner and Secretary Paulson conferencing in via phone). Chairman Bernanke concludes that they "have to go to Congress and get some authority."

September 18, 2008:

After consulting with Treasury and Federal Reserve staff as well as President Bush and Vice President Cheney, Secretary Paulson, Chairman Bernanke, and SEC Chairman Christopher Cox meet with House and Senate leadership in Speaker Pelosi's conference room for 90 minutes, requesting the "authority to spend several hundred billion."

SEC announces a temporary emergency ban on short selling in the stocks of 799 financial stocks.

September 19, 2008:

Troubled Asset Relief Program: Treasury submits draft legislation to Congress for authority to purchase troubled assets.

Federal Reserve announces plans to purchase federal agency discount notes (short-term debt obligations issued by Fannie Mae, Freddie Mac, and Federal Home Loan Banks) from primary dealers.

During the evening, Morgan Stanley's CFO receives a call from the head of the firm's Tokyo office, reporting that Mitsubishi U.F.J., a large Japanese bank, is interested in negotiating a stake. (Morgan Stanley ultimately sells 21 percent of the company to Mitsubishi for $9 billion).

Money Market Mutual Funds:

- Federal Reserve announces the creation of the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) to extend non-recourse loans at the primary credit rate to U.S. depository institutions and bank holding companies to finance their purchase of high-quality asset-backed commercial paper from money market mutual funds.
- Treasury announces a temporary guarantee program that would make available up to $50 billion from the Exchange Stabilization Fund to guarantee investments in participating money market mutual funds.
- By September 19, withdrawal requests had climbed to 95 percent of the Reserve Primary Fund's $62 billion portfolio, necessitating approval from the SEC to delay redemption payments beyond the seven-day requirement.

September 20, 2008: A Chinese delegation, led by Gao Xiqing, the vice chairman of the C.I.C., arrives in NY to meet with Morgan Stanley executives.

September 21, 2008: Federal Reserve approves applications of Goldman Sachs and Morgan Stanley to become bank holding companies.

September 22, 2008: AIG enters into the Fed Credit Agreement (for the RCF provided on September 16) in the form of a 2-year secured loan and a Guarantee and Pledge Agreement with FRBNY.

September 23, 2008: Goldman Sachs announces that Mr. Buffett is buying $5 billion of preferred stock.

September 24, 2008: Goldman Sachs raises another $5 billion in a public offering of common stock.

September 25, 2008: Washington Mutual is closed by OTS and taken over by the FDIC.

September 29, 2008: The House votes down EESA legislation, and the Dow Jones industrial drops 778 points.

October 3, 2008: Congress passes EESA and President Bush then signs it into law.

October 7, 2008: Federal Reserve creates the CPFF.

October 8, 2008: Federal Reserve and other central banks lower short-term rates.

Ongoing Activities: Federal Reserve expanded the scope and scale of its swap lines with central banks in order to provide liquidity in U.S. dollars to overseas markets (September 18, 2008; September 24, 2008; September 26, 2008; October 14, 2008; October 29, 2008).

ANNEX III: WHAT ARE CREDIT DEFAULT SWAPS?

A. Credit Default Swaps Generally

Credit default swaps (CDSs) are privately-negotiated bilateral contracts that obligate one party to pay another in the event that a third party cannot pay its obligations.[844] In essence, the purchaser of protection pays the issuer of protection a fee for the term of the contract and receives in return a promise that if certain specified events occur, the purchaser of protection will be made whole. If a credit event[845] does not occur during the term of the contract, the issuer will have no obligation to the purchaser and retains the fees paid. If a credit event occurs during the term of the contract, the contract is settled—either by cash, in which the parties agree on a market value for the reference obligation, or by physical settlement, in which the protection seller provides the "deliverable obligations" specified by the contract—and the purchaser of protection discontinues the payment. The term of the contract is negotiable, and although five years is the most common term, maturities from a few months to ten years or more are possible. Fees are usually paid quarterly and are expressed in basis points per annum on the notional amount of the CDS.[846] Providers of protection credit are dominated by banks and insurance companies, while banks, security houses, and hedge funds are the predominant protection buyers.[847] Among these parties, CDS dealers maintain matched books, whereby protection sold and protection bought are balanced, and net exposure can be low.[848] These dealers are typically large, global banks, and they try to profit from the spreads between buying and selling protection.[849] Because a dealer is in the middle of a transaction, the success of the dealer's hedge is dependent on relative parity between the protection bought and the protection sold. Figure 41 shows an example of such a hedge.

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[844] International Swaps and Derivatives Association, *AIG and Credit Default Swaps* (Nov. 2009) (online at www.isda.org/c__and__a/pdf/ISDA-AIGandCDS.pdf) (hereinafter "ISDA Paper on AIG and Credit Default Swaps").

[845] Credit events are typically constructed around the issuer of the reference obligation, and can include bankruptcy, failure to pay, acceleration of payments on the issuer's obligations, default on the issuer's obligations, restructuring of the issuer's debt, and similar events. Written Testimony of Robert Pickel, *supra* note 38, at 1.

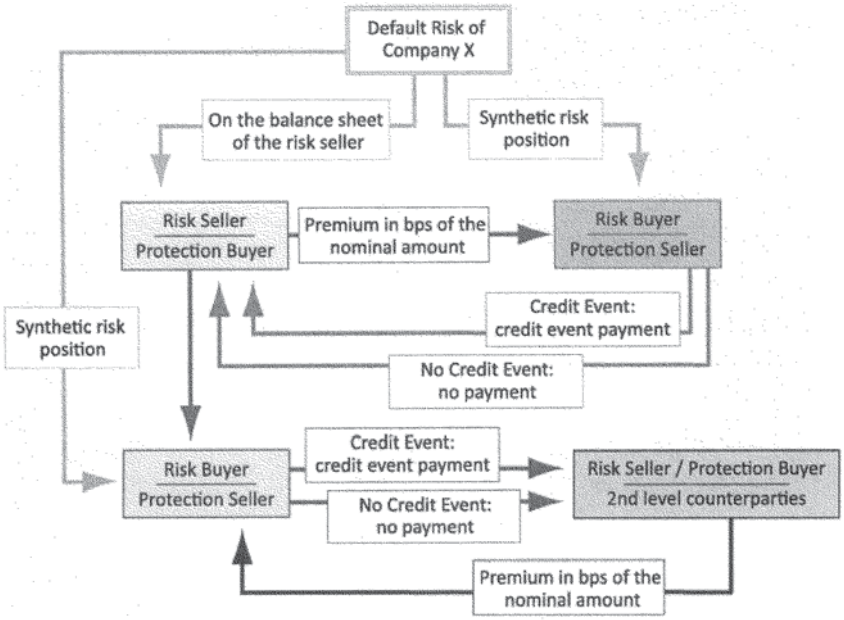
[846] The notional amount is the amount of protection provided by the CDS: for example, if a party enters into a CDS to purchase protection on a $100 million exposure, the notional amount would be $100 million. William K. Sjostrum, Jr., *The AIG Bailout*, Washington and Lee Law Review, Vol. 66, at 943 (Nov. 9, 2009) (online at papers.ssrn.com/sol3/papers.cfm?abstract__id=1346552) (hereinafter "Sjostrum Law Review Article"). Although notional amount is often used to describe CDS exposure, it is not a precise description of the actual exposure of an entity under a CDS. The price of protection also depends on the riskiness of the underlying obligation and increases as the risk associated with the underlying obligation increases. *See* House Committee on Agriculture, Written Testimony of Erik Sirri, director, Division of Trading and Markets, U.S. Securities and Exchange Commission, *The Role of Credit Derivatives in the U.S. Economy*, 110th Cong. (Oct. 15, 2008) (online at www.sec.gov/news/testimony/2008/ts101508ers.htm) (hereinafter "Written Testimony of Erik Sirri").

[847] Francis A. Longstaff, Sanjay Mithal, and Eric Neis, *Corporate Yield Spreads: Default Risk Or Liquidity? New Evidence from the Credit Default Swap Market*, Journal of Finance, Vol. 60, No. 5, at 2216–17 (Oct. 2005) (online at ksuweb.kennesaw.edu/~dtang/CRM/LongstaffMithalNeis2005JF__YieldSpreads.pdf).

[848] ISDA Paper on AIG and Credit Default Swaps, *supra* note 844.

[849] *See* Sjostrum Law Review Article, *supra* note 846, at 943; Written Testimony of Erik Sirri, *supra* note 846. Some, but not all of these parties are regulated entities. Banks, investment banks and investment companies are regulated entities, although insurance companies are subject to state regulation in the U.S. and hedge funds are at present minimally regulated. For a list of ISDA members, *see* International Swaps and Derivatives Association, *Membership* (online at www.isda.org/membership/isdamemberslist.pdf) (accessed June 8, 2010).

FIGURE 41: CREDIT DEFAULT SWAPS



CDSs are built around a debt reference security or a pool of reference securities—called the reference obligation or obligations—and are memorialized by a standardized agreement prepared by the International Swaps and Derivatives Association (ISDA). These agreements, known as ISDA Master Agreements, set forth a variety of terms pursuant to which CDS counterparties can choose the events and terms that will govern their transactions.[850] The Master Agreement sets forth not only the payment terms and credit events for a given CDS but also establishes the general relationship between the parties, including events of default and termination events for the Master Agreement between the parties.[851] Transactions are commonly documented pursuant to either a "1992 Multicurrency Cross-Border ISDA Master Agreement" (the 1992 Agreement) or a "2002 ISDA Master Agreement" (the 2002 Agreement).[852] Each of these agreements consists of preprinted standard provisions and a schedule. While the Master Agreements remain in their standard pre-printed form, the parties may use the schedule to make elections and vary any of the provisions in the Master

[850] Written Testimony of Robert Pickel, *supra* note 38, at 1.

[851] Those events of default in the preprinted ISDA Master Agreement are: failure to pay or deliver; breach of agreement; credit support default; misrepresentation; default underspecified transaction; cross default; bankruptcy; and merger without assumption. Termination events in the preprinted ISDA Master Agreement are illegality; tax event; force majeure (only in the 2002 Agreement); tax event upon merger; credit event upon merger; and additional termination event. Parties may vary or to supply the standardized terms, or may incorporate other events. International Swaps and Derivatives Association, *Market Review of OTC Derivative Bilateral Collateralization Practices*, at 9 (Mar. 1, 2010) (online at www.isda.org/c__and__a/pdf/Collateral-Market-Review.pdf) (hereinafter "Market Review of OTC Derivative Bilateral Collateralization Practices").

[852] Most of AIG's CDSs were documented pursuant to the 1992 Agreement.

Agreement.[853] In addition to the Master Agreement and the schedule, each transaction under a Master Agreement is separately memorialized by a confirmation. According to ISDA, the confirmation of a transaction evidences that transaction, and each transaction is incorporated into the ISDA Master Agreement.[854] The Master Agreement provides that in the event of a disagreement between the terms of the schedule and the Master Agreement, the schedule shall govern, and in the event of a disagreement between the confirmation and the schedule, the confirmation shall govern with respect to the particular transaction.[855] The ISDA documentation also includes a "credit support annex" (CSA) that, if used, governs collateral arrangements and requirements between the parties. The CSA provides for a variety of calculations that determine the collateral taker's "exposure," which is a technical term that sets forth the amount payable from one party to another if all transactions under the relevant ISDA Master Agreement were being terminated as of the time of valuation, calculated using estimates at mid-market of the amounts that would be paid for replacement transactions.[856] After a credit event, CDSs can be cash-settled or physically-settled. If the CDS is physically-settled, it will specify "deliverable obligations" (usually pari passu with the reference obligations) that the protection seller is required to buy at par from the protection buyer. If the CDS is cash-settled, the parties agree on a market value for the reference obligation.[857] After an event of default or termination event under the relevant master agreement, the entire relationship governed by that master agreement will close out, meaning that the agreement will terminate and amounts owed under the contract will be paid.[858] Parties may also (and often do) write multiple contracts under a single master, and if they can use " close-out netting" (whereby a variety of contracts can be set off against each other), all transactions under that ISDA Master Agreement are viewed as a single agreement between the counterparties.[859]

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[853] Market Review of OTC Derivative Bilateral Collateralization Practices, *supra* note 851, at 9.

[854] International Swaps and Derivatives Association, Frequently Asked Questions, at No. 31 (online at www.isda.org/educat/faqs.html#31) (hereinafter "ISDA Frequently Asked Questions") (accessed June 8, 2010).

[855] *See* International Swaps and Derivatives Association, *1992 Agreement and 2002 Agreement*, at Section 1b (Inconsistency) (copies of Master Agreements provided by ISDA).

[856] As described further below, AIG's CSA would ultimately prove critical to AIG's melt-down. In the calculation of the CSA, "exposure" is combined with the Independent Amounts (a lump sum payable) and then the Threshold, the uncollateralized amount discussed further herein, is subtracted. Market Review of OTC Derivative Bilateral Collateralization Practices, *supra* note 851, at 11.

ISDA also provides a variety of other standardized documents, such as definitions. The Master Agreement is typically governed by New York State or English law, because New York and London are the primary trading centers for CDSs. The same version of the Master Agreement would be used for both jurisdictions. The credit support annex, however, differs depending on whether it is the New York form or the English form. *See* Edmund Parker and Aaron McGarry, *The ISDA Master Agreement and CSA*, Butterworths Journal of International Banking and Financial Law (Jan. 2009) (online at www.mayerbrown.com/publications/article.asp?id=8431&nid=6) (hereinafter "ISDA Master Agreement and CSA").

[857] Sjostrum Law Review Article, *supra* note 846, at 949. If the protection buyer does not have the securities, it must obtain them in the market.

[858] International Swaps and Derivatives Association, *The Importance of Close-Out Netting*, ISDA Research Notes, No. 1 (2010) (online at www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf) (hereinafter "The Importance of Close-Out Netting").

[859] ISDA Frequently Asked Questions, *supra* note 854, at No. 31 (accessed June 8, 2010); The Importance of Close-Out Netting, *supra* note 858.

While the ISDA Master Agreement is a common framework used by institutions for initiating, documenting, and closing out CDS contracts, there can be substantial variation in the actual terms of contracts.[860] There are approximately 800 member institutions—all sophisticated market players—registered with ISDA,[861] and as noted above, some of these are dealers that take different sides of the same trade.[862] CDSs can also be used for multiple purposes, including hedging, speculation, and arbitrage.[863] Accordingly, although the ISDA Master Agreement—the CDS base documentation—is theoretically standardized, as the contracts are privately negotiated among sophisticated parties for various reasons, terms can vary greatly. Further, CDSs are not listed on any exchange, and are traded in the over-the-counter market between large financial institutions without any required documentation or record-keeping to track who traded, how much, and when.[864] As a result, not only is variation among the CDS agreements substantial but the market overall is also opaque. The lack of transparency is further compounded by documentation problems that have repeatedly plagued the CDS market. For example, a 2007 GAO report described backlogs of confirmations and poorly documented assignments of CDS contracts, compounded by overreliance on manual systems.[865] Similarly, after the Lehman bankruptcy, a variety of ISDA documentation difficulties came to light. These included the tendency of some parties to enter into derivative transactions without actually signing a Master Agreement first.[866]

Although CDSs are used, in many cases, to decrease exposure to a given credit default risk, entering into a CDS necessarily increases an institution's exposure to counterparty credit risk. Counterparty credit risk is the risk that the seller of the protection will be incapable or unwilling to make payment due under a closed CDS contract after a credit event. Typically, in order to minimize or mitigate counterparty credit risk, the CDS may include a CSA that requires the posting of collateral from the protection seller to the protection buyer.[867] Collateral postings and margin calls are negotiated between the parties. According to ISDA, 97 percent of trades in credit derivatives are covered by collateral arrangements, and over three quarters of all derivatives of any type are collateralized.[868] As noted above, however, the wide variation

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[860] Navneet Arora, Priyank Gandhi and Frances A. Longstaff, *Counterparty Credit Risk and the Credit Default Swap Market* (Jan. 2010) (online at v3.moodys.com/microsites/crc2010/papers/longstaff_counterparty.pdf) (hereinafter "Counterparty Credit Risk and the Credit Default Swap Market").

[861] Counterparty Credit Risk and the Credit Default Swap Market, *supra* note 860.

[862] Written Testimony of Erik Sirri, *supra* note 846.

[863] Sjostrum Law Review Article, *supra* note 846. CDSs can play a similar role in the market to bond insurance, which began as municipal bond insurance but during the 1990s expanded to encompass insurance on a variety of complex products. *See* House Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Written Testimony of Eric Sirri, director, Division of Trading and Markets, U.S. Securities and Exchange Commission, *The State of the Bond Insurance Industry*, 110th Cong. (Feb. 14, 2008) (online at www.house.gov/apps/list/hearing/financialsvcs_dem/ht021408.shtml). Insurance products, however, are regulated, unlike the credit default swap market, which generally reduces flexibility.

[864] Written Testimony of Erik Sirri, *supra* note 846.

[865] U.S. Government Accountability Office, *Credit Derivatives Confirmation Backlogs Increased Dealers' Operational Risks, but were Successfully Addressed after Joint Regulatory Action* (Jun. 2007) (GAO–07–716) (online at www.gao.gov/new.items/d07716.pdf).

[866] *See* ISDA Master Agreement and CSA, *supra* note 856.

[867] Sjostrum Law Review Article, *supra* note 846.

[868] Market Review of OTC Derivative Bilateral Collateralization Practices, *supra* note 851, at 7.

among terms in CDSs means that the parties are not obligated to collateralize CDSs and there are no particular commercial terms that need to be established. Fundamentally, collateralization terms are commercial and credit-risk-management decisions subject to negotiation between the parties.[869]

B. AIG's Credit Default Swaps

AIG has been described as "unique" among large CDS market participants inasmuch as its book consisted almost completely of "sold" protection: AIG, unlike a dealer, did not hold offsetting positions in CDSs.[870] Because its models anticipated that none of the particular underlying reference securities on which AIG wrote protection would ever cause a credit event, AIG anticipated that the CDSs it wrote would expire, and AIGFP would pocket the premiums without further obligation.[871] AIG wrote CDSs on Super Senior, "high grade," and mezzanine tranches of multi-sector CDOs. These CDOs were securities with a pool of underlying assets that included mortgages from multiple sectors, including residential mortgages, commercial mortgages, credit card receivables, and other similar assets. Some of these assets were sub-prime mortgages, which deteriorated at substantially higher rates than were accounted for in AIG's model.[872]

Although the deterioration in the credit quality of the CDOs caused the estimated spreads on the CDSs written on those CDOs to widen and resulted in unrealized losses for AIG, it was the collateral posting obligations embedded in the CDSs that caused AIG to begin to experience a liquidity crunch.[873] According to AIG's quarterly report for the period ended September 30, 2009, counterparties' collateral calls against AIGFP related to the multi-sector CDO portfolio were largely driven by deterioration in the market value of the reference obligations, and the large majority of its obligations to post collateral were associated with arbitrage transactions relating to multi-sector CDOs.[874] As discussed above, collateralization provisions are almost universal for credit derivatives, although the terms of any given credit support annex are privately negotiated among counterparties. For many of AIG's multi-sector CDS contracts, the collateral required was determined based on the change in value of the underlying cash security representing the super senior risk layer subject to credit protection, rather than on the changing value of the derivative. Accordingly, AIG could be obligated to post collateral based not on a widening spread for the

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[869] Market Review of OTC Derivative Bilateral Collateralization Practices, *supra* note 851, at 7.

[870] ISDA Paper on AIG and Credit Default Swaps, *supra* note 844.

[871] Sjostrum Law Review Article, *supra* note 846. *See also* House Committee on Agriculture, Written Testimony of Henry Hu, Allan Shivers Chair in the Law of Banking and Finance, University of Texas School of Law, *The Role of Credit Derivatives in the U.S. Economy* (Oct. 13, 2008) (online at agriculture.house.gov/testimony/110/h81015/Hu.pdf).

[872] Sjostrum Law Review Article, *supra* note 846. The vast majority of these were physically-settled contracts, which obligated the counterparty to deliver the reference obligation at close-out.

[873] Sjostrum Law Review Article, *supra* note 846.

[874] AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 118.

CDS itself, but rather on price changes in the underlying reference security.[875]

In addition to these collateralization provisions keyed to the value of the reference obligation, however, many of AIG's contracts also contained a "ratings trigger." A "ratings trigger" in a CSA creates an obligation to post additional collateral in the event that the party affected experiences a ratings downgrade. Ratings triggers are not particular to AIG CDS contracts: in a recent ISDA survey, almost all market participants reported using ratings triggers when computing their Threshold, which is the amount of exposure a party is willing to bear uncollateralized. ISDA states that market participants often specify the Threshold as a fixed amount, although Thresholds may decrease (and accordingly reduce exposure) with decreases in credit rating.[876]

AIG broke down its description of its collateral calls into (1) regulatory capital transactions; (2) arbitrage portfolio for multi-sector CDOs; and (3) arbitrage portfolio for corporate debt/CLOs. AIG's ratings triggers were complex and varied from contract to contract,[877] but some or many of them contained various requirements to post collateral in the event of ratings triggers, and in its survey ISDA identifies the variable threshold as a particular issue for AIG.[878] For its regulatory capital transactions subject to a CSA, the majority of the contracts used formulae unique to each transaction or counterparty that depended on credit ratings (including AIG's credit ratings and, occasionally, the ratings of notes that were issued with respect to different tranches of the transaction), loss models from rating agencies, or changes in spreads on certain credit indices (although they did not depend on the value of any underlying reference obligation).[879] For some of AIG's regulatory capital contracts, AIG was required to enter into a CSA in the event its credit rating dropped below a specified threshold, and after September 2008 AIG was required to implement a CSA or alternative collateral arrangement for a majority of the regulatory capital transactions for which it was obligated to put a CSA in place if its ratings dropped.[880] For its multi-sector CDO arbitrage portfolio, AIG's calculation of exposure modified the standard CSA provisions and substituted instead a formula based on the difference between the net notional amount of the transaction and the market value of the relevant underlying CDO security (as opposed to the replacement value of the transaction).[881] The arbitrage port-

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[875] AIG Form 10–Q for Third Quarter 2008, *supra* note 23.

[876] AIG has no information as to whether its rating triggers were common in the market, and it noted that when it was involved in these deals, it was generally a thin market. It is therefore difficult to determine whether AIG's CSAs were unusual. As described further below, other market participants require triggered Thresholds.

[877] Sjostrum Law Review Article, *supra* note 846.

[878] Market Review of OTC Derivative Bilateral Collateralization Practices, *supra* note 851, at 7.

[879] AIG Form 10–K for FY07, *supra* note 41.

[880] AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 119.

[881] Replacement value is an alternative form of valuing the amounts due under a closed-out contract that the 2002 Agreement added to the measures in the 1992 Agreement. *See* Mayer Brown Rowe & Maw, *2002 ISDA Master Agreement*, at 1 (2002) (online at www.mayerbrown.com/publications/article.asp?id=332&nid=6) ("If transactions under the 1992 Agreement are terminated following an Event of Default or a Termination Event, a close-out amount is calculated in accordance with the payment measure elected by the counterparties. The two optional payment measures in the 1992 Agreement are Market Quotation and Loss. A new payment measure, 'Replacement Value,' has been developed to replace both of these existing methods. This new measure incorporates many aspects of both existing methods of calcu-

folio also required transaction-specific thresholds, which varied based on the credit ratings of AIG and/or the reference obligations.[882]

According to its quarterly report, as of September 30, 2008 the collateral calls derived largely from counterparties relating to multi-sector CDOs, and to a lesser extent, with respect to regulatory capital relief purposes and in respect of corporate debt/CLOs.[883] Since most of the collateral posting requirements that befell AIG starting in June, 2007 derived from the difference between the notional amount of the CDS and the market value of the reference obligation,[884] is worth noting that the ratings triggers were not the proximate cause of the initial collateral calls. Rather, the collateral calls resulted from the significant and substantial deterioration in the value of the reference obligations around which the CDSs were built. The ratings triggers, however, came in to play when AIG was already struggling, and magnified its difficulties. AIG's variable thresholds were not necessarily unique to AIG, although AIG has since been identified as an object lesson for the procyclical dangers of credit-rating triggered collateral posting requirements. Through such ratings triggers, an individual institution's efforts to reduce its exposure to a struggling counterparty can have significant systemic effects.[885]

Since September 2008, AIG has been in the process of unwinding AIGFP's CDS contracts. As of November 17, 2009, AIG's total CDS exposure had fallen about 32 percent since the end of 2008, from $302 billion to $206 billion.[886] In the quarter ended March 31, 2010, AIG reported that it continued to wind down its CDS portfolio. Among other things, its regulatory capital portfolio shrank according to its terms: these contracts as part of their terms and after could be terminated by counterparties at no cost to AIGFP

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lating the early termination payment while seeking to give the Non-defaulting Party discretion and flexibility in determining the value of any terminated transactions (subject always to the requirement of good faith and commercial reasonableness)"). *See generally* International Swaps and Derivatives Association, *2005 ISDA Collateral Guidelines* (2005) (online at www.isda.org/publications/pdf/2005isdacollateralguidelines.pdf).

[882] AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 119. According to AIG, the multi-sector CDO portfolio includes 2a–7 Puts, pursuant to which holders of securities are required, in certain circumstances, to tender their securities to the issuer at par. AIG's contracts provide that if an issuer's remarketing agent is unable to resell the securities so tendered, AIGFP must (except under certain circumstances) purchase the securities at par. At both March 31, 2010 and December 31, 2009, there was $1.6 billion net notional amount of 2a–7 Puts issued by AIGFP outstanding. AIG Form 10–Q for the First Quarter 2010, *supra* note 731, at 55.

[883] AIG Form 10–Q for Third Quarter 2008, *supra* note 23, at 119.

[884] Sjostrum Law Review Article, *supra* note 846.

[885] Bank for International Settlements, *The Role of Margin Requirements and Haircuts in Procyclicality*, at 11 (Mar. 2010) (online at www.bis.org/publ/cgfs36.pdf?noframes=1) ("While triggers can effectively protect creditor interest against idiosyncratic shocks, they exacerbate procyclicality when the counterparty involved is systemically important and faces financial distress. This was forcefully demonstrated when the credit rating of the insurance company AIG was downgraded, triggering significant amounts of collateral payments that ultimately were met through government intervention"); Market Review of OTC Derivative Bilateral Collateralization Practices, *supra* note 851, at 45.

("Recommendation 10: The use of credit-based Thresholds that reduce as credit ratings decline or credit spreads widen should be carefully considered. Parties that elect to use these elements in collateral arrangements should recognize that they may have a ratcheting effect that reduces credit risk to one party while simultaneously increasing liquidity demands on the other party if the latter suffers credit deterioration. Accordingly, both parties should ensure that they have in place appropriate monitoring to (a) detect and respond to credit deterioration in their counterparty and (b) forecast and manage the liquidity impact of their own credit deterioration. Alternatively, the use of fixed thresholds and/or frequent margin calls should also be considered, and all collateral structures should be considered in the context of guarantees and other credit risk mitigants that may be available.")

[886] SIGTARP Report on AIG Counterparties, *supra* note 246, at 25.

after regulatory events such as the implementation of Basel II.[887] The arbitrage portfolio is composed of CDSs with long-term maturities, and at present AIG is unable to predict or estimate when the final payments will be made.[888] AIG is, functionally, either attempting to sell its positions or is allowing them to expire according to their terms. Some of its positions are such that it will be unable to sell them—for example there is no market for the regulatory capital hedges—and AIGFP must therefore allow them to expire according to their terms or close them out if a credit event occurs.

[887] AIG Form 10–Q for the First Quarter 2010, *supra* note 731, at 55.
[888] AIG Form 10–Q for the First Quarter 2010, *supra* note 731, at 57.

ANNEX IV: LEGAL AUTHORITIES

A. The Bankruptcy Rules That Would Have Applied to AIG

Generally, when a company files for bankruptcy, its creditors will be subject to an automatic stay or an injunction that prevents the creditors from taking further action to collect on their debts.[889] Thus, the debtor's assets will be protected while negotiations take place with creditors. Creditors will be grouped by their level of priority, and creditors of the same priority level will receive equal treatment under the bankruptcy plan.[890] Often, unsecured creditors will be forced to take substantial discounts on what they are owed, and equity holders lose the entire value of their investments. Creditors can request relief from the automatic stay in certain situations such as foreclosing on collateral if the creditor is fully secured or offsetting certain obligations with the debtor.[891] If a creditor has received favorable treatment while the debtor was insolvent (generally assumed within 90 days of the bankruptcy filing), the bankruptcy trustee will be able to undo this favorable treatment through various avoidance actions such as preferential transfer, constructive fraudulent conveyance, and actual fraudulent conveyance actions.[892] The trustee also has the power to assume or reject executory contracts (i.e., contracts in which the parties have not completed performance) and to ignore contractual provisions that allow for modification or termination of contractual rights or obligations based on the debtor's financial condition or bankruptcy filing.[893] These provisions, among others, provide a legal structure for the orderly reorganization or liquidation of businesses in need of bankruptcy protection. However, the complex structure of AIG combined with a variety of provisions in the United States Bankruptcy Code giving additional protection or favorable treatment to the counterparties to AIG's various financial instruments would have complicated the bankruptcy process for AIG.

U.S. bankruptcy courts do not have jurisdiction over all types of debtors and would not have had jurisdiction over all of AIG's companies or subsidiaries. The AIG corporate structure includes a parent company and at least 223 subsidiaries that engage in a wide range of business activities in over 130 countries or jurisdictions. These activities include domestic and foreign insurance-related activities, the issuance of commercial paper to finance operations, mortgage lending, and the structuring and sale of a variety of standard and customized financial products (*e.g.,* CDSs or securities lending).[894] AIG's domestic insurance companies, bank, foreign insurance companies, and other foreign companies without sufficient ties to the United States would not be able to seek protection

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[889] *See* 11 U.S.C. 362(a). It should be noted that the overall bankruptcy structure presented in this paragraph applies to both Chapter 7 and Chapter 11 of the Bankruptcy Code.

[890] *See* 11 U.S.C. 507.

[891] *See* 11 U.S.C. 362(d), 553(a).

[892] *See, e.g.*, 11 U.S.C. 547 (providing that the trustee may avoid preferential transfers), 548 (providing that the trustee may avoid fraudulent transfers).

[893] 11 U.S.C. 365(e)(1).

[894] *See* GAO Report, *supra* note 18.

under U.S. bankruptcy law.[895] This complicates a potential bankruptcy filing for AIG in two ways. First, AIG would have to ascertain which of its companies could file a bankruptcy petition, presumably Chapter 11 (reorganization) rather than Chapter 7 (liquidation), and then decide which of its companies would do so.[896] This can be an intensive and time consuming process and would involve a careful analysis of the corporate structure, financial condition of each company or subsidiary, the existence of intercompany lending arrangements or guarantees, the applicable law, the likely outcome of the bankruptcy filing, and the practical consequences of such a filing on current or future consumers, suppliers, creditors, and investors. Second, AIG would have to consider the impact of a bankruptcy filing on the subsidiaries that did not or could not file, their various regulators, the relevant markets (*e.g.,* capital markets or the derivatives market), and the general public.

The impact of a bankruptcy filing on the insurance subsidiaries could provide particular concern because of the size of AIG's insurance business and the potential impact on its various policyholders. And, there is at least some concern that a number of the insurance subsidiaries were not sufficiently capitalized to handle the liquidity pressures from the securities lending program on their own.[897] There is some uncertainty as to what would have happened to AIG's various insurance subsidiaries if the parent company had filed; however, a few general conclusions can be drawn. Upon filing, the insurance regulators would not necessarily have changed their approach to AIG's insurance subsidiaries. The insurance regulators had been monitoring the activities and financial condition of the insurance subsidiaries prior to September 2008 and believed that they were solvent or sufficiently capitalized.[898] The insurance regulators would have been concerned about the impact of the filing on the subsidiaries' books of business and would have monitored the behavior of policyholders such as heightened surrender activity for life insurance policyholders and decreased renewal rates for shorter-term commercial and property insurance policies.[899] However, it is likely that the insurance regulators would have seized the insur-

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[895] *See* 11 U.S.C. 109(a) (requiring debtors to have a U.S. connection), (b)(2) (excluding domestic insurance companies and certain banks from Chapter 7), (b)(3) (excluding foreign insurance companies from Chapter 7), (d) (making these Chapter 7 exclusions applicable to Chapter 7).

[896] The decision of which subsidiaries would file for bankruptcy is done on an entity-by-entity basis and requires board resolution. If the subsidiary is wholly owned by the parent company, this decision will be influenced by the parent company because the parent company appoints the board of directors.

[897] AIG's Insurance Subsidiaries, *supra* note 591, at 6. For additional discussion of the government assistance provided to the AIG insurance subsidiaries, see Section E. The insurance subsidiaries received capital contributions from the parent company to offset realized losses from the sale of RMBS as part of the securities lending transactions ($5 billion), to maintain capital surplus levels upon unrealized losses in the RMBS investments, and to make up the shortfall in securities lending arrangements when collateral levels were below 100 percent ($434 million). Panel conference call with Texas Department of Insurance (May 24, 2010).

[898] Conference call with the National Association of Insurance Commissioners and representatives from the New York, Pennsylvania, and Texas insurance departments (Apr. 27, 2010). The supervisors have informed the Panel staff that they would not necessarily have seized the subsidiaries and mentioned the Chapter 11 reorganization of Conseco Inc. in 2003 as a practical example of a holding company bankruptcy that did not necessitate insurance regulator intervention. Panel staff conversation with Texas Department of Insurance (May 24, 2010); Panel staff conversation with NAIC (Apr. 27, 2010).

[899] Current insurance customers may have been concerned about their policies, deciding to take their business elsewhere or taking out the cash surrender value of their life insurance policies. And, the insurance subsidiaries may not have been able to attract new customers because of fear about the subsidiary's financial condition or the ability to make contractual insurance payments.

ance subsidiaries, or put them under a stricter form of supervision, regardless of their financial condition in order to more effectively protect the subsidiaries from the bankruptcy process.[900]

Because insurance is regulated by the states, each state could have slightly different legal processes for taking greater oversight or control of its insurance subsidiaries. For example, in Texas, the Commissioner of Insurance has the option of placing a company under supervision.[901] Supervision does not involve an actual seizure of the company, but it provides the Commissioner with greater powers to direct the actions of the company "without immediate resort to the harsher remedy of receivership."[902] In the case of AIG, supervision would have been confidential.[903] Once the Commissioner has put a company under supervision, it may later be converted to receivership.[904] If the Commissioner determines that a receivership is appropriate, then he or she may put the company into receivership by commencing a delinquency proceeding in Texas state court.[905] Texas has other tools in its arsenal. For example, the Commissioner can take action against a company whose financial condition is "hazardous," requiring it to increase its capital and surplus.[906]

The New York Insurance Department has 15 grounds for putting a domestic insurance company into rehabilitation or liquidation.[907] These grounds include insolvency.[908] If the New York Superintendent needed to put a solvent subsidiary into rehabilitation to protect it from actions taken in a bankruptcy, he or she could do so by finding "after examination, [the insurer] to be in such condition that its further transaction of business will be hazardous to policyholders, creditors, or the public."[909] In order to put a company into rehabilitation, the superintendent, represented by the attorney general, will need to get a court order.[910]

The state insurance regulators would have worked with each other as well as with the bankruptcy court, company management, and bankruptcy counsel to ensure that actions taken during the parent company's bankruptcy would not adversely affect the insur-

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[900] If the AIG insurance subsidiary was solvent at the time of the filing, the supervisor would choose to first closely watch and monitor its position. Panel staff call with New York Insurance Department (June 3, 2010). It is likely, however, that the supervisor would seize even the healthy subsidiaries in order to protect them from the bankruptcy. Panel staff conversation with Jay Wintrob, the CEO of the SunAmerica Financial Group (May 27, 2010). If the regulators had placed the insurance subsidiaries into some form of rehabilitation, they would have had more power in the bankruptcy (*e.g.,* by exercising additional regulatory authority to operate, reorganize, or liquidate the subsidiaries), and they would have been able to more fully assess the financial condition of the subsidiaries because of greater access to their books and records. *But see* Panel staff call with New York Insurance Department (June 3, 2010) (the regulators would not have seized the subsidiaries because they were well capitalized).

[901] Tex. Ins. Code Ch. 441; 28 Tex. Admin Code § 8. A conservatorship under Texas law is similar, but imposes more stringent requirements on the Commissioner. For example, supervision is ex parte, but conservatorship requires notice and hearing or consent by the company.

[902] Tex. Ins. Code Ch. 441.001(f).

[903] It is confidential when there is the protection of a guaranty fund. Tex. Ins. Code Ch. 441.201(f). AIG might have been required by auditors, ratings agencies, or disclosure laws to disclose a supervision.

[904] Tex. Ins. Code Ch. 443.057(8).

[905] Tex. Ins. Code Ch. 443.005, 443.057. Texas law provides 22 grounds under which the Commissioner files for rehabilitation or liquidation. These grounds include impairment, insolvency, and when the "insurer is about to become insolvent." Tex. Ins. Code Ch. 443.057.

[906] Tex. Ins. Code Ch. 404.003; 404.053.

[907] NY Ins. Code § 7402.

[908] NY Ins. Code § 7402(a).

[909] NY Ins. Code § 7402(e).

[910] NY Ins. Code § 7417.

ance subsidiaries (actively participating in bankruptcy hearings and filing relevant court orders). For example, the insurance regulators would have to approve the taking of material amounts from the insurance subsidiaries (cash or other assets) or the purchase of the insurance subsidiary by a third party. The regulators would have unwound the securities lending agreements and brought the insurance subsidiaries' share of the collateral in the investment pool onto their balance sheet. During the course of the bankruptcy, if the regulators believed that there was sufficient harm to the insurance subsidiaries or that liquidity or insolvency concerns had emerged, they would place the relevant insurance subsidiaries under heightened supervision or into conservation, rehabilitation, or liquidation, if they had not yet done so. In the worst case scenario, the regulators would have seized the insurance subsidiaries, ceased paying the surrender values of life insurance policies (stopping a run on the life insurance companies, if one had developed), sealed off the company, and preserved the assets to pay off the liabilities.

Seizure of the insurance subsidiaries could have caused protracted delays in paying claims to policyholders. In the past, smaller insurance receiverships have taken up to 10 to 20 years to pay all claims. It could also have caused significant stress to other, solvent insurance companies. When an insurance company goes into receivership, claims that cannot be paid out of the company are paid by the state guarantee fund. State guarantee funds are funded through assessments on the solvent insurance companies in the state. These assessments have annual caps that, based on AIG's size, likely would have been hit, requiring additional assessments the following year. These assessments could have caused substantial strain on these solvent insurance companies.[911]

If the parent company of AIG and some of its eligible subsidiaries decided to file a bankruptcy petition, the bankruptcy laws would not have protected AIG from heightened liquidity problems, the almost complete loss of value of its derivative portfolio, the loss of key sources of short-term funding, or the loss of assets that had been posted as collateral prior to the bankruptcy filing. In general, bankruptcy is fundamentally different for financial companies whose business relationships and financial transactions depend on trust or confidence. For this reason, a bankruptcy filing would have been a death warrant for AIG as a financial company because neither financial institutions nor others will do business with a company if they fear that default is a possibility. Further, the Bankruptcy Code includes a number of safe harbors that would have exempted counterparties to various "financial instruments"—defined broadly to include AIG's CDSs and repurchase agreements—from the automatic stay, the prohibition on modifying or terminating contracts based on a bankruptcy filing, and various avoidance actions related to pre-bankruptcy collateral transfers.[912]

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[911] Panel staff conversation with industry experts (May 14, 2010).

[912] *See* 11 U.S.C. 362(b)(6), (b)(7), (b)(17), (b)(27), (o) (exempting various financial participants or holders of commodities contracts, forward contracts, securities contracts, repurchase agreements, swap agreements, and master netting agreements from the automatic stay); 11 U.S.C. 555, 556, 559, 560, 561, 553, 365(e)(1) (providing that counterparties to securities contracts, forward contracts, commodities contracts, repurchase agreements, swap agreements, and master netting agreements cannot be prevented from exercising any contractual right to liquidate, ter-

In combination, these provisions would have cut off AIG's top-level overnight or short-term funding through repurchase agreements. If AIG had filed for bankruptcy, the counterparties to these derivative instruments would have called their loans, rather than allowing them to roll over (similar to a revolving credit line), and would have withdrawn funds or seized collateral.[913] And, the counterparties to AIG's CDS agreements would have terminated or closed out their contracts (terminating their payment obligations), seized any collateral posted prior to the filing, attempted to purchase replacement positions, and asserted a claim for any deficiency or unrecovered amounts. The deficiency claims asserted by the counterparties, if any, would have been subject to the discount negotiated for unsecured creditors in the bankruptcy plan.

Although bankruptcy proceedings would have provided a legal mechanism to reorganize or liquidate the AIG parent company and its derivative portfolio, such proceedings would not have addressed the potential impact on its insurance subsidiaries, their regulators, or their customers. Bankruptcy proceedings also would not have addressed the impact of AIG's filing (or general default on its obligations) on the counterparties to its various derivative contracts or to the financial system as a whole. All of the counterparties to AIG's derivative contracts would have closed out their contracts creating some level of market panic as the counterparties attempted to mitigate their damages by seizing previously posted collateral, selling securities, or purchasing replacement positions and as the counterparties adjusted their financial statements to properly reflect newly calculated risk levels or asset values. However, such external considerations are outside the scope of the bankruptcy law. The extent to which an AIG filing would have destabilized the capital markets and whether the markets would have been able to recover from such a filing in a timely manner or without severe disruptions is unclear. However, it is clear that there was no resolution authority in place that could manage both the resolution of AIG and the systemic consequences of an AIG failure.

B. Section 13(3) of the Federal Reserve Act

Section 13(3) of the Federal Reserve Act provides three express limitations on the Federal Reserve's emergency lending authority: (1) the Board of Governors must determine that unusual and exi-

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minate, or accelerate their contracts or from offsetting or netting out any termination value, payment amounts, or other obligations); 11 U.S.C. 546(e)–(g), (j) (providing that the trustee cannot avoid transfers made in relation to securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, and master netting agreements based on sections 544 (strong arm provision), 545 (statutory liens), 547 (preferences), or 548(a)(1)(B) and 548(b) (constructive fraudulent transfers); 11 U.S.C. 548(c), (d)(2) (impairing the trustee's ability to bring actual fraudulent transfer actions by protecting counterparties to the extent that they gave value and providing that transfers related to margin payments or transfers related to repurchase, swap, and master netting agreements are always for value). For definitions of these terms, *see* 11 U.S.C. 101(22A) (defining "financial participant"), (25) (defining "forward contract"), (26) (defining "forward contract merchant"), 47 (defining "repurchase agreement"), 46 (defining "repo participant"), 53B (defining "swap agreement"), 53C (defining "swap participant"), 38A (defining "master netting agreement"), 38B (defining "master netting agreement participant"). The bankruptcy court in the Lehman Brothers case has recently clarified that this option has temporal limitations or must be exercised "fairly contemporaneously with the bankruptcy filing" and that the safe harbors only protect those actions listed in the provisions. *See* Wilbur F. Foster, Jr., Adrian C. Azer, and Constance Beverly, *Court Explores Termination Rights Under Bankruptcy Code Section 560*, Pratt's Journal of Bankruptcy Law, at 505–506 (Nov./Dec. 2009).

[913] *See* 11 U.S.C. 362(b)(7), (b)(27); 11 U.S.C. 553, 559, 561.

gent circumstances exist, by the affirmative vote of at least five members, (2) the loans must be secured to the satisfaction of the Federal Reserve Bank, and (3) the Federal Reserve Bank authorized to make the loans must have obtained evidence that adequate credit was not available from other banking institutions.[914]

In general, the Federal Reserve and FRBNY satisfied these three express limitations when providing assistance to AIG in the form of four credit facilities: the RCF, SBF, ML2, and ML3. The Board of Governors authorized each of the facilities after determining that unusual and exigent circumstances existed by the affirmative vote of at least five members, meeting the first prong.[915] The Board authorized the general structure or terms of the facilities and the maximum amounts that could be borrowed from FRBNY. FRBNY also reviewed the assets being pledged as collateral for adequacy and determined that the collateral secured the facilities to its satisfaction, meeting the second prong.[916] Finally, FRBNY used the authorization provided by the Board of Governors to finalize the specific terms and to enter into the facilities after verifying that adequate credit was not available to AIG from other banking institutions, meeting the third prong.[917] Where necessary, the Federal Reserve and FRBNY relied on their legal authority to take actions that were incidental to their lending authority. For example, FRBNY relied on its incidental powers to require the equity kicker of 79.9 percent of AIG's stock (given to Treasury), to set up the SPVs for the Maiden Lane facilities, and to accept preferred equity in AIA and ALICO in partial forgiveness of AIG's outstanding obligations.[918] The following discussion will provide an analysis of the Board's decision regarding the general structure of the facilities as well as the adequacy of the collateral accepted as security.

The structure of the revolving credit facility fits most neatly into the Federal Reserve's Section 13(3) lending authority. Section 13(3) authorizes the Federal Reserve to "discount . . . notes, drafts, and bills of exchange."[919] The term "discount" has been interpreted broadly to refer to any purchase of paper (or essentially any advance of funds in return for a note) with previously computed interest.[920] The RCF provided for the advance of funds by FRBNY to

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[914] 12 U.S.C. 343. For additional explanation of Section 13(3), see Section C.4.

[915] *See* Federal Reserve Press Release, *supra* note 266; Federal Reserve Press Release, *supra* note 320; Federal Reserve Press Release Announcing Restructuring, *supra* note 330; Treasury and the Federal Reserve Announce Participation in Restructuring, *supra* note 518; Board of Governors of the Federal Reserve System, *Minutes: Financial Markets—Extension of credit to American International Group, Inc.* (Sept. 16, 2008), Board of Governors of the Federal Reserve System, *Minutes: American International Group, Inc.—Proposal to provide a securities lending facility* (Oct. 6, 2008).

[916] Panel staff conversation with Federal Reserve Board staff (May 27, 2010).

[917] Panel staff conversation with Federal Reserve Board staff (May 27, 2010).

[918] Panel staff conversation with Federal Reserve Board staff (May 27, 2010).

[919] 12 U.S.C. 343.

[920] Panel staff conversation with Federal Reserve Board staff (May 27, 2010). *See also* Small and Clouse (2004) (stating that Section 13(3) provides virtually no restrictions on the form a credit instrument must take in order to be eligible for discount because the terms "notes, drafts, and bills of exchange" include most forms of written credit instruments); Board of Governors of the Federal Reserve System, Federal Reserve Bulletin, at 269 (Mar. 1958) (providing that "the judicial interpretations of the word 'discount' show that the term is used very broadly. In practice the term 'bank discount' is applied broadly to transactions by which a bank computes interest in advance so that there is the possibility of compound interest, and it seems that any purchase of paper is a 'discount' in that sense since it permits such advance computation and compounding."). The purchase of paper—including notes, promissory notes, drafts, and bills of exchange—recourse or non-recourse—does not necessarily have to be at an amount less than the principal amount of the paper. *Id.*

AIG in return for an interest-bearing note or credit agreement.[921] The quality of the assets pledged as collateral to secure the facility and the requirement that AIG "gift" almost 80 percent of its stock to Treasury as an "equity kicker" (pursuant to its incidental powers) raise more difficult questions.

FRBNY accepted the unencumbered assets of AIG, including AIG's stock in its regulated insurance subsidiaries, as collateral for the $85 billion credit facility.[922] The Federal Reserve relied on information collected by the private consortium (that attempted but ultimately failed to provide capital to AIG) and on a third-party evaluation to estimate the value of the pledged assets.[923] Although reasonable minds can certainly differ on the value of a company or its assets, especially a company as complicated as AIG with market conditions as disrupted as they were, there are some aspects of an AIG asset valuation worth noting.

Although FRBNY determined that the $85 billion RCF was secured to its satisfaction, only days before a private sector consortium apparently concluded that AIG did not have sufficient assets to secure a $75 billion loan.[924] In addition, the valuation of some of the assets—including the stock in AIG's insurance subsidiaries—may have been higher because of the Federal Reserve's support to AIG. The Federal Reserve was entitled to take into account the impact of its intervention on the value of the collateral it was taking. In the event that AIG later defaulted, however, the consequences that the government was trying to avoid (bankruptcy of the parent company, seizure of the insurance subsidiaries, or both) may have occurred, driving down the value of the insurance subsidiaries (and the stock in the insurance subsidiaries that were pledged as collateral to secure the RCF).

The requirement that AIG provide an "equity kicker" in return for the RCF (as part of its incidental powers) is also unique as a requirement for government or central bank assistance. Although

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[921] FRBNY provided funds to AIG in return for a series of demand notes until FRBNY and AIG entered into a Credit Agreement that established the credit facility (the existing demand notes were canceled and the amounts due were transferred to the facility). *See* Board of Governors of the Federal Reserve System, *Report Pursuant to Section 129 of the Emergency Economic Stabilization Act of 2008: Secured Credit Facility Authorized for American International Group, Inc. on September 16, 2008,* at 4 (online at www.federalreserve.gov/monetarypolicy/files/129aigseccreditfacility.pdf) (hereinafter "Federal Reserve Report Pursuant on Secured Credit Facility Authorized for AIG"). For additional information on the Revolving Credit Facility, see Section D.1.

[922] *See* Federal Reserve Press Release, *supra* note 266; Federal Reserve Report Pursuant on Secured Credit Facility Authorized forAIG, *supra* note 921, at 5–7. For additional information on the Revolving Credit Facility, see Section D.1. It should be noted that the assets pledged as collateral did not include securities loaned by the insurance subsidiaries to various counterparties (the counterparties owned the loaned securities), the RMBS purchased with the cash collateral from the counterparties to the securities lending agreements (they were encumbered and thus unable to provide security), or the CDOs or underlying reference securities to CDS contracts issued by AIG (they were owned or intermediated by the CDS counterparties).

[923] Morgan Stanley, which had been hired as an advisor to FRBNY, provided information on the value of the potential collateral to the private consortium. Ernst & Young advised the Federal Reserve Board and FRBNY on the valuation of potential collateral. The latter evaluation was completed before the credit agreement was signed, but not before the Federal Reserve announced the Revolving Credit Facility on September 16 and the first overnight loans were made. The overnight loans made before the credit agreement was signed were secured by AIG securities that the Reserve Bank valued as satisfactory for the amount of credit extended (roughly $37 billion). Panel staff conversation with Federal Reserve Board staff (June 8, 2010); Panel staff conversation with Federal Reserve Board staff (May 27, 2010); Federal Reserve Report Pursuant on Secured Credit Facility Authorized for AIG, *supra* note 921, at 4.

[924] Although both the Federal Reserve and the private consortium were evaluating assets of AIG, it is not clear whether they were evaluating the exact same assets or collateral package. For additional discussion of the private sector consortium, see Sections C.1 and C.2.

"equity kickers" are common requirements in commercial loans—and the requirement to provide 79.9 percent of AIG stock was one of the proposed terms for the private consortium—such "equity kickers" are not common for central banks and have never before been required by the Federal Reserve as a condition for a loan.[925]

Like the $85 billion RCF, the subsequent $37.8 billion SBF fits neatly into the Federal Reserve's lending authority under Section 13(3). As part of this facility, FRBNY can replace existing securities lending counterparties of AIG.[926] If the counterparties wish to exit the program, FRBNY will borrow the investment grade debt obligations from AIG that had been loaned to those counterparties (the borrowed obligations serving as collateral for the transaction) in return for cash collateral "with an interest rate of 100 basis points above the average overnight repo rate offered by dealers on the relevant collateral type."[927] Further, in comparison to the assets pledged as collateral for the RCF, the assets pledged as collateral for the SBF are less risky and more easily valued, including only investment grade debt obligations such as corporate debt obligations, agency pass-through certificates, and obligations of foreign and local governments. As mentioned above, these assets were not eligible to be pledged as collateral for the RCF because they had already been loaned to the securities lending counterparties.[928]

3. Maiden Lane II

The ML2 facility provides a less straightforward fit with the Federal Reserve's authority under Section 13(3) because of its more complicated structure. FRBNY created a wholly-owned SPV (ML2). The Federal Reserve authorized FRBNY to loan up to $22.5 billion to the SPV under a senior note (and AIG loaned $1 billion to the SPV under a subordinated note). The SPV then purchased RMBS from AIG insurance subsidiaries (related to the securities lending program) at their fair market value as of October 31, 2008.[929]

The Federal Reserve Board staff explained that FRBNY created the SPV using its incidental powers for practical purposes. The SPV provided a convenient structure to segregate the RMBS assets and make the ML2 facility more transparent (by making it easier to identify the owner of the assets and to generally control, value, audit, and report on the assets). Thus, placing the assets into the SPV was "incidental" to purchasing those assets at a discount.[930] Technically, an SPV is a "person," even if wholly owned by the

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[925] Panel staff conversation with Federal Reserve Board staff (May 27, 2010).

[926] For additional information on AIG's securities lending program, see Section B.3 and Annex V, and for additional information on the Securities Borrowing Facility, see Section D.1.

[927] Securities Borrowing Facility for AIG, *supra* note 264, at 3. Broken down, securities lending agreements have two parts: (1) the borrower purchases the securities (in this case fixed income debt obligations) from the lender for a certain price (in this case cash collateral "with an interest rate of 100 basis points above the average overnight repo rate offered by dealers on the relevant collateral type") and (2) the borrower agrees to sell and the lender agrees to purchase equivalent securities for the same price as the original transfer upon the demand of either party. In addition to the debt obligations pledged as collateral, the advances were made with recourse to AIG (providing additional security for the loans).

[928] Securities Borrowing Facility for AIG, *supra* note 264, at 3.

[929] Federal Reserve Report on Restructuring, *supra* note 329, at 5, 7–8. For additional discussion of the ML2 facility, see Sections D.3 and F.4.

[930] Panel staff conversation with Federal Reserve Board staff (May 27, 2010). It should be noted that the RMBS assets in ML2 are consolidated onto the Federal Reserve's balance sheet (so the SPV structure was not used as a means to achieve an off balance sheet transaction with AIG.

bank that created it (in this case, FRBNY); thus, it could be the recipient of a loan under Section 13(3). In substance, however, FRBNY was lending money to itself under Section 13(3) and then using the funds to purchase RMBS.[931] The Federal Reserve Board staff further explained that you can "look through" the SPV to see that FRBNY was discounting the RMBS assets. Each RMBS was itself a promissory note or debt obligation so FRBNY was essentially purchasing a note or debt obligation at a discount (a practice that fits more neatly under its 13(3) lending authority).[932]

The Federal Reserve Board staff characterized this loan as a "haircut" because FRBNY loaned $19.5 billion in cash in return for RMBS with a par value of $40 billion (a haircut of around 50 percent). This loan, however, did not require a "haircut" in the normal sense of the term. The securities lending counterparties were not required to take a haircut or make concessions; AIG paid these counterparties in full with the help of the funds provided by FRBNY. The fact that the par value of the RMBS (which served as collateral for the loan) was almost twice the amount of the loan supports the Board's conclusion that the loan was overcollateralized.

4. Maiden Lane III

The 13(3) analysis of the ML3 facility is more complicated because in ML3, FRBNY purchased the debt obligations from the counterparties to AIG's CDS contracts, rather than from AIG or its subsidiaries.[933] Even though the termination of the CDS contracts and the purchase of the CDOs from the CDS counterparties benefited AIG (an institution that could not obtain credit from alternative banking institutions), ML3 did not involve a loan to AIG or a purchase of notes or debt obligations owned by AIG. ML3 involved a loan to an SPV wholly owned by the FRBNY or a purchase of notes or debt obligations from CDS counterparties of AIG (institutions that likely could obtain adequate credit from other banking institutions). Thus, whether one respects the separate corporate status of the SPV, or looks through the SPV, the purchases were made for the benefit of, but not from, institutions that were otherwise unable to obtain credit, unless one regards the SPV itself as being unable to do so.

Even so, however, one can see the structure in one of three ways: as a third party agreement to benefit AIG (a purchase of a discounted note "for" AIG, which is all the statute requires), a restructuring of the original loan made by the Federal Reserve using its

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[931] FRBNY loaned to ML2 under a senior note. The loan accrued interest (at a rate of 1-month LIBOR plus 100 basis points) and was fully secured by the RMBS portfolio. The loan was nonrecourse, meaning that payment could only be collected from the RMBS assets. Panel staff conversation with Federal Reserve Board staff (May 27, 2010); Federal Reserve Report on Restructuring, *supra* note 329, at 7

[932] The RMBS were third party notes; third parties were required to make payments to AIG. AIG sold this payment stream to FRBNY.

[933] The 13(3) analysis for ML3 is otherwise similar to the ML2 analysis. FRBNY created a wholly-owned special purpose vehicle or SPV (ML3). FRBNY then loaned up to $30 billion to the SPV under a senior note (and AIG loaned $5 billion to the SPV under a subordinated note). The SPV purchased CDOs from the CDS counterparties at their market value as of October 31, 2008. Like the RMBS purchased by ML2, the CDOs were promissory notes or debt obligations. And, FRBNY's loan to ML3 was overcollateralized; FRBNY loaned $24.3 billion to ML3 in return for CDOs with a par value of $62 billion. For additional discussion of the terms and reasons for the ML3 facility, see Section D.4. *See also* Federal Reserve Report on Restructuring, *supra* note 329, at 8–9.

incidental powers to buttress section 13(3), or a purchase by an SPV that could not otherwise obtain credit (an admittedly weak characterization).

ANNEX V: SECURITIES LENDING

Securities lending was developed as a means for investors to maintain a long position in a stock while enhancing the stock's ability to generate profit. Securities lenders are usually large institutional investors such as mutual funds, pensions, endowments, and insurance companies. Securities borrowers may be hedge funds, broker-dealers, or trading desks. The borrowed securities are most often used to cover a short sale but may be used for other types of arbitrage or balance sheet management.

In a typical securities lending transaction, the owner lends the security to the borrower in exchange for a fee.[934] The borrower must also post collateral, often cash amounting to 102 to 105 percent of the market value of the security on the day it is lent. While the security is on loan, the borrower holds title to the security and its voting rights. In reality, the security is often sold by the borrower immediately and the proceeds from the sale used as the collateral. That is, the security is lent and sold, and the proceeds posted as collateral as one nearly simultaneous transaction.

The lender may use the collateral for investments and may take as its fee a percentage of the profits made from such investments. As the value of the loaned security fluctuates, the collateral held by the lender may be adjusted to reflect the value of the security plus the additional 2 to 5 percent margin—if the value of the security increases, the borrower must post more collateral; if the value falls, the lender returns a portion of the collateral. To repay the loan and claim the collateral, the borrower must give the lender the same number and type of security that was borrowed. The primary risk to a borrower is therefore the possibility that the security will increase in value and the borrower will have to buy replacement securities at a price higher than the original securities were sold.

Lenders usually invest the borrower's collateral in overnight investments or in other low-risk securities. There is a chance, however, that a lender will make an imprudent investment and lose some of the collateral's value. In that case, the lender will have to make up the difference between the investment's current value and the collateral owed to the borrower. In some cases, the lender may be unable to return the collateral upon request and may therefore become indebted to the borrower. Additionally, if the collateral is invested in securities whose value falls rapidly, the lender may face a double bind: it must return a large portion of the collateral but it may find the market for the securities in which the collateral is invested has lost significant liquidity, making it difficult to sell the investments and redeem the collateral.[935]

Until the credit crunch of late 2008, securities lending was viewed as a low-risk activity; since the start of the current crisis, that view has come into question.

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[934] This is often accomplished through an agent, who may also hold and manage the collateral on behalf of the lender.

[935] This appears to be what happened to at least one securities lender in the wake of Lehman's failure and the near-collapse of AIG in late 2008. *BP Corp. North America, Inc. v. Northern Trust Investments, N.A.,* 2008 WL 5263695 (N.D. Ill., Dec. 16, 2008).

ANNEX VI: DETAILS OF MAIDEN LANE II HOLDINGS

Description of Holdings

ML2 was formed to acquire non-agency (i.e., not eligible for purchase by Fannie Mae and Freddie Mac) RMBS from the reinvestment pool of the securities lending portfolio of several regulated U.S. insurance subsidiaries of the American International Group, Inc. (the "AIG Subsidiaries"). At the time (Q4 2008), 47.1 percent of the securities were rated AAA; 52 percent of the face value of the securities had subprime collateral.

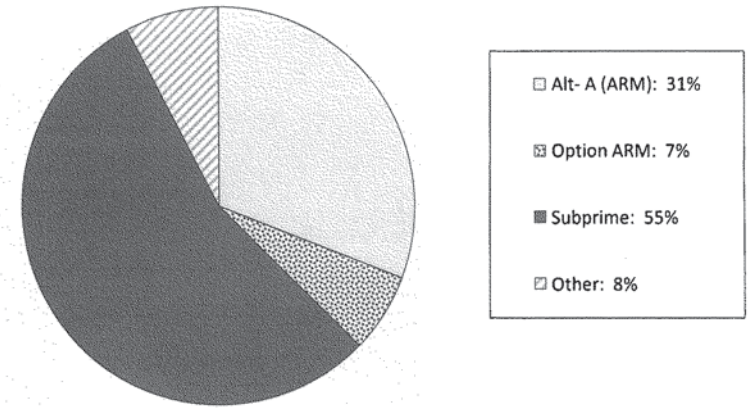
Valuation of Holdings as of December 2008

On December 12, 2008, ML2 purchased from the AIG subs non-agency RMBS with an approximate fair value of $20.8 billion, determined as of October 31, 2008. The purchase was financed with a $19.5 billion loan from FRBNY, $1.0 billion purchase price payable to the AIG subsidiaries, and a $0.3 billion adjustment due to changes between the announcement and settlement date. The $20.8 billion fair value determination relies largely on Levels 2 and 3 mark to market accounting (GAAP) methodology. Level 2 relies upon quoted prices for similar securities to those being valued. Level 3 employs model-based techniques that use assumptions not observable in the market, including option pricing models and discounted cash flow models.

Valuation of Holdings—Latest Estimate

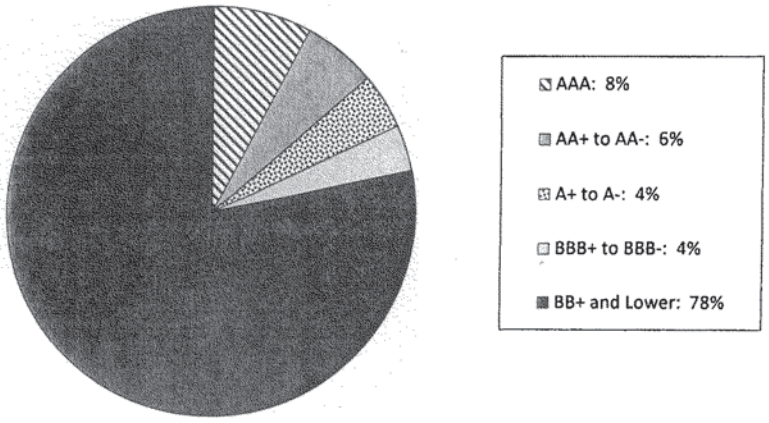
On May 27, 2010 the net portfolio holdings of ML2 was $15.9 billion and the outstanding principal amount of the loan extended by FRBNY plus accrued interest was $14.8 billion.

FIGURE 42: SECURITIES SECTOR DISTRIBUTION FOR ML2 [936]



[936] Credit and Liquidity Programs and the Balance Sheet, *supra* note 324.

FIGURE 43: SECURITIES RATING DISTRIBUTION FOR ML2 [937]



[937] Credit and Liquidity Programs and the Balance Sheet, *supra* note 324.

ANNEX VII: DETAILS OF MAIDEN LANE III HOLDINGS

Description of Holdings

ML3 was formed on October 14, 2008, to acquire asset-backed (ABS) collateralized debt obligations (CDOs) from certain third-party counterparties of AIGFP. The acquisition took place in two stages: the first on November 25, 2008 and the second on December 18, 2008. The majority of the CDOs were categorized as high grade CDOs; CDOs backed by commercial real estate, mezzanine CDOs, and other ABS made up the remaining portion. On December 31, 2008, the ratings composition of ML3 was the following: AAA (18.1%), AA+ to AA− (27.0%), A+ to A− (9.0%), BBB+ to BBB− (12.6%) and BB+ and Lower (33.2%).

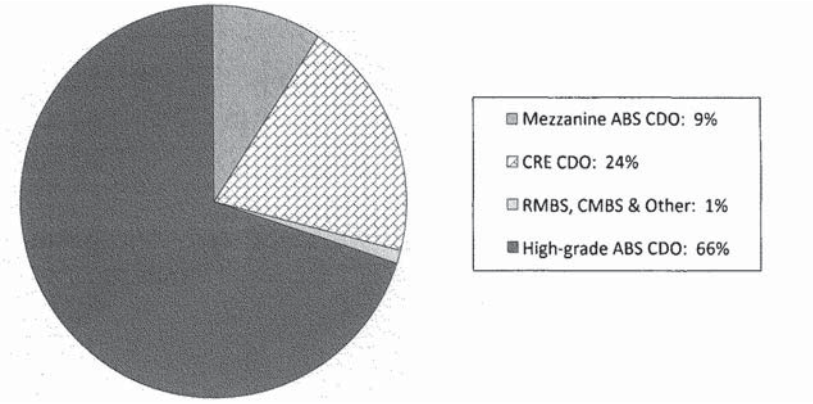
Valuation of Holdings as of December 2008

The fair value of the assets as of year-end 2008 was $26.7 billion. The fair value of the FRBNY Senior Loan was $24.4 billion. These fair values were determined based largely upon Level 3 mark to market accounting methodology.

Valuation of Holdings—Latest Estimate

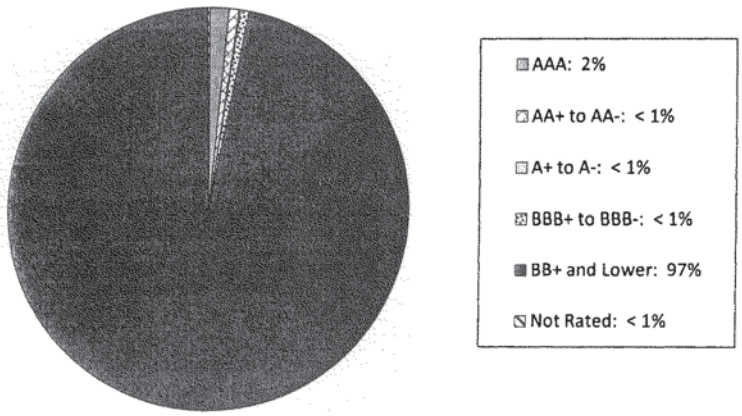
On May 27, 2010, the net portfolio holdings of ML3 were $23.4 billion while the FRBNY outstanding principal loan amount plus accrued interest was $16.6 billion.

FIGURE 46: SECURITIES SECTOR DISTRIBUTION FOR ML3 [938]



[938] Credit and Liquidity Programs and the Balance Sheet, *supra* note 324.

FIGURE 47: SECURITIES RATING DISTRIBUTION FOR ML3 [939]



[939] Credit and Liquidity Programs and the Balance Sheet, *supra* note 324.

ANNEX VIII: COMPARISON OF EFFECT OF RESCUE AND BANKRUPTCY

FIGURE 50: SECURITIES LENDING COUNTERPARTIES

Bankruptcy	Rescue	Difference
Collateral Status: Overcollateralized		
AIG insurance subsidiaries would remain liable to SL CPs for any unpaid obligations. AIG parent company would not provide further capital to provide liquidity to SL collateral pools or to offset insurance subsidiary losses from the sale of impaired assets (RMBS) (guarantees would likely be rejected in bankruptcy and downstream payments would likely stop, unless creditors and DIP believed it would maximize value of stock in insurance subsidiaries). If AIG subsidiaries were unable to provide cash collateral (for collateral calls or early termination payments), SL CPs could sell the lent securities to satisfy any unpaid obligations (and use any excess to pay reasonable costs and expenses).	SL CPs received cash collateral payments (either through collateral calls or upon termination) in full, on demand, or at the termination of AIG's SL program. The impact on the SL CPs is the same regardless of whether the funds were provided to AIG through the Federal Reserve credit facilities or the ML2 transaction.	The financial result would have been the same if the AIG parent company had filed for bankruptcy or as a result of the rescue. However, the SL CPs were better off as a result of the rescue because they did not have to sell the lent securities (incurring related costs and expenses) to satisfy the amount of unpaid obligations.
Collateral Status: Undercollateralized		
AIG insurance subsidiaries would remain liable to SL CPs. AIG parent company would not provide further capital to provide liquidity to SL collateral pools or to offset the insurance subsidiaries' losses from the sale of impaired assets (RMBS) to satisfy required collateral payments. If AIG subsidiaries were unable to provide cash collateral (for collateral calls or termination), SL CPs could sell the lent securities to recover some of the unpaid obligations and assert a claim for any shortfall.	SL CPs received cash collateral payments (either through collateral calls or upon termination) in full, on demand, or at the termination of AIG's SL program. The impact on the SL CPs is the same regardless of whether the funds were provided to AIG through the Federal Reserve credit facilities or the ML2 transaction.	SL CPs received more as a result of the rescue than they would have received if the AIG parent company had filed for bankruptcy. The SL CPs did not have sufficient collateral to satisfy any unpaid obligations, and it is unlikely that they would have been able to collect any shortfall because of the termination of downstream payments from the AIG parent company and likely intervention by the state insurance regulators.

FIGURE 50: SECURITIES LENDING COUNTERPARTIES—Continued

Bankruptcy	Rescue	Difference
The SL CPs' ability to collect on their deficiency claims would depend on the actions of the state insurance regulators. If the regulators seized the insurance subsidiaries, the SL CPs would likely have received nothing for their deficiency (or would have received a minimal amount after all of the policyholders were paid in full, a potentially substantial delay). If the regulators did not seize the insurance subsidiaries, the subsidiaries' ability to pay would depend on their financial condition or solvency at the time of the claim.		

FIGURE 51: CDS COUNTERPARTIES

Bankruptcy	Rescue	Difference
Collateral Status: Fully collateralized; owner of reference securities (CDOs)		
CDS CPs would have been able to terminate their CDS contracts, seize previously posted collateral, and offset or net out other obligations. CDS CPs would have received the estimated value of the CDS contract on the date of the bankruptcy filing because they were fully collateralized (the market value of the CDOs plus posted collateral equaled the value of the CDS contract). The insurance on the CDOs would have disappeared, and the CDS CPs would have had continued exposure to declines in the market value of the CDOs. CDS CPs would be exposed to movements in the market value of the CDOs but not to an AIG bankruptcy per se.	CDS CPs terminated the CDS contracts, kept previously posted collateral, and sold their CDOs for their market value on the date of transfer. Market value payments plus posted collateral approximated the par value of the CDS contracts.	The value of the CDS contracts fluctuated with movements in the market value of the reference CDOs, but the bankruptcy filing date and the ML3 transaction date would have fixed the estimated par value of the CDS contracts. Whether CDS CPs received more in the rescue would have depended on the change in the CDOs' market value from the bankruptcy date to the rescue date and whether CDS CPs continued to hold the CDOs or sold them at a depressed price (e.g., if market values plunged after the bankruptcy filing). If AIG filed for bankruptcy and CDS CPs continued to hold the CDOs and sold them at a value below the value estimated for the ML3 transaction, they would have received more as a result of the rescue. If CDS CPs continued to hold the CDOs and sold them at a value above that estimated for the ML3 transaction, they would have received less as a result of the rescue. CDS CPs also benefited from the rescue to the extent that they did not incur legal fees to protect their claims or actions from bankruptcy challenges.

FIGURE 51: CDS COUNTERPARTIES—Continued

Bankruptcy	Rescue	Difference
Collateral Status: Undercollateralized; owner of reference securities		
CDS CPs would have been able to terminate their CDS contracts, seize previously posted collateral, and offset or net out other obligations. CDS CPs would be protected to the extent that they were collateralized and would have an unsecured claim for their deficiency (subject to the bankruptcy discount). The insurance on the CDOs would have disappeared, and the CDS CPs would have had continued exposure to declines in the market value of the CDOs. CDS CPs would be exposed both to movements in the market value of the CDOs as well as to an AIG bankruptcy to the extent that they were undercollateralized.	CDS CPs terminated the CDS contracts, kept previously posted collateral, and sold their CDOs for their market value on the date of transfer. Market value payments plus posted collateral approximated the par value of the CDS contracts.	The value of the CDS contracts fluctuated with movements in the market value of the reference CDOs, but the bankruptcy filing date and the ML3 transaction date would have fixed the estimated par value of the CDS contracts. Whether CDS CPs received more in the rescue would have depended on the extent to which they were undercollateralized, the change in the CDOs' market value from the bankruptcy date to the rescue date, and whether CDS CPs continued to hold the CDOs or sold them at a depressed price (e.g., if market values plunged after the filing). It is more likely that CDS CPs received more as a result of the rescue because of their exposure to an AIG bankruptcy to the extent that they were undercollateralized. If AIG filed for bankruptcy and CDS CPs continued to hold the CDOs and sold them at a value below the value estimated for the ML3 transaction, they would have received more as a result of the rescue. If CDS CPs continued to hold the CDOs and sold them at a value above that estimated for the ML3 transaction, they would have received less as a result of the rescue. CDS CPs also benefited from the rescue because they were not subject to the bankruptcy discount for deficiency claims and did not incur legal fees to protect their claims or actions from bankruptcy challenges.

FIGURE 51: CDS COUNTERPARTIES—Continued

Bankruptcy	Rescue	Difference
Collateral Status: Fully collateralized; not owner of reference securities		
CDS CPs would have been able to terminate their CDS contracts, seize previously posted collateral, and offset or net out other obligations. CDS CPs would have received the estimated value of the CDS contract on the date of the bankruptcy filing because they were fully collateralized (the market value of the CDOs plus posted collateral equaled the value of the CDS contract). Because CDS CPs did not own the CDOs, they would not have had continued exposure to declines in the market value of the CDOs.	CDS CPs that did not own the reference CDOs had to obtain them (either by con-tract or in the market) in order to benefit from ML3 (transactions were physically settled). When the CDS CPs obtained the reference CDOs, they terminated their CDS contracts, kept pre-viously posted collateral, and sold their CDOs for their market value on the date of transfer. Market value payments plus posted collateral approximated the par value of the CDS contracts. If CDS CPs could not obtain or deliver the reference securities, they would not have been able to benefit from ML3.	The value of the CDS contracts fluctuated with movements in the market value of the reference CDOs, but the bankruptcy filing date and the ML3 transaction date would have fixed the estimated par value of the CDS contracts. Whether CDS CPs received more in the rescue would have depended on the change in the CDOs' market value from the bankruptcy date to the rescue date and whether CDS CPs continued to hold the CDOs or sold them at a depressed price (e.g., if market values plunged after the bankruptcy filing). If AIG filed for bankruptcy and CDS CPs continued to hold the CDOs and sold them at a value below the value estimated for the ML3 transaction, they would have received more as a result of the rescue. If CDS CPs continued to hold the CDOs and sold them at a value above that estimated for the ML3 transaction, they would have received less as a result of the rescue. CDS CPs benefited from the rescue to the extent that the rescue prevented further deterioration in CDO market values. The rescue also prevented the value of the CDS contracts from being fixed on the bankruptcy date (in the likely event that they would have terminated the CDS contracts upon AIG's filing). CDS CPs also benefited from the rescue to the extent that they did not incur legal fees to protect their claims or actions from bankruptcy challenges.

FIGURE 51: CDS COUNTERPARTIES—Continued

Bankruptcy	Rescue	Difference
Collateral Status: Undercollateralized; not owner of reference securities		
CDS CPs would have been able to terminate their CDS contracts, seize previously posted collateral, and offset or net out other obligations. CDS CPs would be protected to the extent that they were collateralized and would have an unsecured claim for their deficiency (subject to the bankruptcy discount). Because CDS CPs did not own the CDOs, they would not have had continued exposure to declines in the market value of the CDOs.	CDS CPs that did not own the reference CDOs had to obtain them (either by contract or in the market) in order to benefit from ML3 (transactions were physi-cally settled). When the CDS CPs obtained the reference CDOs, they terminated their CDS contracts, kept previously posted collateral, and sold their CDOs for their market value on the date of transfer. Market value payments plus posted collateral approximated the par value of the CDS contracts. If CDS CPs could not obtain or deliver the reference securities, they would not have been able to benefit from ML3.	The value of the CDS contracts fluctuated with movements in the market value of the reference CDOs, but the bankruptcy filing date and the ML3 transaction date would have fixed the estimated par value of the CDS contracts. Whether CDS CPs received more in the rescue would have depended on the extent to which they were undercollateralized, the change in the CDOs market value from the bankruptcy date to the rescue date, and whether CDS CPs continued to hold the CDOs or sold them at a depressed price (e.g., if market values plunged after the filing). It is more likely that CDS CPs received more as a result of the rescue because of their exposure to an AIG bankruptcy to the extent that they were undercollateralized. If AIG filed for bankruptcy and CDS CPs continued to hold the CDOs and sold them at a value below the value estimated for the ML3 transaction, they would have received more as a result of the rescue. If CDS CPs continued to hold the CDOs and sold them at a value above that estimated for the ML3 transaction, they would have received less as a result of the rescue. CDS CPs also benefited from the rescue because they were not subject to the bankruptcy discount for deficiency claims and did not incur legal fees to protect their claims or actions from bankruptcy challenges. CDS CPs that could not deliver the reference securities benefited from the rescue to the extent that the rescue prevented further deterioration in CDO market values. The rescue also prevented the value of the CDS contracts from being fixed on the bankruptcy date (in the likely event that they would have terminated the CDS contracts upon AIG's filing).

SECTION TWO: ADDITIONAL VIEWS

A. J. Mark McWatters

I concur with the issuance of the June report and offer the additional observations noted below. I appreciate the spirit with which the Panel and the staff approached this complex issue and incorporated suggestions offered during the drafting process.

1. Cost of AIG Bailout to Taxpayers

Other than the bailouts of Fannie Mae and Freddie Mac, the rescue of AIG has required the allocation of more taxpayer funded resources than any other similar action undertaken by the government since the inception of the current economic crisis. In its January 2010 "Budget and Economic Outlook," the Congressional Budget Office (CBO) estimated that the TARP investment in AIG will cost the taxpayers $9 billion out of $70 billion committed or disbursed.[940] In its March 2010 "Report on the Troubled Asset Relief Program," the CBO *quadrupled* its estimated cost to $36 billion.[941] In the President's Budget for fiscal year 2011 released in February 2010, the OMB estimated that the TARP investment in AIG will cost the taxpayers $49.9 billion.[942] Although the CBO and OMB—experts in making these determinations—appear pessimistic that the taxpayers will recover their investment, AIG nevertheless remains optimistic that the taxpayers will receive repayment in full.[943] It is not entirely clear why such a material disparity exists between CBO scores or on what reasonable basis AIG anticipates that the taxpayers will receive repayment. It is also troublesome that the CBO has quadrupled its estimated cost of the AIG bailout even though market conditions have significantly improved since the last quarter of 2008.

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[940] Congressional Budget Office, *Budget and Economic Outlook*, at 14 (Jan. 2010) (online at www.cbo.gov/ftpdocs/108xx/doc10871/01–26–Outlook.pdf).

[941] Congressional Budget Office, *Report on the Troubled Asset Relief Program—March 2010*, at 4 (Mar. 2010) (online at www.cbo.gov/ftpdocs/112xx/doc11227/03-17-TARP.pdf).

[942] Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2011*, at 40 (Feb. 2010) (online at www.whitehouse.gov/omb/budget/2011/assets/econ__analyses.pdf.)

[943] The challenge presented with repaying the taxpayers in full is evidenced by the recent collapse of the sale of AIA Group Ltd., AIG's main Asian business, to Prudential PLC, a UK insurer. *See* Peter Stein, *U.S. Taxpayers are Big Losers of AIA Deal's Death*, The Wall Street Journal (June 3, 2010) (online at online.wsj.com/article/SB10001424052748703340904575284280012636818.html?mod=WSJ__newsreel__business), which provides:

> In this scenario, AIG is treating U.S. taxpayers like *private-equity* investors funding its growth in hopes of a nice payoff down the line. That's wrong. *The only way to mitigate the moral hazard of saving AIG is to repay U.S. taxpayers sooner, not later*. This is why a sale yielding $23 billion in cash up front clearly beat the alternatives.
>
> An autopsy of this deal might reveal various causes of death. Prudential's overambitious management, fixated on the appeal of a transformative deal, lost sight of the perspective of its more skeptical shareholders. Volatile markets undercut risk appetite right when Prudential and AIG needed investors with strong stomachs.
>
> But it was AIG's board, and its U.S. government owners, that pulled the plug. U.S. taxpayers should mourn the fact that with this deal, their best interests expired as well." [Emphasis added.]

See also Serena Ng, AIG Heads Back to the Drawing Board, The Wall Street Journal (June 3, 2010) (online at online.wsj.com/article/SB10001424052748704515704575282993879628812.html?mod=WSJ__business__whatsNews); *see also* The Associated Press, *Fitch drops positive ratings watch for AIG unit,* Bloomberg Businessweek (June 3, 2010) (online at www.businessweek.com/ap/financialnews/D9G38KH00.htm); *see also* Paul Thomasach, AIG shares overpriced after deal collapse-Barron's," Reuters (June 6, 2010) (online at www.reuters.com/article/idUSN0613653820100606).

As I have done in prior reports,[944] I think that it is instructive to add some perspective to the magnitude of the loss the taxpayers may suffer as a result of the AIG bailout. By comparison, for fiscal year 2011 the National Institute of Health (NIH) has requested $765 million for breast cancer research, and the latest Nimitz-class aircraft carrier commissioned by the Navy cost approximately $4.5 billion.[945] It is entirely appropriate for the taxpayers who funded the TARP program to ask if the bailout of AIG with a CBO estimated cost of $36 billion merited 47 years of breast cancer research or eight (8) Nimitz-class aircraft carriers. The "guns v. butter v. AIG" comparisons clearly demonstrate that our national resources are indeed limited and that the bailout of AIG will require the government to reduce expenditures, increase tax revenue or both.

2. Collapse of World Financial System if AIG not Rescued

The American taxpayers were told in the last quarter of 2008 that they had no choice but to bail out AIG because absent such action the global financial system would have collapsed due to the systemic risk presented by and the financial interconnectedness of AIG.

- Secretary Geithner has stated that "neither AIG's management nor any of AIG's principal supervisors—including the state insurance commissioners and the OTS—understood the magnitude of risks AIG had taken or the threat that AIG posed to the entire financial system." [946]
- Secretary Paulson has stated that the failure of AIG "would have taken down the whole financial system and our economy. It would have been a disaster." [947]
- Chairman Bernanke has stated that the FRBNY "lent AIG money to avert the risk of a global financial meltdown." [948]

Although such assessments no doubt motivated the FRBNY and Treasury to rescue AIG, it is critical to note that the global financial system does not consist of a single monolithic institution but, instead, is comprised of an array of too-big-to-fail financial institutions many of which were, interestingly, also counterparties on AIG credit default swaps (CDS) and securities lending transactions (SL). In other words, the concept of a "global financial system" is really just another term for the biggest-of-the-big financial institutions and, as such, there remains little doubt that the principal

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[944] *See* Congressional Oversight Panel, *March Oversight Report: The Unique Treatment of GMAC Under the TARP: Additional Views of J. Mark McWatters and Paul S. Atkins*, at 122 (Oct. 9, 2009) (cop.senate.gov/documents/cop-031110-report-atkinsmcwatters.pdf).

[945] *See* U.S. Department of Health and Human Services, *National Institutes of Health, Estimates of Funding for Various Research, Condition and Disease Categories (RCDC)* (Feb. 1, 2010) (online at report.nih.gov/rcdc/categories/); *see also* U.S. Navy, *Information about the Ship (online at up-www01.ffc.navy.mil/cvn77/static/aboutus/aboutship.html)* (accessed Mar.10, 2010).

[946] FRBNY and Treasury briefing with Panel and Panel staff, Apr. 12, 2010; House Committee on Oversight and Government Reform, Written Testimony of Timothy F. Geithner, Secretary, U.S. Department of the Treasury, *The Federal Bailout of AIG*, at 3, 111th Cong. (Jan. 27, 2010) (online at oversight.house.gov/images/stories/Hearings/Committee__on__Oversight/TESTIMONY-Geithner.pdf).

[947] House Committee on Oversight and Government Reform, Written Testimony of Henry M. Paulson, Jr., former secretary, U.S. Department of the Treasury, *The Federal Bailout of AIG*, 111th Cong. (Jan. 27, 2010) (online at oversight.house.gov/index.php?option=com__content&task=view&id=4756&Itemid=2).

[948] House Committee on Financial Services, Written Testimony of Chairman of the Board of Governors of the Federal Reserve System Ben S. Bernanke, *Oversight of the Federal Government's Intervention at American International Group* (Mar. 24, 2009) (online at www.house.gov/apps /list/hearing/financialsvcs__dem/statement__-__bernanke032409.pdf).

purpose in bailing out AIG was *by definition* to save these institutions as well as AIG's insurance business from bankruptcy or liquidation. It is troublesome that the plan implemented by the FRBNY and Treasury to save AIG along with the global financial system was without cost to those too-big-to-fail members of the global financial system who were rescued.

Assuming the bailout of AIG was in the best interest of the taxpayers, a number of fundamental questions nevertheless remain for consideration. A private sector solution was negotiated and successfully implemented with respect to the failure of LTCM in 1998. Why not AIG? Was a wholly taxpayer funded bailout of AIG the only viable option available to the FRBNY and Treasury in the last quarter of 2008? What action could the FRBNY and Treasury have taken to orchestrate a pre-packaged bankruptcy of AIG with, for example, post-petition financing provided by the FRBNY and a syndicate of domestic and cross-border private sector financial institutions, insurance companies, hedge funds and private equity firms? Would it have been possible for the FRBNY to have extended AIG a short-term loan of 120 days or so while all parties worked to structure a pre-packaged bankruptcy plan? Would it have been possible to coordinate a pre-packaged bankruptcy with the AIG insurance and other regulators? Would it have been possible for the FRBNY to have guaranteed certain obligations of AIG instead of advancing funds under a credit facility? Did the FRBNY and Treasury attempt to negotiate a public-private arrangement where all of the risk of the AIG bailout was not shouldered by the taxpayers? If so, why did those efforts fail? Did the FRBNY and Treasury seek the participation of hedge funds and private equity firms as well as traditional domestic and cross-border financial institutions and insurance companies in a rescue attempt? If not, why not? The FRBNY and Treasury had their greatest leverage to negotiate a discount to par with the AIG counterparties in September 2008. Why did they fail to use that position of strength for the benefit of the taxpayers? Although the Panel has addressed many of these issues, I remain unconvinced that the only reasonable approach available to the FRBNY and Treasury during the fourth quarter of 2008 was for the taxpayers to have assumed the full burden of bailing out AIG.

3. Counterparties Unwilling to Share Pain of AIG Bailout with Taxpayers

It is ironic that although the bailout of AIG may have also rescued many of its counterparties,[949] none of these institutions were willing to share the pain of the bailout with the taxpayers and accept a discount to par upon the termination of their contractual arrangements with AIG. Instead, they left the American taxpayers with the full burden of the bailout. It is likewise intriguing that

[949] The CDSs of certain AIG counterparties were terminated through the Maiden Lane III transaction, yet the CDSs of other AIG counterparties remained outstanding. It is difficult to appreciate why the former group of AIG counterparties received payment at par as their CDSs were closed out. Like the Financial Crisis Inquiry Commission, it has been challenging for the Panel to fully appreciate the economic and legal relationships among the AIG counterparties and AIG. *See* John Mckinnon, *Finance Panel Accuses Goldman of Stalling*, Wall Street Journal (June 7, 2010) (online at online.wsj.com/article/SB10001424052748703303904575292530057313818.html?mod=WSJ__hps__MIDDLETopStories).

these too-big-to-fail financial institutions (leading members of the "global financial system") were paid at par—that is, 100 cents on the dollar—at the same time the average American's 401(k) and IRA accounts were in free fall, unemployment rates were skyrocketing and home values were plummeting.[950]

It is also critical to recall that during the last quarter of 2008 many of the AIG counterparties were most likely experiencing their own severe liquidity and insolvency challenges and were under attack from short-sellers and purchasers of CDSs on their debt instruments.[951] By receiving payment at par, some of the counterparties were able to convert illiquid and perhaps mismarked CDOs [952] and other securities into cash during the worst liquidity crisis in generations.[953] By avoiding the risk inherent in an AIG bankruptcy and the issues regarding DIP financing,[954] some of the counterparties were also able to accelerate the conversion of their AIG contracts into cash, and in late 2008, cash was king. Although some of the counterparties may argue that they held contractual rights to receive payment at par and were the beneficiaries of favorable provisions of the U.S. bankruptcy code, such rights and benefits would have been of diminished assistance since in late 2008 AIG was out of cash. It also appears problematic if AIG would have been able to obtain sufficient post-petition financing following the implosion of the global financial system that—according to the wisdom of the day—would have followed from the bankruptcy of AIG. Thus, without the taxpayer funded bailout, AIG would have most likely held insufficient cash to honor in full its contractual obliga-

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[950] *See* Congressional Oversight Panel, *January Oversight Report: Exiting TARP and Unwinding Its Impact on the Financial Markets: Additional Views of J. Mark McWatters and Paul S. Atkins*, at 145 (Jan. 14, 2010) (cop.senate.gov/documents/cop-011410-report-atkinsmcwatters.pdf).

[951] In order to hedge their AIG-related risk, some of the AIG counterparties may have shorted the stock of AIG or purchased CDSs over AIG. It also appears that some of the AIG counterparties entered into back-to-back CDSs, as the protection seller, with their clients (AIG CP clients), as the protection buyers. In order to hedge their AIG counterparty-related risk, some of the AIG CP clients may have shorted the stock of their AIG counterparty or purchased CDSs over their AIG counterparty. These actions may have caused the stock of a wide variety of financial institutions to drop precipitously in late 2008. As the shares of financial institutions fell in value it is likely that other investors joined the trend of shorting and selling the stock of anything that looked like a financial institution. Although the SEC responded with its temporary ban on selling short the stock of financial institutions, one of the goals in rescuing AIG may have been to address this issue. If so, such action serves as yet another indication that the bailout of AIG was also intended as a bailout of the AIG counterparties.

[952] If an AIG counterparty had held $100 of face value CDOs with a true fair market value of $60 and $40 of cash collateral posted by AIG, the counterparty would not have suffered a loss upon the bankruptcy of AIG because the counterparty could have sold the CDOs for $60 and retained the $40 of posted cash collateral. This analysis assumes—perhaps incorrectly—that the bankruptcy of AIG would not have resulted in the collapse of the CDO market or the AIG counterparty. If, however, the true fair market value of the CDOs was $20 (that is, the CDOs were mismarked at $60), the AIG counterparty would have most likely suffered a loss of $40 upon the bankruptcy of AIG. Since the CDO market was all but frozen in the last quarter of 2008, it is quite possible that the CDOs held by some of the AIG counterparties were mismarked and that AIG had posted insufficient cash collateral.

[953] If you're inclined to challenge this analysis, ask yourself one question: In the last quarter of 2008 what would you have preferred to own—(i) a CDS with a bankrupt AIG that is searching for post-petition financing following the collapse of the global financial system or (ii) U.S. dollars equal to the full face amount of the referenced securities underlying your CDS?

[954] It is also clear that many of the AIG counterparties (or their counterparties or both) would have suffered in an AIG bankruptcy for three reasons. First, following the collapse of the global financial system the counterparties (as members of the global financial system) certainly would have suffered and perhaps failed. Second, unless they were fully hedged with posted cash collateral, the counterparties most likely would not have received payment at par in an AIG bankruptcy. Third, upon the collapse of the global financial system, where would AIG have secured post-petition financing to pay anyone—including the counterparties—anything (AIG was out of cash on September 16, 2008)?

tions notwithstanding the special rights and benefits afforded the counterparties.[955]

While the facts and circumstances no doubt differed with respect to the contractual and economic relationships of the various counterparties with AIG, the bailout of AIG—at a minimum—reduced systemic risk throughout the global financial system to the benefit of the counterparties and most certainly allowed some of the counterparties to receive a greater distribution than they would have received following the bankruptcy of AIG. Although some of the AIG counterparties were apparently fully hedged—with posted cash collateral—against the bankruptcy of AIG, the retention of the posted cash collateral by the counterparties following the bankruptcy of AIG and the ensuing collapse of the global financial system would have served as little more than a Pyrrhic victory for the counterparties. If President Geithner, Secretary Paulson and Chairman Bernanke were correct in their assessments of the threat posed by the bankruptcy of AIG to the global financial system, the rescue of the company also saved the AIG counterparties from substantial economic peril if not outright failure. In light of this reality, the taxpayers should have received a discount to par[956] upon the termination of AIG's contracts with its counterparties.[957] In addition, since the counterparties under the CDSs that the AIG counterparties employed to hedge their AIG-related risk were in effect bailed out upon the bailout of AIG, it would also not appear unreasonable for the taxpayers to have received a discount to par from such counterparties.[958]

The FRBNY and Treasury contend that their bailout plan for AIG was the only viable approach under the circumstances and they have raised a number of objections to more creative and taxpayer-friendly structures that would have yielded concessions from the AIG counterparties and other claimants. I appreciate the argu-

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[955] This is particularly true if, as previously noted, the referenced CDO securities were mismarked and AIG had posted insufficient cash collateral, or if the fair market value of the referenced CDO securities continued to decline and AIG was unable to post additional cash collateral.

[956] The successful and timely negotiation of discounts to par from the counterparties would have most likely required the intervention of the Secretary of the Treasury and the President of the FRBNY with the senior executive officers of the counterparties. Although time was of the essence, a meeting at the offices of the FRBNY or a series of conference calls with the principals could have saved the taxpayers several billion dollars. In those meetings and conference calls, the Secretary or President of the FRBNY would have had to address the potential collapse of the global financial system and the consequences to the AIG counterparties as well as the "shared sacrifice" expected of the counterparties (as noted by Martin J. Bienenstock in the text below).

[957] Counterparties who were fully hedged against AIG-related risk with posted cash collateral may have argued with conviction that they owed no duty to accept a settlement of their AIG contracts at a discount to par. By making this assertion they would have failed to acknowledge that the bailout of AIG may have also rescued their institution from bankruptcy or liquidation. Such approach also runs contrary to the "shared sacrifice" expected of the counterparties (as noted by Martin J. Bienenstock in the text below).

[958] If an AIG counterparty was fully hedged with cash collateral posted by the protection seller to the AIG counterparty, as the protection buyer, under a CDS over AIG, the AIG counterparty may have recovered the full benefit of its bargain upon the bankruptcy of AIG. Upon the bailout of AIG, the AIG counterparty would have possibly returned the posted cash collateral to its protection seller and cancelled its CDS over AIG. In such event, the protection seller would have directly benefitted from the bailout of AIG because, absent the bailout, the protection seller would have forfeited the cash collateral posted to the AIG counterparty upon the bankruptcy of AIG. Conversely, if the AIG counterparty was not fully hedged against the bankruptcy of AIG, the AIG counterparty should have been willing to offer AIG a discount to tear up its CDS with AIG because, absent the bailout of AIG by the taxpayers, the AIG counterparty would have most likely suffered a loss upon the bankruptcy of AIG.

ments offered, but, for the reasons noted below, I do not find them entirely compelling.

The FRBNY and Treasury have argued that it would have been "unfair" to ask the AIG counterparties to accept a discount to par upon the termination of their CDS and SL contracts when other AIG creditors were scheduled to receive payment at par. In workouts of private sector enterprises, creditors often agree to terms that are less favorable than those expressly provided in their contractual agreements—even without the threat of being crammed-down in a bankruptcy proceeding. As such, it would not seem unusual for a group of multi-billion dollar domestic and foreign[959] AIG counterparties to accept a discount to par where other creditors do not. This is particularly true since the failure of AIG may have resulted in the bankruptcy or liquidation of some of these counterparties. Such a reality, along with the fact that many of the counterparties would have received less than par upon the bankruptcy of AIG—the only realistic alternative to a taxpayer funded bailout in the last quarter of 2008, should have ensured the cooperation of the counterparties. In a perfect world, the concept of shared sacrifice would have included most if not all of the AIG creditors, but it was arguably not possible to administer this remedy to an enterprise with thousands of claimants where time was of the essence. When you aggregate the taxpayer funds employed to finance ML2 and ML3 together with the share of the $85 billion FRBNY loan used to post cash collateral with the CDS counterparties and settle redemptions with the SL counterparties, it appears that the counterparties received a substantial bulk of the taxpayer sourced funds, further indicating that the bailout of AIG was also a bailout of the AIG counterparties.

The FRBNY and Treasury have also argued that the rating agencies would have downgraded AIG upon the successful negotiation of any discounts to par (a "distressed exchange") and that any such downgrade would have caused the insurance regulators to seize or take other adverse action with respect to AIG's insurance subsidiaries. The negotiation of counterparty concessions as consideration for the termination of AIG's CDS and SL contracts would not have been undertaken merely to enhance the liquidity or solvency of AIG, but, instead, AIG, the FRBNY and Treasury should have firmly requested the receipt of such concessions out of a sense of equity and fairness to the taxpayers. In my view, the liquidity and solvency of AIG were most likely assured once the FRBNY advanced $85 billion to AIG and it seems unlikely—although not without possibility—that the government would have walked away from such a substantial investment of taxpayer funds and allowed AIG to fail. Indeed, the government kept pouring money into AIG after the initial infusion, giving the rating agencies little reason to question the long-term liquidity or solvency of AIG. It appears quite clear that AIG's financial stability would not have turned on whether or not the counterparties granted concessions to par upon the termination of their CDS and SL contracts with AIG.

[959] A substantial portion of the taxpayer sourced bailout funds were paid to non-U.S. financial institutions.

Further, it is significant to note that the taxpayers are not members of a private equity or venture capital firm in search of high-risk entrepreneurial activity and they should not have been treated as such.[960] The taxpayers owed no duty to rescue AIG—a private sector firm—but they nevertheless elected to allocate their limited resources to the firm out of concern that its failure would have spawned dramatically adverse consequences for the American economy. For these reasons, the rating agencies—after thoughtful discussions with AIG, the FRBNY and Treasury, including the Secretary of the Treasury and the President of the FRBNY—should not have viewed any concessions granted by the AIG counterparties as "distressed exchanges" but, instead, as appropriate and good faith consideration payable to a reluctant investor—the taxpayers—for performing a significant public service. I have little doubt that the rating agencies would have grasped this fundamental distinction. In addition, it is not at all clear that the AIG insurance regulators would have acted in the rather dramatic manner suggested by the FRBNY and Treasury. I, again, have little doubt that the insurance regulators would have acted in a prudent manner on behalf of present and future policy holders so as to secure the safety and soundness of the AIG insurance subsidiaries they regulate.

In addition, the FRBNY and Treasury have argued that the failure or downgrade (resulting from a "distressed exchange") of the AIG holding company would have resulted in a "run" on the AIG insurance companies. A number of questions—largely unanswered—are raised by this assertion. Where would the AIG policy holders have run upon the seizure of the AIG insurance subsidiaries? Was there enough excess capacity in the global insurance system to absorb the failure of the AIG insurance subsidiaries? Since property and casualty and even health and life insurance may take a considerable amount of time to underwrite, how would the AIG policy holders have effectively run to another insurance company and received coverage on a timely basis? What action might the insurance regulators have taken to effectively stop any such run?

In essence, the FRBNY and Treasury have attempted to justify the bailout of AIG—without the receipt of any concessions to par from the AIG counterparties for the benefit of the taxpayers—by shifting the responsibility for such approach to the AIG counterparties (because they demanded payment at par), the rating agencies (because they might have downgraded the AIG parent upon the occurrence of a "distressed exchange"), and the insurance regulators (because they might have seized the insurance subsidiaries upon the downgrade of the AIG parent). It may have been preferable for the FRBNY and Treasury to respond as follows: "(i) we held no regulatory authority over AIG and its subsidiaries, (ii) to the best of our knowledge the OTS—the primary regulator—was properly discharging its responsibilities, (iii) although we became aware that AIG was experiencing financial stress in the summer of 2008, we reasonably believed that the private sector would supply whatever

[960] Since a private equity firm most likely would have received concessions from creditors in return for providing workout capital to AIG, it is possible that the FRBNY and Treasury committed the taxpayers to a particularly unattractive bailout structure.

new capital that AIG might require, (iv) when we became aware in September 2008 that AIG was experiencing severe financial strain and that the private sector would not provide a timely and robust solution, we responded as best we could under the circumstances, (v) yes, upon reflection, we should have paid closer attention to AIG given the extraordinary problems affecting other similar institutions and we should have more closely monitored the ability of private sector participants to provide AIG with capital (perhaps with our assistance), (vi) yes, upon reflection, we should have pressed the AIG counterparties to accept concessions to par upon the termination of their CDS and SL contracts out of a sense of fairness to the taxpayers who reluctantly funded the bailout, and (vii) yes, upon reflection, we believe that it would have been possible to implement a more taxpayer-friendly approach, such as proposed by Mr. Bienenstock of Dewey & LeBoeuf at the Panel's hearing on the AIG bailout."

4. An Elegant Approach to Protect the Interests of the Taxpayers

As noted, the FRBNY and Treasury have advised the Panel that it was all but impossible for the taxpayers to have received discounts to par from the AIG counterparties upon the termination of their CDS and SL contracts with AIG. Not all agree with this assessment. In his testimony before the Panel, Mr. Bienenstock, a leading bankruptcy and restructuring expert,[961] concludes that the FRBNY and Treasury could have structured the bailout of AIG within the time constraints presented during the fourth quarter of 2008 so as to receive concessions to par from the AIG counterparties for the benefit of the taxpayers. In addition, Mr. Bienenstock argues that the choices presented to the FRBNY and Treasury were not merely "binary," that is, additional approaches existed outside of a bailout at par or a bankruptcy filing, and that the advisers to the FRBNY and Treasury were arguably conflicted. It is also interesting to note that his suggested plan could have been implemented under existing law. Mr. Bienenstock's written testimony contains the following summary of his approach and its impact on AIG creditors:

> . . . AIG was in a position to advise certain creditor groups such as the CDS counterparties, as follows:
>
> 1. State law recovery actions against AIG would be unlikely to yield any benefits due to the prior lien held by FRBNY;
>
> 2. AIG would not voluntarily file bankruptcy;
>
> 3. Creditors would be unable to file involuntary petitions in good faith because AIG was generally paying its debts as they became due, even if AIG were not to post additional collateral or pay certain other debts of the entities that caused its losses;[962]
>
> 4. If creditors nevertheless filed involuntary bankruptcy petitions against AIG, they would render themselves liable for

[961] Martin J. Bienenstock is a member of the law firm, Dewey & LeBoeuf LLP, where he is chair of its Business Solutions & Governance Department and a member of its Executive Committee. Mr. Bienenstock also teaches Corporate Reorganization as a lecturer at Harvard Law School and University of Michigan Law School.

[962] *See* 11 U.S.C. § 303(h).

compensatory and punitive damages if the court found AIG was generally paying its debts as they became due and the creditors had been warned in advance of that fact;[963] and

5. FRBNY was saving AIG with taxpayer funds due to the losses sustained by the business divisions transacting business with these creditor groups, and a fundamental principle of workouts is *shared sacrifice,* especially when creditors are being made better off than they would be if AIG were left to file bankruptcy.

The impact of the foregoing on the creditors would include:

1. The knowledge that enforcement action would be unlikely to yield recoveries;

2. The knowledge that an involuntary bankruptcy petition would be a "bet-the-ranch" venture by the creditors because the risk of suffering compensatory and punitive damages for knowingly bankrupting AIG when it was generally paying its debts as they became due;

3. The knowledge that any creditor enforcement action would be highly publicized and would isolate the creditor in the public as working against the efforts of the United States and its taxpayers to save AIG and the financial system; and

4. The knowledge by some of the creditors that working against the United States would be singularly unwise after the United States either provided them rescue funds or helped them buy a company such as Lehman Brothers for $250 million plus the appraised value of the Manhattan office tower it owned.

The foregoing strategy concentrates pressure on creditors to grant debt concessions, while yielding them very few alternatives to granting concessions, and no alternatives lacking delay, expense, and uncertainty. Unlike the negotiating strategy that SIGTARP described as having had little opportunity for success, this strategy is not based on bluffing bankruptcy. It is based on straight talk and acknowledging there would be no bankruptcy. Additionally, FRBNY retained an outstanding law firm and attorney for its work. But, the law firm is identified as having Wall Street institutions such as JP Morgan as clients, and it would be awkward for it to devise strategies to obtain concessions from those institutions.

Significantly, the foregoing strategy eliminates or at least answers many of the reasons that ultimately caused FRBNY not to obtain concessions.[964] For instance, all lenders are justified in requiring shared sacrifice. *Therefore, FRBNY would not have been using its regulatory status to demand concessions. It could do so in its lender status. Most importantly, FRBNY was not required to bluff about bankruptcy. The correct strategy was the opposite—to show there would be no bankruptcy and no real opportunity for the*

[963] *See* 11 U.S.C. § 303(i)(2).

[964] Office of the Special Inspector General for the Troubled Asset Relief Program, *Factors Affecting Efforts to Limit Payments to AIG Counterparties,* at 18–19 (Nov. 17, 2009) (online at sigtarp.gov/reports/audit/2009/Factors__Affecting__Efforts__to__Limit__Payments__to__AIG__Counterparties.pdf).

creditor to do better. The foregoing process is carried out in conference rooms, not in the public.[965] [Emphasis added.]

It is critical to note that the *amount* of any discount to par the taxpayers may have received from the counterparties under Mr. Bienenstock's approach is not necessarily the key issue. Instead, the fundamental issue concerns the "principle of a discount" for the benefit of the taxpayers or, as Mr. Bienenstock states, the principle of "shared sacrifice" among the AIG creditors. The American taxpayers have repeatedly proven themselves profoundly generous to the commercial and investment banking communities and other institutions such as AIG over the past two years. The reluctant acceptance by the taxpayers of the numerous bailouts, however, is founded upon the implicit understanding that Wall Street *share* the financial burden with the taxpayers. The bailout of the AIG counterparties at par without a gesture of support to the taxpayers breached that agreement and further alienated Main Street from Wall Street.

5. Exacerbation of Main Street v. Wall Street Debate

I appreciate that the senior management and counsel of some of the AIG counterparties may cite standards of fiduciary duty as a defense to their unwillingness to accept any concessions to par. It is quite possible, however, that these officers owed a higher fiduciary duty which was to save their respective institutions from the very real threat of bankruptcy or liquidation that existed in the final quarter of 2008. After all, who can forget the photograph of the two-dollar bill taped to the door of Bear Stearns's New York offices? [966] That image—like Charles Dickens' ghost of Christmas fu-

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[965] *See* Congressional Oversight Panel, Written Testimony of Martin J. Bienenstock, partner and chair of business solutions and government department, Dewey & LeBoeuf, *COP Hearing on TARP and Other Assistance to AIG,* at 3–4 (May 26, 2010) (online at cop.senate.gov/documents/testimony-052610-bienenstock.pdf). Mr. Bienenstock also notes in his testimony:

While the FRBNY might still be concerned about the sanctity of [the] contract, fairness in debtor-creditor relations exists when creditors share the pain, not when taxpayers bail out contracts they did not make. I acknowledge this is often counterintuitive. We all grow up learning to carry out all our promises. In debtor-creditor relations, however, once a debtor cannot carry out one promise to one creditor, it is more fair to break more promises so similarly situated creditors share the pain, rather than having one take all the pain, or worse yet, having innocent taxpayers take all the pain.

I understand there was also a concern about ratings downgrades following any concessions. Intuitively, it should be illogical that AIG would be viewed as a lesser credit risk once it procured concessions from creditors which would reduce the amount AIG needed to borrow from FRBNY and would reduce future debt service expense. To be sure, the ratings protocols may not always appear logical to the layperson, but given the singular unique aspects of the AIG rescue, it is hard to figure out why the ratings agencies would believe AIG would be less credit worthy without creditor concessions.

The argument exists that creditor concessions could signal that FRBNY may not continue to provide AIG funds to satisfy all debt. The answer to that is that FRBNY has not provided that assurance. Indeed, I received many phone calls in September 2008, asking whether it was safe to buy or hold AIG bonds after FRBNY provided the $85 billion facility. The market clearly understood that FRBNY did not provide any guaranties to creditors for the future. Therefore, it would be illogical for a downgrade to turn on whether AIG already obtained concessions. The risk of a future default is the same or less if prior concessions were granted.

Recent experiences with workouts of the monoline insurance companies help corroborate the likelihood of concessions. I have had limited involvement in those negotiations, but my firm has been very involved on behalf of the insurance companies. In those restructurings, institutional lenders, including French institutions, were similarly owed additional collateral to secure credit default swaps and other derivatives. Consensual discounts were and are being granted in very material amounts. Additionally, there is litigation pending today over whether certain credit default swaps qualify for any priorities in payment afforded insured contracts under state law. Accordingly, there are many uncertainties causing counterparties to grant consensual discounts.

[966] *See* Kristina Cooke, *Bear Stearns and the $2 Bill,* Reuters (Mar. 17, 2008) (online at blogs.reuters.com/reuters-dealzone/2008/03/17/bear-stearns-and-the-2-bill/).

ture—told the story of what *would* come to pass for other financial institutions, such as AIG and its counterparties, absent the intercession of the American taxpayers. In the dark days of late 2008 when AIG faltered, the American taxpayers—not the FRBNY or Treasury—stood as the last safe-haven for many of these financial institutions, and much of today's Main Street v. Wall Street debate would have never arisen if Wall Street had properly acknowledged the American taxpayers as its sole benefactor. To many on Main Street, the bailout of AIG serves as the prototypical example of the moral hazard risks presented by government-sponsored bailout funds and implicit guarantees where favored claimants are paid in full out of seemingly limitless taxpayer funds, even though many of the recipients would have surely received less in a bankruptcy proceeding. As such, after the bailouts, it has become exceedingly difficult for many Americans to accept that what's good for Wall Street is necessarily good for Main Street.

6. Other Issues

Other significant issues have arisen with respect to the bailout of AIG, including, without limitation, the following:

(1) Even though, according to OMB, the taxpayers stand to lose up to $49.9 billion[967] on the allocation of TARP funds to AIG, the *pre-bailout* common shareholders of AIG were permitted to retain their interests in the company. These shareholders should have been wiped out, yet, since AIG avoided a bankruptcy filing and its common stock is publicly traded, they are free to sell their shares and retain the proceeds. The FRBNY and Treasury have placed the taxpayers in an awkward position of suffering substantial losses even though the pre-bailout shareholders were permitted to retain their equity positions in AIG.

(2) The FRBNY and Treasury have made much of the fact that the assets acquired by ML2 (RMBS) and ML3 (collateralized debt obligations) have appreciated in value to the benefit of the taxpayers. At the time the ML2 and ML3 deals were struck, however, most of these assets were arguably below junk status with no reasonable expectation that the RMBS and CDO markets would turn in the near future. Far from being an insightful investment opportunity for the taxpayers, the FRBNY simply took what collateral was available in the last quarter of 2008 and benefitted from a fortuitous and unanticipated rebound in the markets.[968]

More significantly, since the FRBNY and Treasury were under no obligation to bail out the AIG CDS and SL counterparties at par, any economic gain generated by ML2 and ML3 should only be viewed as an offset to the economic losses suffered by AIG and the taxpayers upon the termination of the AIG CDS and SL contracts at par. Since the government owns approximately 80 percent of the equity in AIG, the interests of the government and AIG should be treated as a single economic unit in making these determinations. For example, when AIG terminated certain of its CDS contracts in

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[967] Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2011, Analytical Perspective,* Table 4–7 at 40 (online at www.whitehouse.gov/omb/budget/fy2011/assets/econ_analyses.pdf) (accessed June 9, 2010).

[968] If a rebound had been anticipated, the RMBS and CDO markets would not have been moribund at the time the Maiden Lane II and Maiden Lane III transactions were closed.

November 2008 (i) it forfeited approximately $35 billion of previously posted cash collateral to the CDS counterparties and (ii) ML3 purchased the referenced CDO securities from the CDS counterparties for approximately $27 billion. Any subsequent appreciation in the fair market value of the CDO securities above $27 billion should be viewed as a partial recovery of the $35 billion of forfeited cash collateral, not as "profit" generated from the ML3 transaction.

If, instead, AIG had not terminated the CDS contracts in November 2008, the $35 billion of posted cash collateral would have remained in place and upon any subsequent appreciation in the fair market value of the CDO securities above $27 billion, the CDS counterparties would have been obligated to return to AIG cash collateral in an amount equal to the appreciation. Since the taxpayers own approximately 80 percent of AIG, they would have benefitted from the return of the previously posted cash collateral to AIG by the CDS counterparties. In other words, the taxpayers will benefit from any post-November 2008 appreciation in the fair market value of the referenced CDO securities through their ownership interest in ML3, and the taxpayers also would have benefitted from any such appreciation through their ownership interest in AIG if AIG had left the CDS contracts outstanding and not undertaken the ML3 transaction. Since the economic consequences to the taxpayers appear substantially similar under both approaches, the FRBNY could have arguably left the AIG CDS contracts in place with, perhaps, an agreement to post additional cash collateral as required under the CDS contracts (which undertaking would not have been required since the referenced CDO securities in the aggregate have appreciated in value since November 2008). It is problematic for the FRBNY and Treasury to assert that the use of the ML3 vehicle achieved a materially superior result for the taxpayers.

(3) I encourage SIGTARP to continue its investigation into whether the FRBNY or Treasury encouraged or instructed AIG not to release material information to the public, including, without limitation, the names of and referenced securities held by certain AIG counterparties and the decision to terminate the contracts of such counterparties at 100 cents on the dollar.

(4) In order to mitigate the moral hazard risks presented by the bailout of AIG, the government should exit its investment in AIG as soon as is reasonably possible and return AIG to the private sector. Although I do not recommend that the government "fire-sale" its investments in AIG, I cannot endorse a long-term "buy and hold" strategy. I am also troubled that the retention of AIG securities in a trust format may prolong the disposition process and appear to make government sponsored bailouts somehow more palatable to the taxpayers.

(5) Since the overwhelming majority of highly trained investment professionals working on Wall Street and elsewhere throughout the global financial services community failed to recognize on a timely basis the underlying causes of the recent financial crisis, I have little confidence that a group of systemic regulators would have performed in a more insightful or beneficial manner. AIG and its subsidiaries were overseen by more than 400 regulators throughout

the world who were charged with enforcing countless volumes of regulations. Although AIG's primary regulator—the OTS—as well as certain of its other regulators no doubt failed to discharge their oversight responsibilities, particularly with respect to AIGFP, it does not follow that AIG and its subsidiaries were necessarily under-regulated, or that the prudent enforcement of existing regulations would not have averted AIG's financial crisis. It is quite likely that many of AIG's regulators fully understood that AIG was writing trillions of dollars of CDS contracts and purchasing RMBS with proceeds from its SL transactions, but very few, if any—including, apparently, the Ph.D's employed by AIGFP—truly appreciated the interconnected risk embedded in these investment strategies. The distinction between incompetency in execution and insufficiency in scope is critical.[969] This is not to say, however, that out-of-date regulations should not be appropriately revised, that new, thoughtfully targeted regulations should not be introduced and enforced, or that enhanced, yet rational regulatory models should not be explored and implemented.

(6) Additional questions for which the taxpayers have not received satisfactory answers remain, such as the following: Is AIG—as presently structured—too big or too interconnected with the financial system and the overall economy to fail? What action has AIG taken to mitigate the too-big-to-fail problem? What risk management and internal control policies and procedures has AIG implemented so as not to require a future bailout from the taxpayers? What action has AIG taken to prepare for the failure of the holding company and its insurance subsidiaries? What effect does AIG's too big-to-fail status and its implicit guarantee have on its competitors? What is the exit strategy of the FRBNY and Treasury and when will the taxpayers receive repayment of the funds advanced to AIG? In what businesses will AIG be engaged one year and five years from now? Why did the OTS and the other AIG regulators fail to regulate AIG fully and effectively?

[969] *See* Greg Gordon, *To justify AIG's bailout, regulators overlooked its colossal problems,* McClatchy Newspapers (June 8, 2010) (online at www.kansascity.com/2010/06/08/v-print/2002541/to-justify-aigs-bailout-regulators.html).

SECTION THREE: CORRESPONDENCE WITH TREASURY UPDATE

Assistant Secretary of the Treasury for Financial Stability Herbert M. Allison, Jr. sent a letter to Chair Elizabeth Warren on May 18, 2010,[970] in response to a series of questions presented by the Panel regarding General Motors' April 20th repayment of $4.7 billion of TARP debt, and the company's public announcement related to that repayment.[971] The Assistant Secretary enclosed with that letter a copy of two letters Treasury sent in response to similar inquiries from Members of Congress: one dated April 27, 2010 addressed to Senator Charles Grassley,[972] and another dated April 30, 2010 addressed to Representatives Paul Ryan, Jeb Hensarling, and Scott Garrett.[973]

[970] See Appendix I of this report, *infra*.
[971] See Appendix II of the Panel's May Oversight Report. Congressional Oversight Panel, *May Oversight Report: The Small Business Credit Crunch and the Impact of the TARP*, at 135 (May 13, 2010) (online at cop.senate.gov/documents/cop-051310-report.pdf).
[972] See Appendix II of this report, *infra*.
[973] See Appendix III of this report, *infra*.

SECTION FOUR: TARP UPDATES SINCE LAST REPORT

A. TARP Repayments

On May 19, 2010, Texas National Bancorporation repaid Treasury's $4 million investment for the company's preferred shares. As of May 26, 2010, 17 institutions have repurchased their preferred shares in 2010. Treasury received $15.4 billion in repayments from these transactions.

B. CPP Warrant Dispositions

As part of its investment in senior preferred stock of certain banks under the CPP, Treasury received warrants to purchase shares of common stock or other securities in those institutions. During May, Comerica Inc. repurchased its warrants from Treasury for $183.9 million and Texas National Bancorporation repurchased additional preferred shares from Treasury for $199 thousand. Treasury also sold 110,261,688 warrants for Wells Fargo & Company common stock and 2,532,542 warrants for Valley National Bancorp common stock through secondary public offerings. The aggregate net proceeds to Treasury from these offerings were $840.4 million. On June 3, 2010, Treasury closed a secondary public offering for 465,117 warrants to purchase First Financial Bancorp common stock. At $6.20 per warrant, Treasury expects to receive $3 million in aggregate net proceeds. Deutsche Bank acted as the sole underwriter for this offering.

C. Treasury Names Appointee to Ally Financial Board of Directors

On May 26, 2010, Marjorie Magner was named to the Ally Financial Inc. (formerly GMAC Financial Services, Inc.) board of directors. Ms. Magner, who is the current director of Accenture Ltd and Gannett Company, Inc., is the first of two Treasury appointees. When Treasury's ownership interest in Ally increased to 56.3 percent in December 2009, it received the right to designate two additional representatives to the board. Ally Financial is currently a recipient of federal funds through the Automotive Industry Financing Program.

D. Chrysler Holding Settles $1.9 Billion of Original Chrysler Loan

Chrysler Holding (CGI Holding) repaid $1.9 billion to settle a $4 billion Treasury loan extended to Chrysler LLC (the "old Chrysler") in January 2009. As a result of the repayment, CGI Holding and Chrysler Financial currently do not have outstanding obligations to the Treasury under TARP. In June 2009, after old Chrysler filed for bankruptcy the previous month, Chrysler Group LLC (the "new Chrysler") acquired old Chrysler's assets and $500 million of its debt.

In total, Treasury has provided $14.3 billion in loans to old Chrysler, new Chrysler, and Chrysler Financial throughout the duration of TARP. Such loans include $1.5 billion to Chrysler Financial to provide funds for consumer vehicle financing, a $1.9 billion

DIP loan for old Chrysler, and a $7.1 billion investment in new Chrysler. As of May 17, 2010, Treasury has received $3.9 billion in loan repayment from all Chrysler entities.

E. HAMP Update: New Servicer Performance Measures Announced

Data from the Administration's April report on the Home Affordable Modification Program (HAMP) estimates 300,000 homeowners permanently modified their loans through HAMP. The amount of modifications grew 13 percent since March 2010. The Administration also announced plans to include a more thorough evaluation of mortgage servicer performance in its reporting of the program. In July 2010, the monthly HAMP report will include measurable figures on the eight largest servicers and their current management of HAMP. Areas of evaluation include: transparency regarding non-HAMP alternatives for homeowners who do not qualify for the program, compliance with HAMP guidelines, and overall interaction between homeowner and servicer. With this report, the Administration aims to outline areas where various mortgage servicers could improve their execution of HAMP protocols.

F. Metrics

Each month, the Panel's report highlights a number of metrics that the Panel and others, including Treasury, the Government Accountability Office (GAO), (SIGTARP), and the Financial Stability Oversight Board, consider useful in assessing the effectiveness of the Administration's efforts to restore financial stability and accomplish the goals of EESA. This section discusses changes that have occurred in several indicators since the release of the Panel's May report.

• **Interest Rate Spreads.** Since the Panel's May report, interest rate spreads widened, suggesting a slowdown in economic growth. The conventional mortgage spread, which measures the 30-year mortgage rate over 10-year Treasury bond yields, increased by 17.7 percent in May. Despite the growing spread during this period, 30-year mortgage interest rates have been decreasing.[974] The TED Spread, which serves as an indicator for perceived risk in the financial markets, continued its upward trend, growing 39 percent in May. Increases in the LIBOR rates and TED Spread suggest hesitation among banks to lend to other counterparties.[975] The interest rate spread for AA asset-backed commercial paper, which is considered mid-investment grade, has increased by 53.3 percent since the Panel's May report. The interest rate spread on A2/P2 commercial paper, a lower grade investment than AA asset-backed commercial paper, increased by 12.7 percent during May.

The widening commercial paper spreads in May could be attributed to recent problems in the Euro zone. Money market mutual

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[974] Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release H.15: Selected Interest Rates: Historical Data* (Instrument: Conventional Mortgages, Frequency: Weekly) (online at www.federalreserve.gov/releases/h15/data/Weekly__Thursday__/H15__MORTG__NA.txt) (hereinafter "Federal Reserve Statistical Release H.15") (accessed June 8, 2010).

[975] The Federal Reserve Bank of Minneapolis, *Measuring Perceived Risk—The TED Spread* (Dec. 2008) (online at www.minneapolisfed.org/publications__papers/pub__display.cfm?id=4120).

funds are divesting from Greece, Spain, and Portugal. Risk-averse money managers are favoring shorter term commercial paper or long-dated issues from top-rated financial companies. In addition, investors are now calling for higher interest rates on European commercial paper than on U.S. commercial paper, with interest rate spreads increasing to more than 0.50 percentage point.[976]

FIGURE 52: INTEREST RATE SPREADS

Indicator	Current Spread (as of 6/2/10)	Percent Change Since Last Report (5/13/10)
Conventional mortgage rate spread[977]	1.53	17.7
TED Spread (basis points)	39.02	39.0
Overnight AA asset-backed commercial paper interest rate spread[978]	0.11	53.3
Overnight A2/P2 nonfinancial commercial paper interest rate spread[979]	0.20	12.7

[977] Federal Reserve Statistical Release H.15, *supra* note 974 (accessed June 2, 2010); Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release H.15: Selected Interest Rates: Historical Data* (Instrument: U.S. Government Securities/Treasury Constant Maturities/Nominal 10–Year, Frequency: Weekly) (online at www.federalreserve.gov/releases/h15/data/Weekly__Friday__/H15__TCMNOM__Y10.txt) (accessed June 2, 2010).

[978] Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings: Data Download Program* (Instrument: AA Asset-Backed Discount Rate, Frequency: Daily) (online at www.federalreserve.gov/•DataDownload/•Choose.aspx?rel=CP) (hereinafter ''Federal Reserve Statistical Release: Commercial Paper'') (accessed June 2, 2010). In order to provide a more complete comparison, this metric utilizes the average of the interest rate spread for the last five days of the month.

[979] *Id.* In order to provide a more complete comparison, this metric utilizes the average of the interest rate spread for the last five days of the month.

• **LIBOR Rates.** As of June 2, 2010, the 3-month and 1-month LIBOR, the prices at which banks lend and borrow from each other, are 0.538 and 0.351, respectively. Beginning on March 1, 2010, the 3-month LIBOR experienced a 113.6 percent increase, and grew 23.3 percent since the Panel's May report. The 1-month LIBOR has also increased significantly in the past three months. Since March 1, the 1-month LIBOR rate rose 53.8 percent. These heightened levels indicate growing concern among banks about lending to and borrowing from one another.[980]

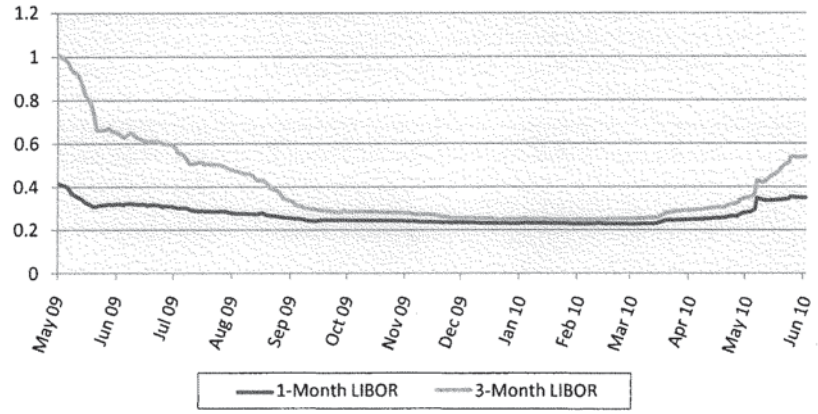
FIGURE 53: 3-MONTH AND 1-MONTH LIBOR RATES (AS OF JUNE 2, 2010)

Indicator	Current Rates (as of 6/2/2010)	Percent Change from Data Available at Time of Last Report (5/13/2010)
3-Month LIBOR[981]	.538	23.3
1-Month LIBOR[982]	.351	4.2

[981] Data accessed through Bloomberg data service on June 2, 2010.
[982] Data accessed through Bloomberg data service on June 2, 2010.

[976] Richard Leong and Emelia Sithole-Matarise, *European, Regulatory Worries Lift Bank Costs*, Reuters (May 25, 2010) (online at www.reuters.com/article/idUSN2516218620100525).
[980] Data accessed through Bloomberg data service on June 2, 2010.

FIGURE 54: 3-MONTH AND 1-MONTH LIBOR RATES



• **Housing Indicators.** Foreclosure actions, which consist of default notices, scheduled auctions, and bank repossessions, dropped 9.1 percent in May to 333,837. This metric is 19.4 percent above the foreclosure action level at the time of the EESA enactment. Both the Case-Shiller Composite 20-City Composite as well as the FHFA Housing Price Index decreased slightly in February 2010. The Case-Shiller and FHFA indices remain at 6.7 percent and 4.9 percent, respectively, below their levels at the time EESA was enacted.

FIGURE 55: HOUSING INDICATORS

Indicator	Most Recent Monthly Data	Percent Change from Data Available at Time of Last Report	Percent Change Since October 2008
Monthly foreclosure actions [983]	333,837	(9.1)	19.4
S&P/Case-Shiller Composite 20 Index [984]	145.9	(.1)	(6.7)
FHFA Housing Price Index [985]	192.9	(.5)	(4.9)

[983] RealtyTrac, *Foreclosure Activity Press Releases* (online at www.realtytrac.com/ContentManagement/PressRelease.aspx) (accessed June 2, 2010). Most recent data available for April 2010.

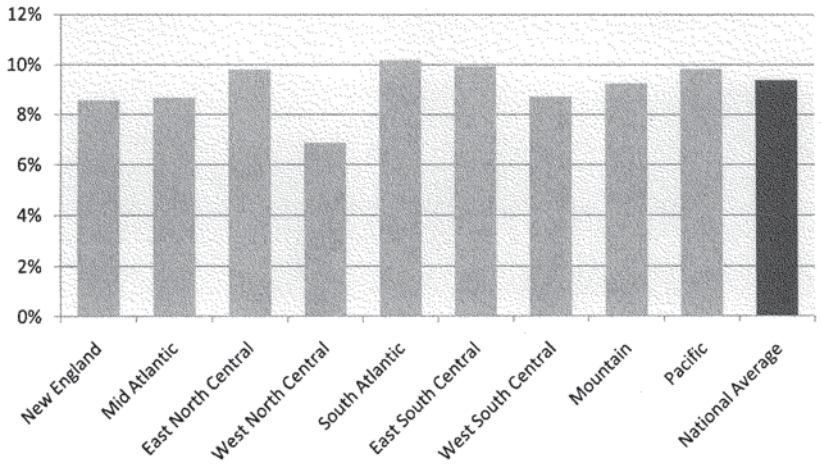
[984] Standard & Poor's, *S&P/Case-Shiller Home Price Indices* (Instrument: Seasonally Adjusted Composite 20 Index) (online at www.standardandpoors.com/spf/docs/case-shiller/SA_CSHomePrice_History.xls) (accessed June 2, 2010). Most recent data available for March 2010. Data accessed through Bloomberg data service.

[985] Federal Housing Finance Agency, *U.S. and Census Division Monthly Purchase Only Index* (Instrument: USA, Seasonally Adjusted) (online at www.fhfa.gov/webfiles/15669/MonthlyIndex_Jan1991_to_Latest.xls) (accessed June 2, 2010). Most recent data available for March 2010. Data accessed through Bloomberg data service.

• **National Delinquency Rates.** The Mortgage Bankers Association's (MBA) National Delinquency Survey, which tracks all loans types that are past due, indicates a non-seasonally adjusted delinquency rate of 9.38 percent for all loans outstanding during the first quarter of 2010. Including loans in foreclosure, the total delinquency rate was 14.01 percent at the end of the first quarter of 2010. Florida, Nevada, Mississippi, Arizona and Georgia continue to have the highest delinquency rates in the country, each with a rate above 10 percent. Compared to the fourth quarter of 2009, seasonally adjusted delinquency rates increased for all loan types except Federal Housing Administration (FHA) loans. Fur-

thermore, foreclosure starts during the first quarter of 2010 are up from the last quarter, with the exception of subprime loans.[986]

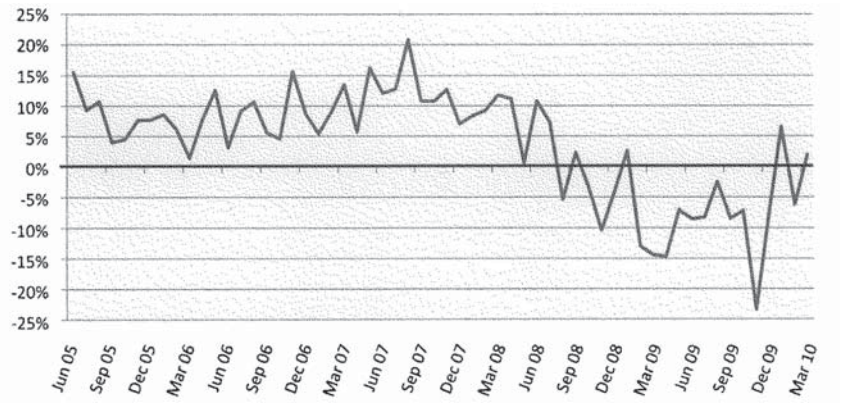
FIGURE 56: TOTAL PERCENTAGE OF LOANS WITH INSTALLMENTS PAST DUE, BY CENSUS REGION, FIRST QUARTER 2010 [987]



• **Consumer Credit.** The Federal Reserve Consumer Credit Index tracks short-term and long-term credit given to individuals for all purposes excluding real estate loans. In March 2010, consumer credit grew at a 0.5 percent annual rate. Revolving credit decreased at a 5.3 percent annual rate, while nonrevolving credit decreased at a 1.2 percent annual rate. Data from the Federal Reserve's G.19 report indicate that there was $2.44 trillion in consumer credit outstanding for the first quarter of 2010. This figure is down from $2.54 trillion in the first quarter of 2009.[988]

[986] Mortgage Bankers Association, *National Delinquency Survey Q1210* (Mar. 31, 2010) (online at www.mbaa.org/ResearchandForecasts/ProductsandSurveys/NationalDelinquencySurvey.htm).
[987] *Id.*
[988] Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release G.19: Consumer Credit: Historical Data* (online at www.federalreserve.gov/releases/g19/current/g19.htm) (accessed June 2, 2010).

FIGURE 57: FEDERAL RESERVE CONSUMER CREDIT TOTAL NET CHANGE (SEASONALLY ADJUSTED) [989]



G. Financial Update

Each month, the Panel summarizes the resources that the federal government has committed to economic stabilization. The following financial update provides: (1) an updated accounting of the TARP, including a tally of dividend income, repayments, and warrant dispositions that the program has received as of April 29, 2010; and (2) an updated accounting of the full federal resource commitment as of May 26, 2010.

1. The TARP

a. Costs: Expenditures and Commitments

Treasury has committed or is currently committed to spend $520.3 billion of TARP funds through an array of programs used to purchase preferred shares in financial institutions, provide loans to small businesses and automotive companies, and leverage Federal Reserve loans for facilities designed to restart secondary securitization markets.[990] Of this total, $214.2 billion is currently outstanding under the $698.7 billion limit for TARP expenditures set by EESA, leaving $481.1 billion available for fulfillment of anticipated funding levels of existing programs and for funding new programs and initiatives. The $214.2 billion includes purchases of preferred and common shares, warrants and/or debt obligations under the CPP, AIGIP/SSFI Program, PPIP, and AIFP; and a loan to TALF LLC, the SPV used to guarantee Federal Reserve TALF loans.[991] Additionally, Treasury has spent $187.8 million under the

[989] *Id.*

[990] EESA, as amended by the Helping Families Save Their Homes Act of 2009, limits Treasury to $698.7 billion in purchasing authority outstanding at any one time as calculated by the sum of the purchase prices of all troubled assets held by Treasury. Pub. L. No. 110–343 § 115(a)–(b); Helping Families Save Their Homes Act of 2009, Pub. L. No. 111–22 § 402(f) (reducing by $1.23 billion the authority for the TARP originally set under EESA at $700 billion).

[991] Treasury Transactions Report, *supra* note 2.

Home Affordable Modification Program, out of a projected total program level of $50 billion.

b. Income: Dividends, Interest Payments, CPP Repayments, and Warrant Sales

As of May 26, 2010, a total of 74 institutions have completely repurchased their CPP preferred shares. Of these institutions, 46 have repurchased their warrants for common shares that Treasury received in conjunction with its preferred stock investments; Treasury sold the warrants for common shares for 10 other institutions at auction.[992] In May 2010, Comerica Inc. repurchased its warrants for $183.8 million. Warrants for common shares of Wells Fargo & Company and Valley National Bancorp were sold at auction for $854.6 million in total proceeds. On May 19, 2010, Treasury received a $4 million repayment from Texas National Bancorporation, along with a warrant to purchase $199,000 in preferred shares. In addition, Treasury receives dividend payments on the preferred shares that it holds, usually five percent per annum for the first five years and nine percent per annum thereafter.[993] To date, Treasury has received approximately $20.8 billion in net income from warrant repurchases, dividends, interest payments, and other considerations derived from TARP investments,[994] and another $1.2 billion in participation fees from its Guarantee Program for Money Market Funds.[995]

c. TARP Accounting

FIGURE 58: TARP ACCOUNTING (AS OF APRIL 29, 2010) [996]

[Dollars in billions]

TARP Initiative	Anticipated Funding	Actual Funding	Total Repayments/ Reduced Exposure	Funding Outstanding	Losses	Funding Available
Capital Purchase Program (CPP) [997]	$204.9	$204.9	$137.3	[998] $67.6	[999] $2.3	$0
Targeted Investment Program (TIP) [1000]	40.0	40.0	40	0	—	0
AIG Investment Program (AIGIP)/Systemically Significant Failing Institutions Program (SSFI)	69.8	[1001] 49.1	0	49.1	—	20.7
Automobile Industry Financing Program (AIFP)	81.3	81.3	[1002] 10.8	67.1	[1003] 3.5	0
Asset Guarantee Program (AGP) [1004]	5.0	5.0	[1005] 5.0	0	—	0
Capital Assistance Program (CAP) [1006]	—	—	—	—	—	—
Term Asset-Backed Securities Lending Facility (TALF)	20.0	[1007] 0.10	0	0.10	—	19.9

[992] Treasury Transactions Report, *supra* note 2.

[993] U.S. Department of the Treasury, *Securities Purchase Agreement [CPP]: Standard Terms,* at 7 (online at www.financialstability.gov/docs/CPP/spa.pdf) (accessed June 8, 2010).

[994] U.S. Department of the Treasury, *Cumulative Dividends and Interest Report as of April 30, 2010* (May 14, 2010) (online at www.financialstability.gov/docs/dividends-interest-reports/April%202010%20Dividends%20and%20Interest%20Report.pdf) (hereinafter "Treasury Cumulative Dividends and Interest Report").

[995] U.S. Department of the Treasury, *Treasury Announces Expiration of Guarantee Program for Money Market Funds* (Sept. 18, 2009) (online at www.treasury.gov/press/releases/tg293.htm).

FIGURE 58: TARP ACCOUNTING (AS OF APRIL 29, 2010) [996]—Continued

[Dollars in billions]

TARP Initiative	Anticipated Funding	Actual Funding	Total Repayments/ Reduced Exposure	Funding Outstanding	Losses	Funding Available
Public-Private Investment Program (PPIP) [1008]	30.0	30.0	0	30.0	—	0
Supplier Support Program (SSP) [1009]	[1010] 3.5	3.5	3.5	0	—	0
Unlocking SBA Lending	15.0	[1011] 0.11	0	0.11	—	14.89
Home Affordable Modification Program (HAMP)	[1012] 50	[1013] 0.19	0	0.19	—	49.8
Community Development Capital Initiative (CDCI)	[1014] 0.78	0	0	0	—	0.78
Total Committed	520.3	414.20	—	214.20	—	106.08
Total Uncommitted	178.4	—	196.6	—	—	[1015] 375.02
Total	**$698.7**	**$414.20**	**$196.6**	**$214.20**	**$5.8**	**$481.10**

[996] Treasury Transactions Report, *supra* note 2.

[997] As of December 31, 2009, the CPP was closed. U.S. Department of the Treasury, *FAQ on Capital Purchase Program Deadline* (online at www.financialstability.gov/docs/FAQ%20on%20Capital%20Purchase%20Program%20Deadline.pdf).

[998] Treasury has classified the investments it made in two institutions, CIT Group ($2.3 billion) and Pacific Coast National Bancorp ($4.1 million), as losses on the Transactions Report. Therefore Treasury's net current CPP investment is $65.4 billion due to the $2.3 billion in losses thus far. Treasury Transactions Report, *supra* note 2.

[999] This figure represents the TARP losses associated with CIT Group ($2.3 billion) and Pacific Coast National Bancorp ($4.1 million). This number does not include UCBH Holdings or Midwest Banc Holdings, Inc. UCBH Holdings, Inc. received $299 million in TARP funds and is currently in bankruptcy proceedings. As of May 26, 2010, the banking subsidiary of the TARP recipient Midwest Banc Holdings, Inc. ($89.4 million) was in receivership. Treasury Transactions Report, *supra* note 2.

[1000] Both Bank of America and Citigroup repaid the $20 billion in assistance each institution received under the TIP on December 9 and December 23, 2009, respectively. Therefore the Panel accounts for these funds as repaid and uncommitted. Treasury Transactions Report, *supra* note 2.

[1001] AIG has completely utilized the $40 billion made available on November 25, 2008 and drawn-down $7.54 billion of the $29.8 billion made available on April 17, 2009. This figure also reflects $1.6 billion in accumulated but unpaid dividends owed by AIG to Treasury due to the restructuring of Treasury's investment from cumulative preferred shares to non-cumulative shares. AIG Form 10–K for FY09, *supra* note 50, at 45; Treasury Transactions Report, *supra* note 2; information provided by Treasury staff in response to Panel request.

[1002] On May 14, 2010, Treasury accepted a $1.9 billion settlement payment from Chrysler Holding to satisfy Chrysler Holdco's existing debt. In addition, Chrysler LLC, ''Old Chrysler,'' repaid $30.5 million of its debt obligations to Treasury on May 10, 2010 from proceeds earned from collateral sales. Treasury Transactions Report, *supra* note 2.

[1003] The $1.9 billion settlement payment represents a $1.6 billion loss on Treasury's Chrysler Holding Investment. This amount is in addition to losses connected to the $1.9 billion loss from the $4.1 billion debtor-in-possession credit facility, or Chrysler DIP Loan. U.S. Department of the Treasury, *Chrysler Financial Parent Company Repays $1.9 Billion in Settlement of Original Chrysler Loan,* Press Release (May 17, 2010) (online at www.financialstability.gov/latest/pr_05172010c.html); Treasury Transactions Report, *supra* note 2.

[1004] Treasury, the Federal Reserve, and the Federal Deposit Insurance Corporation terminated the asset guarantee with Citigroup on December 23, 2009. The agreement was terminated with no losses to Treasury's $5 billion second-loss portion of the guarantee. Citigroup did not repay any funds directly, but instead terminated Treasury's outstanding exposure on its $5 billion second-loss position. As a result, the $5 billion is now counted as uncommitted. U.S. Department of the Treasury, *Treasury Receives $45 Billion in Repayments from Wells Fargo and Citigroup* (Dec. 22, 2009) (online at www.treas.gov/press/releases/20091229716198713.htm).

[1005] Although this $5 billion is no longer exposed as part of the AGP and is accounted for as available, Treasury did not receive a repayment in the same sense as with other investments. Treasury did receive other income as consideration for the guarantee, which is not a repayment and is accounted for in Figure 59.

[1006] On November 9, 2009, Treasury announced the closing of this program and that only one institution, GMAC, was in need of further capital from Treasury. GMAC subsequently received an additional $3.8 billion in capital through the AIFP on December 30, 2009. U.S. Department of the Treasury, Treasury Announcement Regarding the Capital Assistance Program (Nov. 9, 2009) (online at www.financialstability.gov/latest/tg_11092009.html); U.S. Department of the Treasury, *Treasury Announces Restructuring of Commitment to GMAC* (Nov. 9, 2009) (online at www.financialstability.gov/latest/tg_11092009.html) (updated Jan. 5, 2010); Treasury Transactions Report, *supra* note 2.

[1007] Treasury has committed $20 billion in TARP funds to a loan funded through TALF LLC, a special purpose vehicle created by the Federal Reserve Bank of New York. The loan is incrementally funded and as of May 26, 2010, Treasury provided $104 million to TALF LLC. This total includes accrued payable interest. Treasury Transactions Report, *supra* note 2; Federal Reserve H.4.1 Statistical Release, *supra* note 342.

[1008] On April 20, 2010, Treasury released its second quarterly report on the Legacy Securities Public-Private Investment Partnership. As of March 31, 2010, the total value of assets held by the PPIP managers was $10 billion. Of this total, 88 percent was non-agency Residential Mortgage-Backed Securities and the remaining 12 percent was Commercial Mortgage-Backed Securities. U.S. Department of the Treasury, *Legacy Securities Public-Private Investment Program, Program Update—Quarter Ended March 31, 2010* (Apr. 20, 2010) (online at www.financialstability.gov/docs/External%20Report%20-%2003-10%20Final.pdf).

[1009] On April 5, 2010 and April 7, 2010, Treasury's commitment to lend to the GM SPV and the Chrysler SPV respectively under the ASSP ended. In total, Treasury received $413 million in repayments from loans provided by this program ($290 million from the GM SPV and $123 million from the Chrysler SPV). Further, Treasury received $101 million in proceeds from additional notes associated with this program. Treasury Transactions Report, *supra* note 2.

[1010] On July 8, 2009, Treasury lowered the total commitment amount for the program from $5 billion to $3.5 billion. This action reduced GM's portion from $3.5 billion to $2.5 billion and Chrysler's portion from $1.5 billion to $1 billion. GM Supplier Receivables LLC, the special purpose vehicle (SPV) created to administer this program for GM suppliers has made $290 million in partial repayments and Chrysler Receivables SPV LLC, the SPV created to administer the program for Chrysler suppliers, has made $123 million in partial repayments. These were partial repayments of drawn-down funds and did not lessen Treasury's $3.5 billion in total exposure under the ASSP. Treasury Transactions Report, *supra* note 2.

[1011] Treasury settled on the purchase of three floating rate Small Business Administration 7(a) securities on March 24, 2010, and another on April 30, 2010. Treasury anticipates a settlement on one floating rate SBA 7(a) security on May 28, 2010. As of May 3, 2010, the total amount of TARP funds invested in these securities was $58.64 million. Treasury Transactions Report, *supra* note 2.

[1012] On February 19, 2010, President Obama announced the Housing Finance Agency Innovation Fund for the Hardest Hit Housing Markets (HFA Hardest Hit Fund). The proposal commits $1.5 billion of the $50 billion in TARP funds allocated to HAMP to assist the five states with the highest home price declines stemming from the foreclosure crisis: Nevada, California, Florida, Arizona, and Michigan. The White House, *President Obama Announces Help for Hardest Hit Housing Markets* (Feb. 19, 2010) (online at www.whitehouse.gov/the-press-office/president-obama-announces-help-hardest-hit-housing-markets). On March 29, 2010, Treasury announced $600 million in funding for a second HFA Hardest Hit Fund which includes North Carolina, Ohio, Oregon Rhode Island, and South Carolina. U.S. Department of the Treasury, *Administration Announces Second Round of Assistance for Hardest-Hit Housing Markets* (Mar. 29, 2010) (online at www.financialstability.gov/latest/pr_03292010.html). Until further information on these programs is released, the Panel will continue to account for the $50 billion commitment to HAMP as intact and as the newly announced programs as subsets of the larger initiative. For further discussion of the newly announced HAMP programs, and the effect these initiatives may have on the $50 billion in committed TARP funds, *see* section D.1 of the Panel's April report. Congressional Oversight Panel, April Oversight Report: *Evaluating Progress on TARP Foreclosure Mitigation Programs,* at 227 (Apr. 14, 2010) (online atcop.senate.gov/documents/cop-041410-report.pdf).

[1013] In response to a Panel inquiry, Treasury disclosed that, as of May 31, 2010, $187.8 million in funds had been disbursed under HAMP. As of May 26, 2010, the total of all the caps set on payments to each mortgage servicer was $39.8 billion. Treasury Transactions Report, *supra* note 2.

[1014] On February 3, 2010, the Administration announced an initiative under TARP to provide low-cost financing for Community Development Financial Institutions (CDFIs). Under this program, CDFIs are eligible for capital investments at a two percent dividend rate as compared to the five percent dividend rate under the CPP. In response to Panel request, Treasury stated that it projects the CDCI program to utilize $780.2 million.

[1015] This figure is the sum of the uncommitted funds remaining under the $698.7 billion cap ($178.4 billion) and the repayments ($196.5 billion).

FIGURE 59: TARP PROFIT AND LOSS

[Dollars in millions]

TARP Initiative	Dividends [1016] (as of 4/30/10)	Interest [1017] (as of 4/30/10)	Warrant Repurchases [1018] (as of 5/26/10)	Other Proceeds (as of 4/30/10)	Losses [1019] (as of 5/26/10)	Total
Total	$14,996	$726	$7,031	$3,833	($5,822)	$20,764
CPP	8,969	28	5,760	[1020] 1,308	(2,334)	13,731
TIP	3,004	–	1,256	–	–	4,260
AIFP	[1021] 2,701	674	15	–	(3,488)	(97)
ASSP	N/A	15	–	–	–	15
AGP	321	–	0	[1022] 2,234	–	2,555
PPIP	–	9	–	[1023] 15	–	24
Bank of America Guarantee	–	–	–	[1024] 276	–	276

[1016] Treasury Cumulative Dividends and Interest Report, *supra* note 994.

[1017] Treasury Cumulative Dividends and Interest Report, *supra* note 994.

[1018] Treasury Transactions Report, *supra* note 2.

[1019] See note 999, *supra.*

[1020] As a fee for taking a second-loss position up to $5 billion on a $301 billion pool of ring-fenced Citigroup assets, as part of the AGP, Treasury received $4.03 billion in Citigroup preferred stock and warrants; Treasury exchanged these preferred stocks for TruPS in June 2009. Following the early termination of the guarantee, Treasury cancelled $1.8 billion of the TruPS, leaving Treasury with a $2.23 billion investment in Citigroup TruPS in exchange for the guarantee. At the end of Citigroup's participation in the FDIC's TLGP, the FDIC may transfer $800 million of $3.02 billion in Citigroup TruPS it received in consideration for its role in the AGP to the Treasury. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending May 26, 2010 (May 28, 2010)* (online at www.financialstability.gov/docs/transaction-reports/5-2810%20Transactions%20Report%20as%20of%205-26-10.pdf).

[1021] This figure includes $815 million in dividends from GMAC preferred stock, trust preferred securities and mandatory convertible preferred shares. The dividend total also includes a $748.6 million senior unsecured note from Treasury's investment in General Motors. Information provided by Treasury in response to Panel inquiry.

[1022] As a fee for taking a second-loss position up to $5 billion on a $301 billion pool of ring-fenced Citigroup assets, as part of the AGP, Treasury received $4.03 billion in Citigroup preferred stock and warrants; Treasury exchanged these preferred stocks for trust preferred securities in June 2009. Following the early termination of the guarantee, Treasury cancelled $1.8 billion of the trust preferred securities, leaving Treasury with a $2.23 billion investment in Citigroup trust preferred securities in exchange for the guarantee. At the end of Citigroup's participation in the FDIC's TLGP, the FDIC may transfer $800 million of $3.02 billion in Citigroup Trust Preferred Securities it received in consideration for its role in the AGP to the Treasury. Treasury Transactions Report, *supra* note 2.

[1023] As of April 29, 2010, Treasury has earned $15.4 million in membership interest distributions from the PPIP. Treasury Cumulative Dividends and Interest Report, *supra* note 994.

[1024] Although Treasury, the Federal Reserve, and the FDIC negotiated with Bank of America regarding a similar guarantee, the parties never reached an agreement. In September 2009, Bank of America agreed to pay each of the prospective guarantors a fee as though the guarantee had been in place during the negotiations. This agreement resulted in payments of $276 million to Treasury, $57 million to the Federal Reserve, and $92 million to the FDIC. U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Bank of America Corporation, *Termination Agreement,* at 1–2 (Sept. 21, 2009) (online at www.financialstability.gov/docs/AGP/BofA%20-%20Termination%20Agreement%20-%20executed.pdf).

d. Rate of Return

As of June 8, 2010, the average internal rate of return for all financial institutions that participated in the CPP and fully repaid the U.S. government (including preferred shares, dividends, and warrants) was 9.9 percent. The internal rate of return is the annualized effective compounded return rate that can be earned on invested capital.

e. Warrant Disposition

FIGURE 60: WARRANT REPURCHASES/AUCTIONS FOR FINANCIAL INSTITUTIONS THAT HAVE FULLY REPAID CPP FUNDS AS OF JUNE 8, 2010

Institution	Investment Date	Warrant Repurchase Date	Warrant Repurchase/ Sale Amount	Panel's Best Valuation Estimate at Repurchase Date	Price/ Estimate Ratio	IRR (Percent)
Old National Bancorp	12/12/2008	5/8/2009	$1,200,000	$2,150,000	0.558	9.3
Iberiabank Corporation	12/5/2008	5/20/2009	1,200,000	2,010,000	0.597	9.4
Firstmerit Corporation	1/9/2009	5/27/2009	5,025,000	4,260,000	1.180	20.3
Sun Bancorp, Inc	1/9/2009	5/27/2009	2,100,000	5,580,000	0.376	15.3
Independent Bank Corp.	1/9/2009	5/27/2009	2,200,000	3,870,000	0.568	15.6
Alliance Financial Corporation	12/19/2008	6/17/2009	900,000	1,580,000	0.570	13.8
First Niagara Financial Group	11/21/2008	6/24/2009	2,700,000	3,050,000	0.885	8.0
Berkshire Hills Bancorp, Inc.	12/19/2008	6/24/2009	1,040,000	1,620,000	0.642	11.3
Somerset Hills Bancorp	1/16/2009	6/24/2009	275,000	580,000	0.474	16.6
SCBT Financial Corporation	1/16/2009	6/24/2009	1,400,000	2,290,000	0.611	11.7
HF Financial Corp	11/21/2008	6/30/2009	650,000	1,240,000	0.524	10.1
State Street	10/28/2008	7/8/2009	60,000,000	54,200,000	1.107	9.9
U.S. Bancorp	11/14/2008	7/15/2009	139,000,000	135,100,000	1.029	8.7
The Goldman Sachs Group, Inc.	10/28/2008	7/22/2009	1,100,000,000	1,128,400,000	0.975	22.8
BB&T Corp.	11/14/2008	7/22/2009	67,010,402	68,200,000	0.983	8.7
American Express Company	1/9/2009	7/29/2009	340,000,000	391,200,000	0.869	29.5
Bank of New York Mellon Corp	10/28/2008	8/5/2009	136,000,000	155,700,000	0.873	12.3
Morgan Stanley	10/28/2008	8/12/2009	950,000,000	1,039,800,000	0.914	20.2
Northern Trust Corporation	11/14/2008	8/26/2009	87,000,000	89,800,000	0.969	14.5
Old Line Bancshares Inc.	12/5/2008	9/2/2009	225,000	500,000	0.450	10.4
Bancorp Rhode Island, Inc.	12/19/2008	9/30/2009	1,400,000	1,400,000	1.000	12.6
Centerstate Banks of Florida Inc.	11/21/2008	10/28/2009	212,000	220,000	0.964	5.9
Manhattan Bancorp	12/5/2008	10/14/2009	63,364	140,000	0.453	9.8
Bank of Ozarks	12/12/2008	11/24/2009	2,650,000	3,500,000	0.757	9.0
Capital One Financial	11/14/2008	12/3/2009	148,731,030	232,000,000	0.641	12.0
JPMorgan Chase & Co.	10/28/2008	12/10/2009	950,318,243	1,006,587,697	0.944	10.9
TCF Financial Corp	1/16/2009	12/16/2009	9,599,964	11,825,830	0.812	11.0
LSB Corporation	12/12/2008	12/16/2009	560,000	535,202	1.046	9.0
Wainwright Bank & Trust Company	12/19/2008	12/16/2009	568,700	1,071,494	0.531	7.8
Wesbanco Bank, Inc.	12/5/2008	12/23/2009	950,000	2,387,617	0.398	6.7
Union Bankshares Corporation	12/19/2008	12/23/2009	450,000	1,130,418	0.398	5.8
Trustmark Corporation	11/21/2008	12/30/2009	10,000,000	11,573,699	0.864	9.4
Flushing Financial Corporation	12/19/2008	12/30/2009	900,000	2,861,919	0.314	6.5
OceanFirst Financial Corporation	1/16/2009	2/3/2010	430,797	279,359	1.542	6.2
Monarch Financial Holdings, Inc.	12/19/2008	2/10/2010	260,000	623,434	0.417	6.7

FIGURE 60: WARRANT REPURCHASES/AUCTIONS FOR FINANCIAL INSTITUTIONS THAT HAVE FULLY REPAID CPP FUNDS AS OF JUNE 8, 2010—Continued

Institution	Investment Date	Warrant Repurchase Date	Warrant Repurchase/ Sale Amount	Panel's Best Valuation Estimate at Repurchase Date	Price/ Estimate Ratio	IRR (Percent)
Bank of America	[1025] 10/28/08 [1026] 1/9/2009 [1027] 1/14/2009	3/3/2010	1,566,210,714	1,006,416,684	1.533	6.5
Washington Federal Inc./ Washington Federal Savings & Loan Association	11/14/2008	3/9/2010	15,623,222	10,166,404	1.537	18.6
Signature Bank	12/12/2008	3/10/2010	11,320,751	11,458,577	0.988	32.4
Texas Capital Bancshares, Inc.	1/16/2009	3/11/2010	6,709,061	8,316,604	0.807	30.1
Umpqua Holdings Corp.	11/14/2008	3/31/2010	4,500,000	5,162,400	0.872	6.6
City National Corporation	11/21/2008	4/7/2010	18,500,000	24,376,448	0.759	8.5
First Litchfield Financial Corporation	12/12/2008	4/7/2010	1,488,046	1,863,158	0.799	15.9
PNC Financial Services Group Inc.	12/31/2008	4/29/2010	324,195,686	346,800,388	0.935	8.7
Comerica Inc	11/14/2008	5/4/2010	183,673,472	276,426,071	0.664	10.8
Valley National Bancorp	11/14/2008	5/18/2010	5,571,592	5,955,884	0.935	8.3
Wells Fargo Bank	10/28/2008	5/20/2010	849,014,998	1,064,247,725	0.798	7.8
First Financial Bancorp	12/23/2008	6/2/2010	3,116,284	3,051,431	1.021	8.2
Total			$7,014,943,327	$7,131,508,443	0.984	9.90

[1025] Investment date for Bank of America in CPP.
[1026] Investment date for Merrill Lynch in CPP.
[1027] Investment date for Bank of America in TIP.

FIGURE 61: VALUATION OF CURRENT HOLDINGS OF WARRANTS AS OF JUNE 8, 2010

[Dollars in millions]

Stress Test Financial Institutions with Warrants Outstanding	Warrant Valuation		
	Low Estimate	High Estimate	Best Estimate
Citigroup, Inc.	$10.95	$1,001.97	$318.78
SunTrust Banks, Inc.	13.70	333.82	200.48
Regions Financial Corporation	16.21	235.88	137.59
Fifth Third Bancorp	90.72	381.08	239.21
Hartford Financial Services Group, Inc.	380.32	725.70	545.72
KeyCorp	16.81	158.87	104.25
AIG	173.36	1,594.41	1,020.39
All Other Banks	893.43	2,096.14	1,661.88
Total	$1,595.49	$6,527.87	$4,228.32
Citigroup, Inc.	$10.95	$1,001.97	$318.78

2. Other Financial Stability Efforts

Federal Reserve, FDIC, and Other Programs

In addition to the direct expenditures Treasury has undertaken through the TARP, the federal government has engaged in a much broader program directed at stabilizing the U.S. financial system. Many of these initiatives explicitly augment funds allocated by

Treasury under specific TARP initiatives, such as FDIC and Federal Reserve asset guarantees for Citigroup, or operate in tandem with Treasury programs, such as the interaction between PPIP and TALF. Other programs, like the Federal Reserve's extension of credit through its Section 13(3) facilities and SPVs and the FDIC's Temporary Liquidity Guarantee Program, operate independently of the TARP.

Figure 62 below reflects the changing mix of Federal Reserve investments. As the liquidity facilities established to address the crisis have been wound down, the Federal Reserve has expanded its facilities for purchasing mortgage-related securities. The Federal Reserve announced that it intended to purchase $175 billion of federal agency debt securities and $1.25 trillion of agency mortgage-backed securities.[1028] As of May 26, 2010, $167.4 billion of federal agency (government-sponsored enterprise) debt securities and $1.1 trillion of agency mortgage-backed securities were purchased.[1029] These purchases were completed on March 31, 2010.[1030] In addition, $174.7 billion in GSE MBS remain outstanding as of May 2010 under Treasury's GSE Mortgage Backed Securities Purchase Program.[1031]

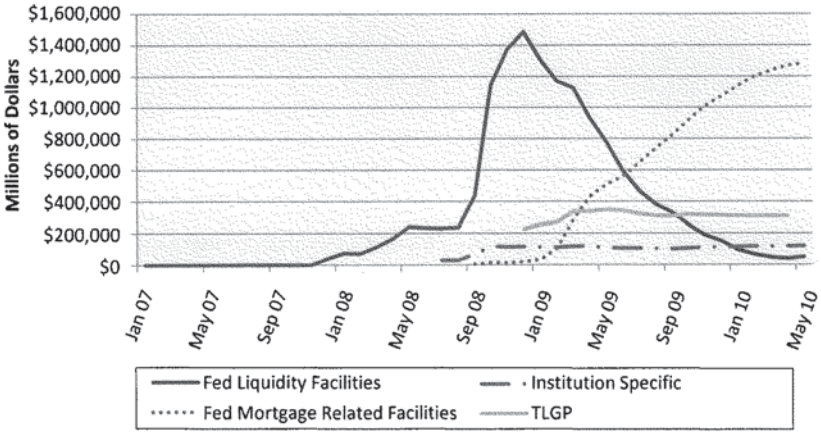
[1028] Board of Governors of the Federal Reserve System, *Minutes of the Federal Open Market Committee,* at 10 (Dec. 15–16, 2009) (online at www.federalreserve.gov/newsevents/press/monetary/fomcminutes20091216.pdf) ("[T]he Federal Reserve is in the process of purchasing $1.25 trillion of agency mortgage-backed securities and about $175 billion of agency debt").

[1029] Federal Reserve Data Download Program, *supra* note 317.

[1030] Federal Reserve Bank of New York, *Agency Mortgage-Backed Securities Purchase Program* (online at www.newyorkfed.org/markets/mbs/); Federal Reserve H.4.1 Statistical Release, *supra* note 809.

[1031] U.S. Department of the Treasury, *MBS Purchase Program: Portfolio by Month* (online at www.financialstability.gov/docs/May%202010%20Portfolio%20by%20month.pdf) (accessed June 2, 2010). Treasury received $42.2 billion in principal repayments $10.3 billion in interest payments from these securities. U.S. Department of the Treasury, *MBS Purchase Program Principal and Interest* (online at www.financialstability.gov/docs/May%202010%20MBS%20Principal%20and%20Interest%20Monthly%20Breakout.pdf) (accessed June 2, 2010).

FIGURE 62: FEDERAL RESERVE AND FDIC FINANCIAL STABILITY EFFORTS (AS OF APRIL 28, 2010) [1032]



3. Total Financial Stability Resources (as of April 30, 2010)

Beginning in its April 2009 report, the Panel broadly classified the resources that the federal government has devoted to stabilizing the economy through myriad new programs and initiatives such as outlays, loans, or guarantees. Although the Panel calculates the total value of these resources at nearly $3 trillion, this would translate into the ultimate "cost" of the stabilization effort only if: (1) assets do not appreciate; (2) no dividends are received, no warrants are exercised, and no TARP funds are repaid; (3) all loans default and are written off; and (4) all guarantees are exercised and subsequently written off.

With respect to the FDIC and Federal Reserve programs, the risk of loss varies significantly across the programs considered here, as do the mechanisms providing protection for the taxpayer against such risk. As discussed in the Panel's November report, the FDIC assesses a premium of up to 100 basis points on TLGP debt guarantees.[1033] In contrast, the Federal Reserve's liquidity programs are generally available only to borrowers with good credit,

[1032] Federal Reserve Liquidity Facilities include: Primary credit, Secondary credit, Central Bank Liquidity Swaps, Primary dealer and other broker-dealer credit, Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, Net portfolio holdings of Commercial Paper Funding Facility LLC, Seasonal credit, Term auction credit, and Term Asset-Backed Securities Loan Facility. Federal Reserve Mortgage Related Facilities Include: Federal agency debt securities and Mortgage-backed securities held by the Federal Reserve. Institution Specific Facilities include: credit extended to American International Group, Inc., the preferred interests in AIA Aurora LLC and ALICO Holdings LLC, and the net portfolio holdings of Maiden Lanes I, II, and III. Federal Reserve Data Download Program, *supra* note 317. For related presentations of Federal Reserve data, *see* Board of Governors of the Federal Reserve System, *Credit and Liquidity Programs and the Balance Sheet,* at 2 (Nov. 2009) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200911.pdf). The TLGP figure reflects the monthly amount of debt outstanding under the program. Federal Deposit Insurance Corporation, *Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program* (Dec. 2008–Mar. 2010) (online at www.fdic.gov/regulations/resources/TLGP/reports.html). The total for the Term Asset-Backed Securities Loan Facility has been reduced by $20 billion throughout this exhibit in order to reflect Treasury's $20 billion first-loss position under the terms of this program.

[1033] November Oversight Report, *supra* note 411, at 36.

and the loans are over-collateralized and with recourse to other assets of the borrower. If the assets securing a Federal Reserve loan realize a decline in value greater than the "haircut," the Federal Reserve is able to demand more collateral from the borrower. Similarly, should a borrower default on a recourse loan, the Federal Reserve can turn to the borrower's other assets to make the Federal Reserve whole. In this way, the risk to the taxpayer on recourse loans only materializes if the borrower enters bankruptcy. The only loan currently "underwater"—where the outstanding principal loan amount exceeds the current market value of the collateral—is the loan to Maiden Lane LLC,[1034] which was formed to purchase certain Bear Stearns assets.

FIGURE 63: FEDERAL GOVERNMENT FINANCIAL STABILITY EFFORT (AS OF MAY 26, 2010) [i]

[Dollars in billions]

Program	Treasury (TARP)	Federal Reserve	FDIC	Total
Total	**$698.7**	**$1,642.6**	**$670.4**	**$2,995.2**
Outlays [ii]	271.4	1,316.3	69.4	1,630.6
Loans	37.8	326.3	0	380.1
Guarantees [iii]	20	0	601	621
Uncommitted TARP Funds	369.5	0	0	363.4
AIG [iv]	**69.8**	**90.1**	**0**	**159.9**
Outlays	[v] 69.8	[vi] 25.4	0	95.2
Loans	0	[vii] 64.7	0	64.7
Guarantees	0	0	0	0
Citigroup	**25**	**0**	**0**	**25**
Outlays	[viii] 25	0	0	25
Loans	0	0	0	0
Guarantees	0	0	0	0
Capital Purchase Program (Other)	**42.7**	**0**	**0**	**42.7**
Outlays	[ix] 42.7	0	0	42.7
Loans	0	0	0	0
Guarantees	0	0	0	0
Capital Assistance Program	**N/A**	**0**	**0**	[x] N/A
TALF	**20**	**180**	**0**	**200**
Outlays	0	0	0	0
Loans	0	[xii] 180	0	180
Guarantees	[xi] 20	0	0	20
PPIP (Loans) [xiii]	**0**	**0**	**0**	**0**
Outlays	0	0	0	0
Loans	0	0	0	0
Guarantees	0	0	0	0
PPIP (Securities)	[xiv] **30**	**0**	**0**	**30**
Outlays	10	0	0	10
Loans	20	0	0	20
Guarantees	0	0	0	0
Home Affordable Modification Program	**50**	**0**	**0**	**50**
Outlays	[xv] 50	0	0	50
Loans	0	0	0	0
Guarantees	0	0	0	0
Automotive Industry Financing Program	[xvi] **67.1**	**0**	**0**	**67.1**
Outlays	59.0	0	0	59.0
Loans	8.1	0	0	8.1
Guarantees	0	0	0	0
Auto Supplier Support Program	**3.5**	**0**	**0**	**3.5**
Outlays	0	0	0	0
Loans	[xvii] 3.5	0	0	3.5
Guarantees	0	0	0	0
Unlocking SBA Lending	[xviii] **15**	**0**	**0**	**15**

[1034] Maiden Lane LLC is often referred to as Maiden Lane I, due to the later establishment of ML2 and ML3.

FIGURE 63: FEDERAL GOVERNMENT FINANCIAL STABILITY EFFORT (AS OF MAY 26, 2010) [i]—Continued

[Dollars in billions]

Program	Treasury (TARP)	Federal Reserve	FDIC	Total
Outlays	15	0	0	15
Loans	0	0	0	0
Guarantees	0	0	0	0
Community Development Capital Initiative	[xix] **0.78**	**0**	**0**	**0.78**
Outlays	0	0	0	0
Loans	0.78	0	0	0.78
Guarantees	0	0	0	0
Temporary Liquidity Guarantee Program	**0**	**0**	**569**	**569**
Outlays	0	0	0	0
Loans	0	0	0	0
Guarantees	0	0	[xx] 569	569
Deposit Insurance Fund	**0**	**0**	**69.4**	**69.4**
Outlays	0	0	[xxi] 69.4	69.4
Loans	0	0	0	0
Guarantees	0	0	0	0
Other Federal Reserve Credit Expansion	**0**	**1410.7**	**0**	**1410.7**
Outlays	0	[xxii] 1305.7	0	1305.7
Loans	0	[xxiii] 105	0	105
Guarantees	0	0	0	0
Uncommitted TARP Funds	**374.8**	**0**	**0**	**374.8**

[i] All data in this exhibit is as of May 26, 2010, except for information regarding the FDIC's Temporary Liquidity Guarantee Program (TLGP). This data is as of April 30, 2010.

[ii] The term ''outlays'' is used here to describe the use of Treasury funds under the TARP, which are broadly classifiable as purchases of debt or equity securities (e.g., debentures, preferred stock, exercised warrants, etc.). The outlays figures are based on: (1) Treasury's actual reported expenditures; and (2) Treasury's anticipated funding levels as estimated by a variety of sources, including Treasury pronouncements and GAO estimates. Anticipated funding levels are set at Treasury's discretion, have changed from initial announcements, and are subject to further change. Outlays used here represent investment and asset purchases and commitments to make investments and asset purchases and are not the same as budget outlays, which under section 123 of EESA are recorded on a ''credit reform'' basis.

[iii] Although many of the guarantees may never be exercised or exercised only partially, the guarantee figures included here represent the federal government's greatest possible financial exposure.

[iv] AIG received an $85 billion credit facility (reduced to $60 billion in November 2008 and then to $35 billion in December 2009 and then to $34 billion in May 2010) from FRBNY. A Treasury trust received Series C preferred convertible stock in exchange for the facility and $0.5 million. The Series C shares amount to 79.9 percent ownership of common stock, minus the percentage common shares acquired through warrants. In November 2008, Treasury received a warrant to purchase shares amounting to 2 percent ownership of AIG common stock in connection with its Series D stock purchase (exchanged for Series E noncumulative preferred shares on April 17, 2009). Treasury also received a warrant to purchase 3,000 Series F common shares in May 2009. Warrants for Series D and Series F shares represent 2 percent equity ownership, and would convert Series C shares into 77.9 percent of common stock. However, in May 2009, AIG carried out a 20:1 reverse stock split, which allows warrants held by Treasury to become convertible into 0.1 percent common equity. Therefore, the total benefit to Treasury would be a 79.8 percent voting majority in AIG in connection with its ownership of Series C convertible shares. Government Accountability Office, *Troubled Asset Relief Program: Update of Government Assistance Provided to AIG* (Apr. 2010) (GAO–10–475) (online at www.gao.gov/new.items/d10475.pdf). Additional information was also provided by Treasury in response to the Panel's inquiry.

[v] This number includes investments under the AIGIP/SSFI Program: $40 billion investment made on November 25, 2008 and $30 billion investment committed on April 17, 2009 (less a reduction of $165 million, representing bonuses paid to AIGFP employees). As of March 31, 2010, AIG had utilized $47.5 billion of the available $69.8 billion under the AIGIP/SSFI and owed $1.6 billion in unpaid dividends. This information was provided by Treasury in response to the Panel's inquiry.

[vi] As part of the restructuring of the U.S. government's investment in AIG announced on March 2, 2009, the amount available to AIG through the Revolving Credit Facility was reduced by $25 billion in exchange for preferred equity interests in two special purpose vehicles, AIA Aurora LLC and ALICO Holdings LLC. These SPVs were established to hold the common stock of two AIG subsidiaries: American International Assurance Company Ltd. (AIA) and American Life Insurance Company (ALICO). As of May 26, 2010, the book value of FRBNY's holdings in AIA Aurora LLC and ALICO Holdings LLC was $16 billion and $9 billion in preferred equity, respectively. Hence, the book value of these securities is $25 billion, which is reflected in the corresponding table. Federal Reserve Bank of New York, *Factors Affecting Reserve Balances (H.4.1)* (May 27, 2010) (online at www.federalreserve.gov/releases/h41/20100527/).

[vii] This number represents the full $34 billion that is available to AIG through the Revolving Credit Facility with FRBNY ($26.1 billion had been drawn down as of May 26, 2010), and the outstanding principal of the loans extended to the ML2 and ML3 SPVs to purchase AIG assets (as of May 26, 2010, $15 billion and $16 billion, respectively). The amounts outstanding under the ML2 and ML3 facilities do not reflect the accrued interest payable to FRBNY. Income from the purchased assets is used to pay down the loans made under ML2 and ML3, reducing the taxpayers' exposure to losses over time. Board of Governors of the Federal Reserve System, *Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet,* at 17 (Oct. 2009) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200910.pdf). On December 1, 2009, AIG entered into an agreement with FRBNY to reduce the debt AIG owes the FRBNY by $25 billion. In exchange, FRBNY received preferred equity interests in two AIG subsidiaries. This also reduced the debt ceiling on the loan facility from $60 billion to $35 billion. American International Group, *AIG Closes Two Transactions That Reduce Debt AIG Owes Federal Reserve Bank of New York by $25 billion* (Dec. 1, 2009) (online at phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MjE4ODI8Q2hpbGRJRD0tMXxUeXBlPTM=&t=1). The maximum available amount from the credit facility was reduced from $34.1 billion to $34 billion on May 6, 2010, as a result of the sale of HighStar Port Partners, L.P. Board of Governors of the Federal Reserve System, *Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet,* at 17 (May 2010) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport201005.pdf).

[viii] On May 26, 2010, Treasury completed sales of 1.5 billion shares of Citigroup common stock for $6.1 billion in gross proceeds and $1.3 billion in net proceeds. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending May 26, 2010,* at 15 (May 28, 2010) (online at financialstability.gov/docs/transaction-reports/5-28-10%20Transactions%20Report%20as%20of%205-26-10.pdf).

[ix] This figure represents the $204.9 billion Treasury disbursed under the CPP, minus the $25 billion investment in Citigroup identified above, and the $137.3 billion in repayments that are reflected as available TARP funds. This figure does not account for future repayments of CPP investments, dividend payments from CPP investments, or losses under the program. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending May 26, 2010* (May 28, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-28-10%20Transactions%20Report%20as%20of%205-26-10.pdf).

[x] On November 9, 2009, Treasury announced the closing of the CAP and only one institution, GMAC, was in need of further capital from Treasury. GMAC, however, received further funding through the AIFP. Therefore, the Panel considers CAP unused and closed. U.S. Department of the Treasury, *Treasury Announcement Regarding the Capital Assistance Program* (Nov. 9, 2009) (online at www.financialstability.gov/latest/tg__11092009.html).

[xi] This figure represents a $20 billion allocation to the TALF SPV on March 3, 2009. However, as of May 26, 2010, TALF LLC had drawn only $104 million of the available $20 billion. Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (May 27, 2010) (online at www.federalreserve.gov/releases/h41/20100527/); U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending May 26, 2010* (May 28, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-28-10%20Transactions%20Report%20as%20of%205-26-10.pdf). As of June 2, 2010, investors had requested a total of $73.3 billion in TALF loans ($13.2 billion in CMBS and $60.1 billion in non-CMBS), and $71 billion in TALF loans had been settled ($12 billion in CMBS and $59 billion in non-CMBS). Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: CMBS* (online at www.newyorkfed.org/markets/cmbs__operations.html) (accessed June 2, 2010); Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: non-CMBS* (online at www.newyorkfed.org/markets/talf__operations.html) (accessed June 2, 2010).

[xii] This number is derived from the unofficial 1:10 ratio of the value of Treasury loan guarantees to the value of Federal Reserve loans under the TALF. U.S. Department of the Treasury, *Fact Sheet: Financial Stability Plan* (Feb. 10, 2009) (online at www.financialstability.gov/docs/fact-sheet.pdf) (describing the initial $20 billion Treasury contribution tied to $200 billion in Federal Reserve loans and announcing potential expansion to a $100 billion Treasury contribution tied to $1 trillion in Federal Reserve loans). Because Treasury is responsible for reimbursing the Federal Reserve for $20 billion of losses on its $200 billion in loans, the Federal Reserve's maximum potential exposure under the TALF is $180 billion.

[xiii] It is unlikely that resources will be expended under the PPIP Legacy Loans Program in its original design as a joint Treasury-FDIC program to purchase troubled assets from solvent banks. *See also* Federal Deposit Insurance Corporation, *FDIC Statement on the Status of the Legacy Loans Program* (June 3, 2009) (online at www.fdic.gov/news/news/press/2009/pr09084.html); Federal Deposit Insurance Corporation, *Legacy Loans Program—Test of Funding Mechanism* (July 31, 2009) (online at www.fdic.gov/news/news/press/2009/pr09131.html). The sales described in these statements do not involve any Treasury participation, and FDIC activity is accounted for here as a component of the FDIC's Deposit Insurance Fund outlays.

[xiv] As of February 25, 2010, Treasury reported commitments of $19.9 billion in loans and $9.9 billion in membership interest associated with the program. On January 4, 2010, Treasury and one of the nine fund managers, TCW Senior Management Securities Fund, L.P., entered into a ''Winding-Up and Liquidation Agreement.'' U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending May 26, 2010* (May 28, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-28-10%20Transactions%20Report%20as%20of%205-26-10.pdf).

[xv] Of the $50 billion in announced TARP funding for this program, $39.8 billion has been allocated as of May 26, 2010. However, as of February 2010, only $187.8 million in non-GSE payments have been disbursed under HAMP. Disbursement information provided by Treasury in response to the Panel's inquiry. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending May 26, 2010* (May 28, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-28-10%20Transactions%20Report%20as%20of%205-26-10.pdf).

[xvi] A substantial portion of the total $81.3 billion in loans extended under the AIFP have since been converted to common equity and preferred shares in restructured companies. $8.1 billion has been retained as first lien debt (with $1 billion committed to old GM, and $7.1 billion to Chrysler). This figure ($67.1 billion) represents Treasury's current obligation under the AIFP after repayments.

[xvii] U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending May 26, 2010* (May 28, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-28-10%20Transactions%20Report%20as%20of%205-26-10.pdf).

[xviii] U.S. Department of Treasury, *Fact Sheet: Unlocking Credit for Small Businesses* (Apr. 26, 2010) (online at www.financialstability.gov/roadtostability/unlockingCreditforSmallBusinesses.html) (*''Jumpstart Credit Markets For Small Businesses By Purchasing Up to $15 Billion in Securities''*).

[xix] This information was provided by Treasury in response to the Panel's inquiry.

[xx] This figure represents the current maximum aggregate debt guarantees that could be made under the program, which is a function of the number and size of individual financial institutions. $305.4 billion of debt subject to the guarantee is currently outstanding, which represents approximately 53.7 percent of the current cap. Federal Deposit Insurance Corporation, *Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program: Debt Issuance Under Guarantee Program* (Apr. 30, 2010) (online at www.fdic.gov/regulations/resources/TLGP/total__issuance04-10.html). The FDIC has collected $10.4 billion in fees and surcharges from this program since its inception in the fourth quarter of 2008. Federal Deposit Insurance Corporation, *Monthly Reports Related to the Temporary Liquidity Guarantee Program* (Apr. 30, 2010) (online at www.fdic.gov/regulations/resources/tlgp/fees.html).

[xxi] This figure represents the FDIC's provision for losses to its deposit insurance fund attributable to bank failures in the third and fourth quarters of 2008, and the first, second, and third quarters of 2009. Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Fourth Quarter 2008)* (online at www.fdic.gov/about/strategic/corporate/cfo__report__4qtr__08/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Third Quarter 2008)* (online at www.fdic.gov/about/strategic/corporate/cfo__report__3rdqtr__08/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (First Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo__report__1stqtr__09/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Second Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo__report__2ndqtr__09/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Third Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo__report__3rdqtr__09/income.html). This figure includes the FDIC's estimates of its future losses under loss-sharing agreements that it has entered into with banks acquiring assets of insolvent banks during these five quarters. Under a loss-sharing agreement, as a condition of an acquiring bank's agreement to purchase the assets of an insolvent bank, the FDIC typically agrees to cover 80 percent of an acquiring bank's future losses on an initial portion of these assets and 95 percent of losses of another portion of assets. *See, e.g.,* Federal Deposit Insurance Corporation, *Purchase and Assumption Agreement Among FDIC, Receiver of Guaranty Bank, Austin, Texas, FDIC and Compass Bank, at 65–66* (Aug. 21, 2009) (online at www.fdic.gov/bank/individual/failed/guaranty-tx__p__and__a__w__addendum.pdf). In information provided to Panel staff, the FDIC disclosed that there were approximately $132 billion in assets covered under loss-sharing agreements as of December 18, 2009. Furthermore, the FDIC estimates the total cost of a payout under these agreements to be $59.3 billion. Since there is a published loss estimate for these agreements, the Panel continues to reflect them as outlays rather than as guarantees.

[xxii] Outlays are comprised of the Federal Reserve Mortgage Related Facilities and the preferred equity holdings in AIA Aurora LLC and ALICO Holdings LLC. The Federal Reserve's balance sheet accounts for these facilities under Federal agency debt securities, mortgage-backed securities held by the Federal Reserve, and the preferred interests in AIA Aurora LLC and ALICO Holdings LLC. Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H41) (accessed June 2, 2010). Although the Federal Reserve does not employ the outlays, loans, and guarantees classification, its accounting clearly separates its mortgage-related purchasing programs from its liquidity programs. *See* Board of Governors of the Federal Reserve, *Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet,* at 2 (Nov. 2009) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200911.pdf).

On September 7, 2008, Treasury announced the GSE Mortgage Backed Securities Purchase Program (Treasury MBS Purchase Program). The Housing and Economic Recovery Act of 2008 provided Treasury with the authority to purchase Government Sponsored Enterprise (GSE) MBS. Under this program, Treasury purchased approximately $214.4 billion in GSE MBS before the program ended on December 31, 2009. As of May 2010, there was $174.5 billion outstanding under this program. U.S. Department of the Treasury, *MBS Purchase Program: Portfolio by Month* (online at www.financialstability.gov/docs/May%202010%20Portfolio%20by%20month.pdf) (accessed June 2, 2010). Treasury has received $45.9 billion in principal repayments and $11.1 billion in interest payments from these securities. U.S. Department of the Treasury, *MBS Purchase Program Principal and Interest* (online at www.financialstability.gov/docs/May%202010%20MBS%20Principal%20and%20Interest%20Monthly%20Breakout.pdf) (accessed June 2, 2010).

[xxiii] Federal Reserve Liquidity Facilities classified in this table as loans include: Primary credit, Secondary credit, Central bank liquidity swaps, Primary dealer and other broker-dealer credit, Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, Net portfolio holdings of Commercial Paper Funding Facility LLC, Seasonal credit, Term auction credit, Term Asset-Backed Securities Loan Facility, and loans outstanding to Bear Stearns (Maiden Lane I LLC). Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H41) (accessed June 2, 2010).

SECTION FIVE: OVERSIGHT ACTIVITIES

The Congressional Oversight Panel was established as part of the Emergency Economic Stabilization Act of 2008 (EESA) and formed on November 26, 2008. Since then, the Panel has produced eighteen oversight reports, as well as a special report on regulatory reform, issued on January 29, 2009, and a special report on farm credit, issued on July 21, 2009. Since the release of the Panel's May oversight report, which assessed the credit crunch facing the nation's small businesses and Treasury's ongoing efforts to spur lending to that sector of the economy, the following developments pertaining to the Panel's oversight of the TARP took place:

- The Panel held a hearing in Washington, DC on May 26, 2010, to discuss the financial assistance provided to AIG under the TARP and other financial stability programs. The Panel heard testimony from both current and former AIG executives, policymakers and regulators in charge at the time of the government's initial rescue of the company, the official from Treasury in charge of monitoring the company's current government-held assets, as well as other analysts with insight regarding the company's current financial health. A video recording of the hearing, the written testimony from the hearing witnesses, and Panel Members' opening statements all can be found online at cop.senate.gov/hearings.

Upcoming Reports and Hearings

The Panel will release its next oversight report in July 2010. The report will focus on financial assistance provided to small- and medium-sized banks under the CPP, discussing, among other things, a full accounting of the investments made in small banks under the program, the restrictions on and expectations of banks that have received financial assistance, and Treasury's plan for managing and ultimately divesting its portfolio of investments in these banks.

The Panel is planning a hearing in Washington on June 22, 2010, with Treasury Secretary Timothy Geithner. The Panel will seek to get a general update from the Secretary on the current status and future direction of TARP. This will be Secretary Geithner's fourth appearance before the Panel.

SECTION SIX: ABOUT THE CONGRESSIONAL OVERSIGHT PANEL

In response to the escalating financial crisis, on October 3, 2008, Congress provided Treasury with the authority to spend $700 billion to stabilize the U.S. economy, preserve home ownership, and promote economic growth. Congress created the Office of Financial Stability (OFS) within Treasury to implement the TARP. At the same time, Congress created the Congressional Oversight Panel to "review the current state of financial markets and the regulatory system." The Panel is empowered to hold hearings, review official data, and write reports on actions taken by Treasury and financial institutions and their effect on the economy. Through regular reports, the Panel must oversee Treasury's actions, assess the impact of spending to stabilize the economy, evaluate market transparency, ensure effective foreclosure mitigation efforts, and guarantee that Treasury's actions are in the best interests of the American people. In addition, Congress instructed the Panel to produce a special report on regulatory reform that analyzes "the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers." The Panel issued this report in January 2009. Congress subsequently expanded the Panel's mandate by directing it to produce a special report on the availability of credit in the agricultural sector. The report was issued on July 21, 2009.

On November 14, 2008, Senate Majority Leader Harry Reid and the Speaker of the House Nancy Pelosi appointed Richard H. Neiman, Superintendent of Banks for the State of New York, Damon Silvers, Director of Policy and Special Counsel of the American Federation of Labor and Congress of Industrial Organizations (AFL–CIO), and Elizabeth Warren, Leo Gottlieb Professor of Law at Harvard Law School, to the Panel. With the appointment on November 19, 2008, of Congressman Jeb Hensarling to the Panel by House Minority Leader John Boehner, the Panel had a quorum and met for the first time on November 26, 2008, electing Professor Warren as its chair. On December 16, 2008, Senate Minority Leader Mitch McConnell named Senator John E. Sununu to the Panel. Effective August 10, 2009, Senator Sununu resigned from the Panel, and on August 20, 2009, Senator McConnell announced the appointment of Paul Atkins, former Commissioner of the U.S. Securities and Exchange Commission, to fill the vacant seat. Effective December 9, 2009, Congressman Jeb Hensarling resigned from the Panel and House Minority Leader John Boehner announced the appointment of J. Mark McWatters to fill the vacant seat. Senate Minority Leader Mitch McConnell appointed Kenneth Troske, Sturgill Professor of Economics at the University of Kentucky, to fill the vacancy created by the resignation of Paul Atkins on May 21, 2010.

Acknowledgements

The Panel wishes to thank the numerous insurance specialists, analysts, academics, auditors, investors, and other experts for their insight and assistance. The Panel also thanks Professor Susan Koniak for her assistance in reading the report.

APPENDIX I: LETTER TO CHAIR ELIZABETH WARREN FROM ASSISTANT SECRETARY HERB ALLISON, RE: GM LOAN REPAYMENT, DATED MAY 18, 2010

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

May 18, 2010

Professor Elizabeth Warren
Chair, Congressional Oversight Panel
732 North Capitol Street, NW
Room C-320 and C-617
Mailstop: COP
Washington, DC 20401

Dear Chair Warren:

On behalf of Secretary Geithner, I am writing to respond to your recent letter regarding General Motors' April 20 repayment of $4.7 billion of TARP debt. GM made the repayment with cash from an escrow account that it owns. As you may know, I have described GM's loan repayment and the nature of the escrow account in two recent, detailed letters to Members of Congress. I have enclosed copies of the two letters for your convenience.

Treasury approved GM's loan repayment because it was consistent with the core principles that the Obama Administration announced publicly on May 31, 2009 and that guide Treasury's management of its ownership interests in private corporations—specifically, recovering funds for the American taxpayer and exiting TARP investments as soon as practicable. Treasury has never suggested that GM's loan repayment represents a return of *all* government assistance. In fact, the opposite is true. Treasury issued a press release on the day of the loan repayment that specifically states: "After this repayment, the remaining Treasury stake in GM consists of $2.1 billion in preferred stock and 60.8 percent of the common equity."

Treasury's full and accurate description of the loan repayment is consistent with its practice of communicating openly with the American people. Treasury has disclosed the details of its assistance to GM in numerous public reports and filings; its officials have testified repeatedly before Congress about the restructuring; and it has posted a huge volume of information and data on its TARP website (available at www.financialstability.gov). This Administration strongly supports transparency, and Treasury has disclosed publicly all of its efforts to assist GM, including the nature of GM's recent loan repayment.

As a general matter, Treasury does not intervene in the day-to-day management of GM or any other company in which it holds equity. The Obama Administration's core principles cited above provide that the government will act in a "hands-off, commercial manner." Further, Secretary Geithner previously wrote to you that Treasury is a "reluctant shareholder," and that "taxpayer interests will be best protected by minimizing the extent of government involvement."

Although GM does provide information to Treasury on a variety of matters, Treasury does not express a view in the overwhelming majority of circumstances. In this case, GM provided Treasury staff members with certain materials prior to the loan repayment, including a description of GM's planned public relations campaign. Given its "hands-off" approach, Treasury did not ask GM to make any changes to the materials. Again, Treasury's own public statements and reporting on www.financialstability.gov provided full information about the loan repayment and the government's remaining investment in GM.

Finally, you cited Secretary Geithner's recent testimony before the Senate Subcommittee on Financial Services and General Government. As the Secretary testified, he has not seen GM's television advertisement or any of the related materials provided by GM. Nonetheless, he noted that various Treasury officials have expressed some concern about GM's public statements. The reason is simple. Although GM's public statements were accurate—the company did fully repay its existing "government loan"—it would have been more informative to note the government's continuing equity interest in GM, as Treasury did in its press release.

Thank you for your letter. We appreciate your attention to these important matters.

Sincerely,

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

Enclosures

APPENDIX II: LETTER TO SENATOR CHARLES GRASSLEY FROM SECRETARY TIMOTHY GEITHNER, RE: GM LOAN REPAYMENT, DATED APRIL 27, 2010

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

April 27, 2010

The Honorable Charles E. Grassley
United States Senate
Washington, DC 20510

Dear Senator Grassley:

Thank you for your letter dated April 22, 2010 to the Secretary regarding General Motors' (GM) repayment of its loan from the Department of the Treasury. He asked me to respond on his behalf.

Your letter states that the repayment of the loan was made with funds from "an escrow account at Treasury" and that it constituted a "debt-for-equity" swap. These statements are not accurate.

On April 20, GM repaid the Treasury loan with cash in an escrow account that it owns. The escrow account was created last summer in connection with the restructuring of GM. The money used to fund the escrow account came from a portion of the proceeds of a loan made by both the Treasury and the Canadian government. The escrowed funds were expected to be used for extraordinary expenses, and a portion of the funds were so used. Treasury retained approval rights over GM's use of funds from the escrow account in order to protect the taxpayer, but the cash was still the property of GM.

In making its April 20 loan repayment, GM determined that it did not need to retain the escrowed funds for expenses. The fact that GM made that determination and repaid the remaining $4.7 billion to the U.S. government now is good news for the company, our investment, and the American people. Consistent with Treasury's goal of recovering funds for the taxpayer and exiting TARP investments as soon as practicable, we approved GM's loan repayment.

It has long been public knowledge that GM would use these specific funds to repay the Treasury and Canadian loans, if it did not otherwise need them for expenses. Under GM's loan agreement with Treasury, any funds in the escrow account on June 30, 2010 had to be used to repay the Treasury and Canadian loans. We have highlighted the repayment requirement in our monthly Section 105(a) reports to Congress. During a meeting last fall, we also informed the staff of the Special Inspector General of TARP (SIGTARP), Neil Barofsky, that we expected GM to use these funds to repay these loans. In fact, according to the SIGTARP Report on the Use of Funds (released on December 10, 2009), "GM officials stated that it intends to seek release of additional escrow funds to repay its outstanding $6.7 billion loan to Treasury and $1.3 billion loan to the Canadian Government."

After the full repayment of the Treasury loan, approximately $6.6 billion remained in GM's escrow account. These funds became unrestricted on April 20 and available for GM's general use.

In addition, it is not correct that the timing of the repayment was motivated by concurrent Senate hearings. In fact, GM's Board of Directors approved the loan repayment at its monthly meeting on April 13, 2010.

As is widely known, Treasury continues to hold $2.1 billion in preferred stock and 60.8% of the GM's common equity that it received in the restructuring in July 2009. Treasury will begin selling equity once GM makes an initial public offering.

Thank you again for your attention to this important matter.

Sincerely,

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

APPENDIX III: LETTER TO REPRESENTATIVES PAUL RYAN, JEB HENSARLING, AND SCOTT GARRETT FROM SECRETARY TIMOTHY GEITHNER, RE: GM LOAN REPAYMENT, DATED APRIL 30, 2010

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

April 30, 2010

The Honorable Paul Ryan
U.S. House of Representatives
Washington, DC 20515

The Honorable Jeb Hensarling
U.S. House of Representatives
Washington, DC 20515

The Honorable Scott Garrett
United States House of Representatives
Washington, DC 20515

Dear Representatives Ryan, Hensarling, and Garrett:

Thank you for your letter dated April 28, 2010, to Secretary Geithner regarding General Motors' (GM) repayment of its loan from the Department of the Treasury. He asked me to respond on his behalf.

As you may know, I responded to similar questions about GM's loan payment in a letter to Senator Grassley dated April 28. GM repaid the balance of its $6.7 billion loan with cash from an escrow account that it owns. As we have widely reported, after this repayment, the Treasury's stake in GM consists of $2.1 billion of preferred stock and 60.8% of GM's common equity.

GM's escrow account was created last summer in connection with its restructuring. The money used to fund the escrow account came from a portion of the proceeds of a loan made by both the Treasury and the Canadian government during the bankruptcy.

The escrowed funds were expected to be used for extraordinary expenses, and a portion of the funds were so used. In making its April 20 loan repayment, GM determined that it did not need to retain the escrowed funds for those expenses The fact that GM made that determination and repaid the remaining $4.7 billion to the U.S. government now is good news for the company, our investment, and the American people.

These specific details of Treasury's assistance to GM have been disclosed in at least ten different public documents beginning in July 2009; Treasury officials have testified before Congress about the restructuring numerous times; and there have been countless press reports about the issue. More specifically, Treasury has highlighted the repayment requirement in monthly reports to Congress, which are publically available on Treasury's website.

During a meeting last fall, we also informed the staff of the Special Inspector General of TARP (SIGTARP), Neil Barofsky, that we expected GM to use these funds to repay these loans. In fact, according to the SIGTARP Report on the Use of Funds (released on December 10, 2009), "GM officials stated that it intends to seek release of additional escrow funds to repay its outstanding $6.7 billion loan to Treasury and $1.3 billion loan to the Canadian Government."

Treasury has never suggested that the loan repayment represented a full return of all government assistance. In fact, the press release announcing the loan repayment, which is attached to this letter, ends with the following sentence: "After this repayment, the remaining Treasury stake in GM consists of $2.1 billion in preferred stock and 60.8 percent of the common equity." This Administration strongly supports transparency, and Treasury has fully and accurately disclosed its efforts to assist GM, including the nature of GM's recent loan repayment.

Your letter also asks about the value of Treasury's remaining investment in GM. No official market valuation exists, given that GM's preferred and common stock are not publicly held or traded yet. However, Treasury's audited financial statements provided a value by program as of September 30, 2009. In this case, the GM investment was grouped with the GMAC and Chrysler investments. The estimated value of all these investments was $42.3 billion, which represents a loss of $31.5 billion. This was updated to a loss of $28 billion in an April 2010 letter to Congressional leaders (publicly available on www.financialstability.gov). Treasury will publish in May an update to the valuation of Treasury's auto investments, which will take into account the repayment. Treasury will begin selling its equity interest once GM makes an initial public offering.

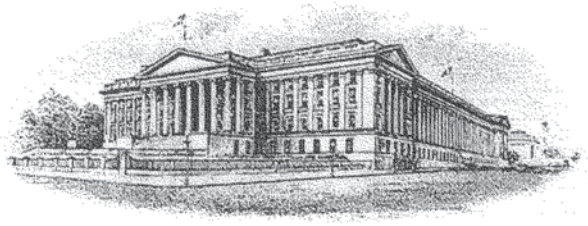
Finally, your letter states that "there is little publically-available information on the current financial health of GM." This is not accurate. Despite being a private company, GM voluntarily files periodic, publically-available reports with the Securities and Exchange Commission.

Thank you again for your attention to this important matter.

Sincerely,

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

Enclosures



U.S. TREASURY DEPARTMENT
OFFICE OF PUBLIC AFFAIRS

FOR IMMEDIATE RELEASE: April 21, 2010
CONTACT: Treasury Public Affairs (202) 622-2960

GM REPAYS TREASURY LOAN IN FULL, TARP REPAYMENTS REACH $186 BILLION

GM Repayment of Remaining $4.7 Billion in Debt Comes Five Years Ahead of Maturity Date

WASHINGTON – The U.S. Department of the Treasury today announced that General Motors (GM) has fully repaid its debt under the Troubled Asset Relief Program (TARP). GM paid the remaining $4.7 billion of the total $6.7 billion in debt owed to Treasury. The repayment comes five years ahead of the loan maturity date and ahead of the accelerated repayment schedule the company announced last year.

Total TARP repayments now stand at $186 billion – well ahead of last fall's repayment projections for 2010. With this repayment, less than $200 billion in TARP disbursements remain outstanding.

"We are encouraged that GM has repaid its debt well ahead of schedule and confident that the company is on a strong path to viability," said Treasury Secretary Tim Geithner. "This continued progress is a positive sign for our auto investment – not only more funds recovered for the taxpayer but also countless jobs saved and the successful stabilization of a vital industry for our country."

After this repayment, the remaining Treasury stake in GM consists of $2.1 billion in preferred stock and 60.8 percent of the common equity.

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