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Joint Written Testimony of Thomas C. Baxter and Sarah Dahlgren Before the Congressional Oversight Panel

Thomas C. Baxter Jr.

Sarah J. Dahlgren

Joint Written Testimony of

Thomas C. Baxter,

Executive Vice President and General Counsel, and

Sarah Dahlgren,

Executive Vice President, Special Investments Management,

Federal Reserve Bank of New York

before the

Congressional Oversight Panel

regarding

The Federal Reserve Bank of New York's Involvement with AIG

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Chair Warren and Members of the Panel, thank you for giving us the opportunity to testify here today regarding the Federal Reserve Bank of New York's ("New York Fed") involvement with AIG.

I. The Decision to Lend to AIG

On the morning of September 16, 2008, it became clear to Federal Reserve and Treasury policymakers that AIG, then one of the world's largest insurance and financial firms, was facing a potentially fatal liquidity crisis. AIG's crisis was coming amidst the collapse of the housing market, within weeks of the receiverships of Fannie Mae and Freddie Mac, and within 24 hours of the bankruptcy of Lehman Brothers. Confidence in the financial system was exceptionally fragile, and financial firms were taking dramatic and unusual measures to protect their balance sheets. Money market funds, long viewed as a safe investment by millions of Americans, were experiencing massive withdrawals. The run on these funds, in turn, severely disrupted the commercial paper market, a vital source of funding for American businesses. Securitization markets started to seize up, especially those that relied upon instruments backed by consumer loans. Banks sharply curtailed their lending. A full fledged panic had started and was spreading rapidly; the financial system was facing the threat of collapse.

In light of the circumstances at the time, a bankruptcy filing by AIG would have had disastrous consequences. Federal Reserve Chairman Bernanke has stated that it could well have "resulted in a 1930's-style global financial and economic meltdown, with catastrophic implications for production, income, and jobs." Because of the decisions made that morning, we can never really know.

Let us be clear, though, about the risks that the policymakers did know. Policymakers knew that AIG's largest creditors were other financial firms and that those firms clearly would have been directly impacted by an AIG bankruptcy filing. But the gravest risks were not the direct exposure of other financial firms to AIG. The gravest risks related to the indirect consequences of a bankruptcy of AIG, indirect consequences that would impact millions of Americans.

AIG's role as one of the world's largest and storied insurance companies meant that its failure likely would have had a contagion effect, causing damage as it spread throughout the insurance industry. Policy holders would be hurt. Municipalities, who were already reeling from a lack of financing options for their building projects, would have seen their financial protection disappear. 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 see that insurance disappear. Pension plans that had placed funds in AIG guaranteed investment contracts, or GICs, which function much like deposits in a bank, would have experienced significant losses, losses that would be passed along to retirees or to others whose aspirations to be retirees would surely have been changed.

And these indirect consequences of an AIG bankruptcy would not have stopped at the U.S. border. AIG was global in scope. It conducted its operations in more than 130 countries, and across various parts of the financial industry, insurance as well as banking. The damage from an AIG filing would have been felt from the farms of Iowa to the streets of San Francisco to the far off corners of the world. The unplanned and chaotic bankruptcy of this trillion dollar financial conglomerate (especially a day after Lehman's filing) would have been a global catastrophe.

That catastrophe did not happen.

More than a year and a half later, it is easy to forget the level of panic and fear that gripped the world during the week of September 16, 2008. A bankruptcy of AIG would have fueled the fear, much as gasoline fuels a fire. And let us not forget what Federal Reserve and Treasury officials have said many times in testimony –we did not have the necessary tools, such as legal authority for a special resolution regime, with which to limit the damage of an AIG collapse.

We also did not have the luxury of time. AIG needed liquidity and it needed it that day. In 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. It is worth noting that this choice fell to the Federal Reserve because Congress had equipped it with an ability to lend to a non bank like AIG in extraordinary and exigent circumstances. Given AIG's situation on September 16, 2008, and given what had transpired over the preceding days and months, how could we responsibly not have lent pursuant to our statutory authority?

With authorization from the Board of Governors under Section 13(3) of the Federal Reserve Act, the Federal Reserve Bank of New York had the ability to provide liquidity to AIG by making a fully secured loan. The decision to activate the authority and lend was clearly justified on the merits but was difficult because of the collateral consequence, the moral hazard resulting from AIG's rescue. Within hours of the policy determination, the Federal Reserve took over the term sheet originally created by a private sector consortium of commercial banks. In the aftermath of Lehman's bankruptcy, the consortium was no longer prepared to lend to AIG. On the evening of September 16th, we advanced \$14 billion in credit to AIG through a fully collateralized lending, and announced the term sheet for what would become an \$85 billion revolving credit facility with AIG ("Fed Facility").[1]

Some have asked why the Federal Reserve did not see the threat that AIG posed to the financial system before September 16th. The short answer is that AIG had hundreds of regulators, none of which was the Federal Reserve. The Federal Reserve had no regulatory authority over the firm--no authority over its capital, no authority over its liquidity, and no oversight over its control functions. The Federal Reserve was not engaged in supervision of AIG. It did not have the legal authority to do so. These roles and responsibilities remained with state insurance regulators, and with the comprehensive consolidated supervisor, the Office of Thrift Supervision. Throughout the weekend of September 13th and 14th we were assured by those regulators that a private sector consortium of commercial banks had a solution to AIG's liquidity problems, and we had no basis to question those assurances. But then Lehman filed for bankruptcy protection and the private sector consortium unequivocally stated that they were no longer prepared to lend to AIG.

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[1] The Fed Facility was (and remains) secured by a pledge of a substantial portion of AIG's assets, including ownership interests in the company's domestic and foreign insurance subsidiaries. As additional compensation for the Fed Facility, AIG agreed to issue to a trust for the benefit of the Treasury, preferred stock convertible into 79 percent of AIG's outstanding common stock.

The AIG situation is both different and similar to that of Long-Term Capital Management ("LTCM"), a hedge fund that nearly collapsed in the fall of 1998. In the LTCM situation, the Federal Reserve called together a private sector consortium made up of LTCM's major counterparties, who agreed to rescue LTCM by investing about $3.6 billion in new equity, in return for a 90 percent equity stake in LTCM's portfolio along with operational control. The counterparties made this decision after the Federal Reserve encouraged them to recognize their self-interest in saving LTCM. The consortium invested in LTCM because its members came to believe that the Federal Reserve staff was right. Several years later, when the investors received back all of their capital with interest, they came to see that the Federal Reserve was right. The market conditions in September 2008 presented a very different situation to AIG's counterparties who, in the aftermath of Lehman's failure, found themselves facing liquidity concerns that compelled them to maintain cash on their balance sheets rather than lend to AIG. Moreover, the unprecedented size of AIG's liquidity need – ultimately more than $150 billion – could not have been met by the private sector. There is, however, one very important similarity. We believe that we will receive full payment of principal and interest from AIG, much like the consortium did in LTCM.

Still others have wondered why Lehman went bankrupt, while the Federal Reserve extended credit to AIG that prevented its default. The answer is that AIG presented a very different case. AIG had enough high-quality collateral to permit the Federal Reserve to extend a secured loan to provide liquidity to the firm. On September 16th, our focus was on providing liquidity so that AIG could meet its obligations and avoid default. To be clear, we were <u>not</u> making an investment in AIG; we were making a fully secured loan. We were not assuming management responsibility for the company; we were a lender to the company. The recently released Volukas Report shows in a thorough, exhaustive manner that an effective solution to Lehman required a strong merger partner that could provide much needed capital to ensure a going concern. While Federal Reserve and Treasury officials tried very hard to find that merger partner for Lehman, in the end we did not succeed as we had succeeded in March of 2008, when we brought in JPMorgan Chase to acquire Bear Stearns.

As a liquidity provider, we did not consider conditioning our lending to AIG on a requirement that the company obtain concessions from some of its major creditors. Conditioning our lending on AIG coercing certain creditors to agree to reduce the amounts due and owing from AIG would have been to ensure failure. The tactic would have undercut our primary goal in providing AIG with necessary liquidity -- enabling AIG to pay creditors, maintain consumer, regulator, and counterparty confidence, and avoid default. A default would have triggered AIG's bankruptcy, with all of the systemic risk that bankruptcy would have entailed. While these 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.

Any 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. Would the conditions extend only to AIG's Credit Default Swap ("CDS") counterparties, or might the Federal government make value judgments as to other AIG contracts? Would senior unsecured debt holders be forced to take concessions? And most importantly, would a creditor who was pressed for a discount simply refuse and declare a default? Conditional lending would have heightened the risk of an AIG default, which is what we were trying to – and did – avoid.

The default risk would have been exacerbated by the credit rating downgrade that almost certainly would have followed any effort by AIG to coerce creditor concessions. AIG's failure to pay all of its contractual obligations in full would likely constitute a selective default resulting in a downgrade. That downgrade not only would have triggered potential terminations and collateral calls at AIG's Financial Products unit ("AIG FP"), but also would have resulted in substantial value destruction at AIG's insurance companies. Large annuity distributors likely would have stopped selling AIG products, replacing them with better-rated, more stable competitors. High-end life insurance sales would have decreased significantly, and remaining sales would have been vulnerable to adverse selection. Withdrawals and surrenders among existing customers would have increased, depleting cash reserves and creating pressure for asset sales at depressed levels. As a result of a downgrade, many of AIG's insurance companies may have been unable to write new business, and state and foreign insurance regulators may have begun seizing AIG insurance company assets in their respective jurisdictions. Conditional lending would not have allowed AIG to remain a going concern, but rather would have pushed it into bankruptcy.

II. Continuing Pressures on AIG

By the end of September 2008, AIG had drawn $61 billion from the Fed Facility. While successful in providing AIG with the liquidity it needed to avoid default and bankruptcy in the short term, over the longer term AIG's borrowings from the Fed Facility were perceived by some to be potentially unsustainable. The company continued to experience pressing liquidity needs that necessitated rapid draws on the Fed Facility and concerns that AIG's needs might well exceed the facility's capacity. Even greater concerns arose out of the continued downgrade risk. The probability of a ratings downgrade was considered high unless the Federal Reserve took further action because the aggregate size of AIG's draws on the Fed Facility was greater than rating agency expectations -- the rating agencies felt that AIG had too much debt-- and AIG's expected third quarter losses, which were to be announced on November 10, 2008, far exceeded analyst estimates.

As discussed in Vice Chairman Kohn's testimony of March 5, 2009, in early October 2008, the Board of Governors approved an additional credit facility (the "Securities Borrowing Facility") that permitted the New York Fed to lend to certain AIG domestic insurance subsidiaries up to $37.8 billion in order to allow them to return the cash collateral they received from their securities borrowing counterparties. Additionally, toward the end of October, four AIG affiliates began participating in the Federal Reserve's Commercial Paper Funding Facility (CPFF) on the same terms and conditions as other participants. The CPFF is a generally available program that involves the purchase, through a special purpose vehicle with financing from the Federal Reserve, of three-month unsecured and asset-backed commercial paper directly from eligible issuers.

Notwithstanding AIG's access to these additional Federal Reserve credit facilities, AIG remained extremely vulnerable to the ongoing and intensifying financial crisis. Falling asset values generated both substantial losses on its balance sheet and increases in required payments to AIG's counterparties under the terms of its credit protection contracts. The liquidity crisis was not driven solely by AIG's need to meet collateral calls on its CDS; AIG also faced severe liquidity pressures arising out of its losses on residential mortgage backed securities ("RMBS") in which its domestic life insurance companies had invested as part of its securities lending program. These factors undermined market confidence in AIG and again put its investment-grade credit rating at risk.

To address AIG's untenable debt burden, the Federal Reserve decided to reduce AIG's debt by transferring RMBS and CDO exposures from AIG's balance sheet to the balance sheets of the two Federal Reserve Limited Liability Companies ("LLCs"), Maiden Lane II and Maiden Lane III. The LLCs acquired these assets by paying to AIG the cash proceeds of certain loans and capital contributions made to the LLCs by the Federal Reserve and AIG respectively. On November 10, 2008, the Federal Reserve Board and the Treasury announced this restructuring of the government's financial support to establish a more durable capital structure, resolve liquidity issues, facilitate AIG's execution of its plan to sell certain of its businesses in an orderly manner, promote market stability, and protect the interests of the U.S. government and taxpayers. The details of this restructuring have already been the focus of an examination by the Treasury Special Inspector General for the Troubled Asset Relief Program. They have also been the focus of testimony before a number of committees in Congress, including Secretary Geithner and Thomas Baxter's January 27, 2010 testimony before the House Oversight and Government Reform Committees. A summary of the salient facts, however, follows.

As part of the November 2008 restructuring, Treasury invested $40 billion in newly issued Senior Preferred Stock of AIG under its TARP authority.[2] In connection with that investment, the Federal Reserve modified the terms of the Fed Facility to be more sustainable: The maturity of the Fed Facility was extended to five years (due 2013), the maximum amount available was reduced from $85 billion to $60 billion, and the interest rate and commitment fees were reduced. The Fed Facility remained secured by substantially all of AIG's assets, and the company continued to be required to apply proceeds of asset sales to permanently repay any outstanding balances under the facility.

At the same time, the Board approved the establishment of an additional lending facility that would provide a permanent solution to the AIG securities lending program's losses and liquidity drains, thus eliminating the need for the Securities Borrowing Facility. Under the new facility, the New York Fed extended approximately $19.5 billion in secured, non-recourse credit to a special purpose limited liability company, Maiden Lane II, in which AIG would hold a $1 billion first-loss position. Maiden Lane II then purchased, at market prices, RMBS with a par value of $39.3 billion from certain AIG domestic insurance company subsidiaries. This facility allowed AIG to terminate its domestic securities lending program and to repay fully all outstanding amounts under the Securities Borrowing Facility, which was then terminated.

The Federal Reserve also took steps to help address the drain of liquidity on AIG arising from potential collateral calls associated with credit default swap contracts written by AIG FP on multi-sector CDOs. The New York Fed made a secured, non-recourse loan in the amount of $24.3 billion to another special purpose limited liability company, Maiden Lane III. Maiden

[2] In April 2009, Treasury restructured this investment and provided an additional preferred stock facility of $29.8 billion, of which only $7.5 billion has been drawn.

Lane III then purchased, at market prices, multi-sector collateralized debt obligations with a par value of approximately $62 billion from credit default swap counterparties of AIG FP in return for the agreement of the counterparties to terminate the credit default swaps. AIG provided $5 billion in equity to Maiden Lane III to absorb any potential future losses on the CDOs held by Maiden Lane III. The Federal Reserve loans to Maiden Lane II and III have a term of six years and are secured by the entire portfolio of each LLC.

III. Ongoing Investment Management of the Maiden Lane II and Maiden Lane III Portfolios

The Panel has asked us to discuss the New York Fed's "strategy for divesting its AIG holdings." We must emphasize that the New York Fed did not ever decide to invest in AIG. We cannot make such an investment. Our role has always been that of lender, although we are a lender that re-structured our original Fed Facility to accommodate AIG's changing circumstances. The New York Fed is the managing member of Maiden Lane II and Maiden Lane III, and, as set forth above, has control rights over the RMBS and CDOs that were acquired by these LLCs. BlackRock Financial Management Inc., an investment manager, has been retained to serve as the New York Fed's agent in managing the RMBS and the CDOs. The management objective for both is maximization of long-term cash flows to pay the New York Fed's Senior Loans to the LLCs (subject to certain fees, costs, and reserves that are senior to the Senior Loans), and refraining from investment actions that would disturb general financial market conditions. Distribution of all cash flows realized by the Maiden Lane II and Maiden Lane III occurs on a monthly basis.

Cash proceeds from the assets may be invested solely in U.S. Treasury or agency securities that have a remaining maturity of one year or less, U.S. 2a-7 government money market funds, reverse repurchase agreements collateralized by U.S. Treasury and agency securities, and dollar denominated deposits. However, in the case of Maiden Lane III, a broader range of assets may be acquired as part of a portfolio liquidation of one or more CDOs held in the Maiden Lane III portfolio.

The Maiden Lane II and Maiden Lane III assets continue to generate substantial proceeds, which are distributed monthly to pay down the New York Fed's Senior Loans to the respective Maiden Lane LLCs. While the New York Fed may direct its investment manager to sell Maiden Lane II and Maiden Lane III assets into the market at any time, as a practical matter, the value maximizing strategy has been largely to hold the assets to maturity while collecting interest income, and principal repayments. Currently, the hold-to-maturity expected proceeds of each LLC's portfolio are greater than the LLC's debt to the New York Fed. As of May 20, 2010, the balance on the New York Fed's Senior Loan to Maiden Lane II was $14.9 billion (inclusive of accrued interest), while the total asset value was $15.8 billion. The balance on the New York Fed's Senior Loan to Maiden Lane III was $16.6 billion (inclusive of accrued interest), while the total asset value was $23.4 billion. In sum, the LLCs have repaid approximately $13.1 billion of the loans made to them by the Federal Reserve. Based on the current performance of both portfolios, as well as our analysis of forecasts provided by our investment advisor, it is anticipated that the proceeds from both portfolios will exceed the principal and interest due on the New York Fed's Senior Loans to both Maiden Lane II and Maiden Lane III.

We expect to recover our principal and interest on the loans to the LLCs, and on the Fed Facility. The funds necessary to repay the balance of the Fed Facility will ultimately come from the cash proceeds of the AIA and ALICO transactions, cash AIG generates as it monetizes the non-cash sales proceeds of the AIA and ALICO transactions, the divestiture of certain non-core assets, and profit derived from AIG's core operating businesses. That said, our goal was never to make money – it was to avoid the systemic consequences that would have resulted from an AIG default and bankruptcy and to foster financial stability.

IV. Conclusion

In all that the Federal Reserve has done, we have been motivated by two goals: to foster financial stability and to protect the U.S. taxpayer. Had we not acted to prevent an AIG failure, the financial crisis would have been substantially worse and even greater economic damage and suffering would have occurred. The decision to lend to AIG was a difficult one because addressing the systemic issues required us to provide liquidity to a non-banking company we did not supervise whose management had made poor business decisions. Still, our understanding of the consequences of an AIG failure left us no real choice.

Thank you again for giving us the opportunity to appear before you today. We look forward to answering your questions.