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Proposed steps to stabilize American International Group, Inc. (Memo)

Federal Reserve System: Board of Governors

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DATE: November 6, 2008

TO: Board of Governors

FROM: Staff [1]

SUBJECT: Proposed steps to stabilize American International Group, Inc.

ACTION REQUESTED AND SUMMARY: Staff proposes that the Board authorize the Federal Reserve Bank of New York ("FRBNY") to take several actions to prevent the imminent downgrade of the credit rating of American International Group, Inc. ("AIG"), help stabilize the company and its subsidiaries, mitigate the risks to the financial system that might otherwise occur from a downgrade of AIG, and protect the interests of the Federal Reserve, the Treasury Department ("Treasury") and taxpayers. These actions would be taken in conjunction with the purchase by the Treasury of $40 billion in newly issued Senior Preferred Stock from AIG under the Troubled Asset Relief Program established by the Emergency Economic Stabilization Act of 2008 ("EESA").[2]

The proposal is substantially as discussed with Board members in briefings over the past week. Specifically, it is proposed that the Board authorize FRBNY to take the following actions to complement Treasury's investment—

1. Restructure the current revolving credit facility authorized by the Board in September 2008 (the "September Facility") by (i) reducing

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[2] The current draft term sheet for Treasury's proposed $40 billion preferred stock investment is attached as Appendix A. This investment would be in addition to the preferred stock (which is convertible into 79.9 percent of AIG's common shares) that will be issued to a trust for Treasury's benefit as a result of the Federal Reserve's $85 billion loan to AIG.

its maximum amount to $60 billion from $85 billion, (ii) extending the maturity of the facility from two to five years, (iii) reducing the rate payable on drawn amounts from LIBOR plus 850 basis points to LIBOR plus 300 basis points, and (iv) reducing the fee payable on undrawn but available amounts from 850 basis points to 75 basis points;

2. Extend up to $22.5 billion in secured, non-recourse credit under section 13(3) to a new limited liability company ("Maiden Lane II") for the purpose of partially funding the acquisition by Maiden Lane II from AIG of approximately $23.5 billion (market value) in residential mortgage-backed securities ("RMBS") purchased by AIG with the cash collateral received through the securities lending operations of AIG's regulated insurance subsidiaries. This new facility would eliminate the need for the $37.8 billion securities borrowing facility authorized by the Board for AIG on October 6, 2008 (the "Securities Borrowing Facility") and this facility would be wound down and terminated; and

3. Extend up to $30 billion in secured, non-recourse credit under section 13(3) to a separate, newly formed limited liability company ("Maiden Lane III") for the purpose of partially funding the acquisition by Maiden Lane III from the current counterparties of AIG's Financial Products business unit ("AIGFP") of up to $35 billion (market value) in multi-sector collateralized debt obligations ("CDOs") currently protected by credit default swaps ("CDS") written by AIGFP.

It is anticipated that these actions, if approved, and Treasury's investment would be publicly announced before the U.S. markets open on Monday, November 10, 2008, contemporaneously with AIG's release of its earnings for the third quarter of 2008.

The loans to Maiden Lane II and III would remove from AIG's balance sheet certain assets and exposures that have caused substantial liquidity drains on the company and generated significant losses that have eroded AIG's capital base. These special purpose vehicles, like the similar

Maiden Lane structure used to facilitate the acquisition of Bear Stearns & Companies, Inc., likely would be consolidated on the balance sheet of FRBNY, and the assets so consolidated would be subject to certain mark-to-market volatility. Importantly, AIG would retain a first loss position in both Maiden Lane II and III, and the FRBNY would have a first lien on all of the assets of these entities to secure its senior loans to the entities. In addition, based on estimates prepared by BlackRock, which is serving as financial advisor to the Federal Reserve, it is expected that the assets of each entity will provide sufficient cash flows to repay FRBNY in full over time even under very stressed scenarios, because the intrinsic values of these assets are estimated by BlackRock to be greater than their current market values.

Because the extension of credit to Maiden Lane II would eliminate the need for the $37.8 Securities Borrowing Facility, the proposed actions described above would <u>reduce</u> the aggregate amount of Federal Reserve credit targeted to assist AIG from a current maximum of $122.8 billion to a maximum of $112.5 billion.[3]

BACKGROUND:

During the past few weeks, the major credit rating agencies (S&P, Moody's, Fitch and A.M. Best) have conducted a review of the credit ratings assigned to AIG's senior unsecured debt and insurance company

[3] Certain eligible subsidiaries of AIG also have sold highly rated commercial paper to the Commercial Paper Funding Facility ("CPFF") and this lending is expected to continue under the CPFF so long as the paper of the subsidiaries continues to meet the eligibility requirements of the facility. AIG has reported that the maximum aggregate amount of commercial paper that its subsidiaries may sell to the CPFF under the terms of the program is approximately $20.9 billion. AIG also has stated that the proceeds received through the sale of commercial paper to the CPFF will be used to refinance AIG's outstanding commercial paper as it matures, meet other working capital needs, and make voluntary prepayments on the September Facility.

subsidiaries.[4] During this review, the rating agencies expressed significant concerns with several aspects of AIG's capital structure, financial exposures and operations. In particular, the agencies have indicated that—

- The firm's current leverage is significantly higher than that generally considered acceptable by the agencies to maintain an A or better debt rating;[5]

- The size of the September Facility creates significant structural subordination of AIG's senior, unsecured debt;

- The current interest rates payable on the September Facility may be unsustainable by the company and significantly weaken the company's interest coverage ratio, which is a key metric used by the rating agencies;

- The company will have difficulty in obtaining sufficient value from its planned divestitures to repay the September Facility in full by September 2010 (the current maturity date of this facility) because of the ongoing strains in the financial markets and the recent declines in the share prices of other large insurance firms, who are the natural buyers for most of AIG's principal subsidiaries; and

- The company remains subject to further liquidity and capital depletion from the CDS exposures held by AIGFP and the potential for further write-downs on the portfolio of RMBS acquired with the proceeds of the securities lending program of AIG's regulated insurance subsidiaries.

In addition, AIG recently disclosed to the credit rating agencies the firm's earnings for the quarter ending September 30, 2008. AIG currently expects

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[4] Currently, AIG's senior debt is rated A- by S&P, A3 by Moody's, and A by Fitch. A.M Best has assigned AIG a financial strength rating of A.

[5] For property and casualty/life insurance firms, the rating agencies' guidelines generally permit an A rated firm to have an adjusted leverage ratio (excluding AOCI) of up to 30 to 40 percent (Moody's) or 25 to 35 percent (S&P). AIG's adjusted leverage ratios under Moody's and S&P's guidelines were 58 percent and 54 percent, respectively, as of September 30, 2008.

to announce on Monday, November 10, 2008, losses of approximately $23 billion for the third quarter, an amount that is significantly above analyst loss estimates for the company.

These and other factors likely would cause the credit rating agencies to downgrade the senior unsecured debt of AIG to BBB or below shortly after AIG's earnings announcement. A downgrade of AIG's senior unsecured debt would pose significant new liquidity problems for AIG and likely would adversely impact the ratings, value and operations of the company's principal insurance subsidiaries.[6] For example, it is estimated that a downgrade to BBB would require an additional $42 billion in liquidity to meet collateral calls and termination events on the exposures held by AIGFP alone. The liquidity pressures resulting from a downgrade could well lead to the insolvency and bankruptcy of AIG. Appendix B provides additional information concerning the potential consequences of an AIG bankruptcy on the financial markets. A bankruptcy by AIG also likely would significantly reduce the value of AIG's assets, including the stock of its regulated insurance subsidiaries, which currently serve as collateral for the September Facility.

DISCUSSION OF PROPOSED ACTIONS:

Staff proposes that the Board authorize several actions in conjunction with the Treasury to help (i) stabilize AIG and its subsidiaries, (ii) mitigate the risks to the financial system that might otherwise occur from such a downgrade, and (iii) protect the interests of the Federal Reserve, the Treasury and taxpayers. These actions would preserve the value of the

[6] The rating agencies have policies that typically limit the extent to which a subsidiary's rating may differ from the rating of its parent.

company's assets and subsidiaries and provide the company additional time to realize such value through the orderly sale of assets.

Importantly, S&P, Moody's and Fitch each have indicated that it will retain its current rating on AIG's senior unsecured debt, and A.M. Best will retain its current financial strength rating for AIG, if the complete package of proposals is authorized and executed. S&P and Moody's have indicated that they will keep AIG's ratings on a short-term "negative watch," and will be looking for the company to make progress in the short-term on asset sales and the wind down of AIGFP's general businesses, as well as in retaining insurance business at its regulated subsidiaries. Fitch has indicated that it will adopt a "stable outlook" for the company. Finally, A.M. Best has indicated that it will move AIG from its equivalent of "negative watch" to "negative outlook."

The proposed actions require approval under section 13(3) of the Federal Reserve Act, which generally requires the affirmative vote of at least five Board members. The Board may authorize a discount[7] to an individual, partnership or corporation under section 13(3) only if (i) the Board finds that "unusual and exigent circumstances" exist; (iii) the lending Reserve Bank obtains evidence that the borrower is unable to secure adequate credit accommodations from other banking institutions; and (iii) the notes are indorsed or otherwise secured to the satisfaction of the Reserve Bank.

[7] The Board has long held that a "discount" of a note under section 13(3) includes a broad range of transactions, including a simple advance to the counterparty on a note newly issued or made by the counterparty and a purchase of one or more third-party notes held by the counterparty. Moreover, even if the facilities provided to Maiden Lane II and III were characterized as an acquisition by FRBNY of the assets of these vehicles, the loans would still be a "discount" of notes of an individual, partnership or corporation permitted under section 13(3) because the assets of these limited liability companies will consist exclusively of third-party secured notes (RMBS and CDOs) that are eligible for discount under section 13(3).

As discussed in previous memoranda, the Board has substantial flexibility in assessing whether "unusual and exigent circumstances" exist. In authorizing the $85 billion September Facility, the Board found that the disorderly potential failure of AIG posed significant systemic consequences in light of fragile market conditions. As explained in Appendix B, the systemic consequences of an AIG bankruptcy have decreased somewhat since September, but still remain significant. Moreover, available evidence indicates that AIG remains unable to secure adequate credit accommodations from other banking institutions and that AIG and other entities, including the proposed Maiden Lane II and III special purpose vehicles, are unable to secure adequate credit accommodations from other banking institutions to finance the types of RMBS and multi-sector CDOs that are the subject of the proposed Maiden Lane facilities.

The proposed restructuring would improve the likelihood that the Federal Reserve will be fully secured and repaid on the September Facility. In addition, FRBNY's new advances to Maiden Lane II and III would be secured by the assets of these entities (which would exceed the amount of FRBNY's advances) and would be protected by a first loss position of AIG that is estimated to fully protect repayment of the FRBNY's senior note over time even under very stressed environments. For these reasons, the proposed Board actions are legally permissible under section 13(3) of the Federal Reserve Act.

A. Restructuring of the $85 Billion September Facility

Currently, all advances made under the September Facility, including accrued and unpaid interest and fees, must be repaid in full by AIG no later than September 22, 2010. In addition, advances under the facility bear interest at a rate equal to 3-month LIBOR plus 850 basis points, payable quarterly. AIG also is obligated to pay an ongoing commitment fee each quarter equal to 850 basis points of the average undrawn amount available under the September Facility during the preceding quarter. Interest and the initial and ongoing commitment fees generally are payable through an increase in the outstanding balance of the Credit Facility, with interest thereafter accruing on such balances at the rate of 3-month LIBOR plus 850 basis points. As of November 5, 2008, AIG had approximately $61 billion in advances and fees outstanding under the September Facility.

As noted above, Treasury proposes to acquire $40 billion in newly issued Senior Preferred Stock of AIG. In connection with Treasury's investment, the terms of the September Facility would be modified to—

- Extend the maturity of the loan to five years (i.e., until September 22, 2013);
- Reduce the maximum amount available under the facility from $85 billion to $60 billion upon the acquisition of the Senior Preferred Stock by Treasury;
- Reduce the interest rate payable on outstanding advances to 3-month LIBOR plus 300 basis points; and
- Reduce the ongoing commitment fee on undrawn amounts to 75 basis points.

These modifications will help address the leverage and interest coverage ratio concerns of the credit rating agencies and are more consistent with the stabilized condition and prospects of the company following completion of the proposed package of actions. In addition, these modifications, including in particular the term extension, should improve the likelihood that AIG will be able to repay advances under the facility by providing AIG additional time to execute its large and global divesture program, which is the primary source of funding for repayment of the facility.[8]

Importantly, other material terms of the September Facility would remain unchanged. For example, the facility would still be secured by AIG's pledge or commitment to pledge substantially all of its assets and the assets of its primary non-regulated subsidiaries, including all of AIG's ownership interest in its regulated U.S. subsidiaries and 66 percent of AIG's ownership interest in its regulated foreign subsidiaries.[9] In addition, AIG's obligations under the September Facility would continue to be guaranteed by each of the company's domestic, non-regulated subsidiaries that have more than $50 million in assets. Moreover, the amended Credit Agreement would continue to include provisions designed to ensure that the proceeds of any asset sales to be conducted by AIG are used to permanently repay any outstanding balances under the September Facility.[10]

B. Maiden Lane II Loan

Certain of AIG's regulated insurance subsidiaries conduct a securities lending program under which the subsidiaries lend out investment grade securities in exchange for cash collateral. AIG used the cash collateral obtained through these securities lending transactions to purchase approximately $48.9 billion par value ($31.2 market value) of RMBS and commercial mortgage-backed securities ("CMBS"). AIG has experienced

[8] The Credit Agreement also would be modified to allow AIG to pay dividends on the Preferred Stock acquired by Treasury.

[9] Due to certain restrictions in AIG's certificate of incorporation, certain assets that AIG has agreed to pledge to secure the facility will not be formally pledged until AIG receives shareholder approval at an upcoming meeting to amend these restrictions in its charter. AIG would incur adverse tax consequences if it were to pledge more than 66 percent of its ownership interest in its regulated foreign subsidiaries.

[10] The terms of the new Treasury Preferred Stock also would prohibit any redemptions of such stock by AIG until the modified September Facility is fully paid.

significant liquidity pressures as its securities lending counterparties have pulled away from the company. On October 6, 2008, the Board authorized the creation of the $37.8 billion Securities Borrowing Facility for AIG to address the immediate liquidity needs caused by the ongoing withdrawal of AIG's securities lending counterparties.[11]

AIG, however, remains exposed to further declines in the value of the securities in the reinvestment portfolio, particularly the RMBS securities (approximately $39.6 billion par value) that primarily compose this portfolio. This exposure puts ongoing stress on the liquidity and capital of AIG and weakens the company. It also is of concern to the rating agencies. AIG already has experienced approximately $16.1 billion in mark-to-market losses on these RMBS (as of September 30, 2008) and the market for these securities currently is illiquid. To address these concerns, it is proposed that AIG sell all of the RMBS in the reinvestment portfolio to a new limited liability company, Maiden Lane II, that would be established solely for the purpose of holding these assets.

Under the proposal, AIG would provide $1 billion in equity to Maiden Lane II in the form of a subordinated loan, and FRBNY would extend up to $22.5 billion in senior credit on a non-recourse basis to the limited liability company under section 13(3). The senior loan from FRBNY would have a maturity of six years, subject to extension by the Reserve Bank. The aggregate proceeds of the subordinated and senior notes would be used to purchase the RMBS portfolio from AIG at the market value of the RMBS as of October 31, 2008, as determined in consultation with BlackRock, which

[11] This facility essentially permitted FRBNY to replace all of AIG's existing securities lending counterparties if necessary. As of November 5, 2008, approximately $20 billion was outstanding under this facility.

is advising the Federal Reserve. The market value of the RMBS was $23.5 billion as of September 30, 2008, based on AIG's marks. It is expected that the October 31 marks will be lower, which will reduce the size of the senior loan from FRBNY on a dollar-for-dollar basis. AIG's subordinated equity position ($1 billion) in Maiden Lane II was sized to fully protect FRBNY's senior note while also limiting the immediate and potential future cash drains on AIG from its retained position in the RMBS portfolio.

In addition to reducing the strain on AIG from its RMBS exposures, the Maiden Lane II facility would eliminate the need for the $37.8 billion Securities Borrowing Facility. Accordingly, this existing facility would be wound down and terminated, primarily through the use of the proceeds from the Maiden Lane II facility to close out securities borrowing transactions as they come due.[12]

The senior financing provided by the FRBNY would earn interest at a rate of 1-month LIBOR plus 100 basis points and all incoming cash flows would be applied to the senior debt until principal and interest on the note is fully paid (expected to occur between 2014 and 2019 under the scenarios modeled by BlackRock). AIG's subordinated first loss position in Maiden Lane II would accrue interest at a rate of 1-month LIBOR plus 300 basis points, but AIG will receive no cash payments until the principal and interest on the senior debt is fully repaid. After both the senior debt position and AIG's subordinated position are fully repaid, any residual returns will be

[12] To fully wind down the Securities Borrowing Facility, AIG must receive approval from the relevant insurance authorities to have the insurance subsidiaries participating in the securities lending program purchase the approximately $9.3 billion par value ($6 billion market value) of CMBS remaining in the reinvestment portfolio. AIG expects to be able to receive such approvals promptly once the package of proposed actions is announced.

apportioned 5/6th to FRBNY and 1/6th to AIG. Although the rating agencies have expressed concern about AIG's continuing downside exposure to the RMBS, the rating agencies also have indicated that they believe it is important for the company retain some upside in the portfolio, which is why AIG would share some portion of the residual cash flows.

It is expected that Maiden Lane II would be consolidated on the balance sheet of FRBNY. A financial advisor would be hired by FRBNY to manage Maiden Lane II's assets with a view toward maximizing repayment of its obligations with minimum disruption to the financial markets.

The FRBNY loan would be secured by the entire portfolio of RMBS acquired by Maiden Lane II (including the proceeds of any sale or repayment at maturity of such assets) and these RMBS are in turn secured by interests in residential mortgages.[13] The RMBS are backed primarily by subprime and Alt-A residential mortgages and are primarily rated AAA (47.1 percent), although approximately 15 percent of the portfolio is rated lower than BBB or not rated.[14] Because the estimated intrinsic values of the RMBS are greater than current market values, BlackRock projects that, even under very stressed scenarios, the FRBNY senior financing would be repaid over time. However, because the market values of these assets are volatile

[13] Section 110 of the Emergency Economic Stabilization Act requires that the Board implement a plan to maximize assistance to homeowners and reduce foreclosures with respect to residential mortgages and RMBS owned or controlled by a Reserve Bank. These provisions, however, do not apply to mortgages or RMBS (i) held as collateral for a discount window loan that is not in default, or (ii) acquired in open market operations. Accordingly, these provisions would not apply to the residential mortgage-related assets to be acquired by Maiden Lane II or III unless and until the FRBNY's loans to such entities were in default. Federal Reserve staff currently are drafting foreclosure mitigation policies that would meet the requirements of section 110 if triggered.

[14] These data are based on the lowest rating given by any of the three major rating agencies to the assets.

and would be reflected on the balance sheet of FRBNY, it is estimated that the transaction would result in approximately $1.5 to $2.6 billion in quarterly mark-to-market volatility on FRBNY's balance sheet at least in the short run.

C. Maiden Lane III Loan

One of the greatest strains on AIG arises from the derivative exposures of AIGFP and, in particular, the exposures arising from approximately 140 CDS contracts written by AIGFP on mortgage-related multi-sector CDOs with about 20 financial institution counterparties.[15] Under the CDS, AIG has provided counterparties with credit protection on specific CDOs (the "reference securities"). In particular, AIG has agreed to purchase the reference security at par in the event of a credit event (e.g., a downgrade or default) during the term of the CDS. In return, AIG receives an upfront or periodic fee from the counterparty.

The total notional amount of the multi-sector CDOs on which AIGFP had written credit protection is approximately $65 billion. As the mark-to-market value of the CDOs has declined, AIG has been required to post collateral with the counterparties to secure its payment in the event of a credit event and has incurred fair value losses on the CDS derivatives based on such assets. As of October 24, AIG had posted approximately $30.3 billion in collateral with its multi-sector CDO counterparties. Further declines in the market value of the reference CDOs would require AIG to provide additional collateral to the counterparties, creating a significant

[15] The data in this section excludes one relatively small ($1.8 billion) CDS exposure on a synthetic multi-sector CDO that would be excluded from the Maiden Lane III facility for operational and legal reasons.

potential liquidity drain on the company and additional fair value losses for the company.

To address these concerns, a proposed credit facility has been developed to substantially reduce AIG's exposure to the multi-sector CDOs, which has been the single greatest source of losses for AIGFP. In order to implement this facility, AIG's multi-sector CDO counterparties must first agree to "tear up" their CDS contract with AIGFP. In return for doing so, AIG would agree to purchase from the counterparty the CDO reference asset underlying the CDS at par, less a concession amount to be negotiated with the counterparty.[16] The CDOs acquired by AIGFP would then be sold to Maiden Lane III, a separate limited liability company established for the sole purpose of holding these CDOs.

The funding for AIGFP's purchases of the CDOs from the counterparties would come from two sources. First, the counterparties would retain the cash collateral that AIGFP had already posted with respect to the CDS (approximately $30.3 billion). If necessary, AIGFP would provide additional collateral (that also would be retained by the counterparty) to bring the collateral amount in line with a mutually agreed market value of the CDOs on or near the tear up date. The amount of additional collateral that AIGFP will need to post through this process currently is estimated to be in the range of $4 billion to $6 billion.

[16] Certain counterparties may not own the CDOs underlying the CDS, in which case the counterparty would have to obtain the CDO reference asset (or a CDO with substantially similar characteristics) to engage in the tear up process and receive funding from the Maiden Lane III facility.

The remaining cash needed to fund the purchase[17] of the CDOs by AIGFP would come from Maiden Lane III. AIG would provide $5 billion in equity to Maiden Lane III in the form of a subordinated loan. The FRBNY would make a non-recourse senior loan to Maiden Lane III of up to $30 billion under section 13(3).[18] AIGFP would immediately transfer the CDOs purchased to Maiden Lane III, effectively completing the purchase of the CDOs by Maiden Lane III at their then current market value. The CDOs would then collateralize the loan from FRBNY. These transactions may take place at different times with different counterparties, with the amount of the senior note increasing over time as the transactions with additional counterparties are consummated.

It is expected that Maiden Lane III would be consolidated on the balance sheet of FRBNY. A financial advisor would be hired by FRBNY to manage Maiden Lane III's assets with a view toward maximizing repayment of its obligations with minimum disruption to the financial markets.

Like the proposed Maiden Lane II loan, the interest rate on the FRBNY loan to Maiden Lane III would be 1-month LIBOR plus 100 basis points and the rate on the AIG subordinated loan would be 1-month LIBOR plus 300 basis points. All cash flows from the CDO assets would be applied first to the senior note until principal and interest on the note was paid in full

[17] Remaining amount = $65 billion par value of CDOs less $30.3 billion posted collateral less the additional collateral to be posted by AIGFP less any concession obtained from the counterparty.

[18] The $30 billion is the maximum amount of senior financing that would be provided by FRBNY to Maiden Lane III and would be reduced by the estimated $4 billion to $6 billion of additional collateral that AIGFP will have to post prior to the tear up of the CDS as well as any concessions obtained from the counterparties. In addition, some of AIGFP's counterparties may elect not to participate in the tear up process and others representing smaller exposures may be excluded from the process for technical or operational reasons.

(expected to be between October 2013 and July 2014 under the scenarios modeled by BlackRock), and would then be applied to the junior note until it was repaid in full. Any residual cash flows would be divided between FRBNY (67 percent) and AIGFP (33 percent). The FRBNY's senior loan would have a maturity of six years, subject to extension by the FRBNY.

AIG's equity position in Maiden Lane III ($5 billion) again was sized to fully protect the FRBNY's senior position under a variety of stress scenarios, while limiting the continuing downside exposure of AIG to the multi-sector CDOs, a significant concern of the rating agencies. The residual interest split also was designed to address a concern expressed by the rating agencies—that AIG receive a fair return for the risk taken on its equity contribution and have some opportunity to share in the upside of these currently distressed assets.

The primary assets backing the CDOs are residential mortgages (52 percent subprime and Alt-A U.S. RMBS by dollar amount), with the remaining assets composed of CMBS (18 percent), prime or agency-guaranteed mortgage-backed securities (17 percent), other CDOs (10 percent) and other asset-backed securities (2 percent). Ratings on these assets are distributed from Aaa (36 percent) to below Baa3 (18 percent), with approximately 90 percent of the underlying collateral having been originated between 2004 and 2007.

Cash flow projections prepared by BlackRock indicate that, even in relatively extreme stress scenarios, the FRBNY's senior note is likely to be repaid in full over time. However, because the market values of these assets are volatile and would be reflected on the balance sheet of FRBNY, it is estimated that the transaction would result in approximately $3.2 to

$4.0 billion in quarterly mark-to-market volatility on FRBNY's balance sheet at least in the short run.

Attachments

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APPENDIX A:

TARP Capital Purchase Program

Senior Preferred Stock

Summary of Senior Preferred Terms

Issuer:	American International Group, Inc. ("AIG").
Initial Holder:	United States Department of the Treasury (the "UST").
Size:	$40 Billion aggregate liquidation preference.
Security:	Senior Preferred, liquidation preference $10,000 per share; provided that UST may, upon transfer of the Senior Preferred, require AIG to appoint a depositary to hold the Senior Preferred and issue depositary receipts.
Ranking:	Senior to common stock and pari passu with existing preferred shares other than preferred shares which by their terms rank junior to the Senior Preferred. At the meeting of stockholders called to effect the amendments to AIG's Restated Certificate of Incorporation contemplated by the terms of the convertible preferred stock, AIG shall propose amendment to its Restated Certificate of Incorporation to allow the Senior Preferred to rank senior to the convertible preferred stock.
Term:	Perpetual life.
Dividend:	The Senior Preferred will accrue cumulative dividends at a rate of 9% per annum. Dividends will be payable quarterly in arrears on [ ], [ ], [ ] and [ ] of each year. Dividends will be payable when, as and if declared by the Board of Directors of AIG. Accrued but unpaid dividends shall compound quarterly.
Redemption:	Senior Preferred may be redeemed, in whole or in part, at any time and from time to time, at the option of AIG to the extent the senior secured revolving credit facility governed by the Credit Agreement dated as of September 22, 2008 (the "Credit Agreement") between AIG and the Federal Reserve Bank of New York ("FRBNY") is terminated. All redemptions of the Senior Preferred shall be at 100% of its issue price, plus an amount equal to accrued and unpaid dividends (including, if applicable, dividends on such amount).
Restrictions on Dividends:	Subject to certain exceptions, for as long as any Senior Preferred is outstanding, no dividends may be declared or paid on junior preferred shares, preferred shares ranking pari passu with the Senior Preferred ("Parity Stock"), or common shares (other than (i) in the case of pari passu preferred shares, dividends on a pro

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	rata basis with the Senior Preferred and (ii) in the case of junior preferred shares, dividends payable solely in common shares), nor may AIG repurchase or redeem any junior preferred shares, preferred shares ranking pari passu with the Senior Preferred or common shares, unless all accrued and unpaid dividends for all past dividend periods on the Senior Preferred are fully paid or declared and a sum sufficient for the payment thereof set apart.
Common dividends:	The UST's consent shall be required for any increase in common dividends per share until the fifth anniversary of the date of this investment unless prior to such fifth anniversary the Senior Preferred is redeemed in whole or the UST has transferred all of the Senior Preferred to third parties.
Repurchases:	The UST's consent shall be required for repurchases of any common shares, other capital stock, trust preferred securities or other equity securities (other than (i) repurchases of the Senior Preferred, (ii) repurchases of junior preferred shares or common shares ("Junior Stock") in connection with the administration of any employee benefit plan in the ordinary course of business and consistent with past practice (including purchases to offset share dilution pursuant to a publicly announced repurchase plan), (iii) any redemption or repurchase of rights pursuant to any stockholders' rights plan and (iv) the exchange or conversion of Junior Stock for or into other Junior Stock or of Parity Stock or trust preferred securities for or into other Parity Stock (with the same or lesser aggregate liquidation amount) or Junior Stock, in each case, solely to the extent required pursuant to binding contractual agreements entered into prior to the signing date of UST's agreement to purchase the Senior Preferred or any subsequent agreement for the accelerated exercise, settlement or exchange thereof for common stock), until the fifth anniversary of the date of this investment unless prior to such fifth anniversary the Senior Preferred is redeemed in whole or the UST has transferred all of the Senior Preferred to third parties.
Voting rights:	The Senior Preferred shall be non-voting, other than class voting rights on (i) any authorization or issuance of shares ranking senior or pari passu to the Senior Preferred, (ii) any amendment that adversely affects the rights of Senior Preferred, or (iii) any merger, exchange or similar transaction unless the Senior Preferred remains outstanding or is converted into or exchanged for preference securities of the surviving or resulting entity or its ultimate parent and the Senior Preferred or such preference shares have such rights, preferences, privileges and voting powers, and limitations and restrictions thereof, taken as a whole, as are not materially less favorable to the holders thereof than those of the Senior Preferred immediately prior to such transaction, taken as a whole. If dividends on the Senior Preferred are not paid in full for four dividend periods, whether or not consecutive, the Senior Preferred will have the right to elect the greater of 2 directors and a number of directors (rounded upward) equal to 20% of the total number of directors after giving effect to such election. The right to elect directors will end when full dividends have been paid for

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	all past dividend periods.
Transferability:	The Senior Preferred will not be subject to any contractual restrictions on transfer other than such as are necessary to insure compliance with U.S. federal and state securities laws. AIG will file a registration statement (which may be a shelf registration statement) covering the Senior Preferred as promptly as practicable, but in any event within 15 days, after notification by UST and, if necessary, shall take all action required to cause such registration statement to be declared effective as soon as possible. During any period that an effective registration statement is not available for the resale by AIG of the Senior Preferred, AIG will also grant to the UST piggyback registration rights for the Senior Preferred and will take such other steps as may be reasonably requested to facilitate the transfer of the Senior Preferred including, if requested by the UST, using reasonable best efforts to list the Senior Preferred on a national securities exchange. If requested by the UST, AIG will appoint a depositary to hold the Senior Preferred and issue depositary receipts.
Claim in Bankruptcy:	Equity claim with liquidation preference to common equity claim.
Acceleration Rights:	None
Use of Proceeds:	To repay the senior secured revolving credit facility governed by the Credit Agreement.
Tax Treatment:	Dividends on the Senior Preferred are non tax-deductible to AIG.
Restrictions on Expenses:	AIG shall continue to maintain and implement its comprehensive written policy on corporate expenses and distribute such policy to all AIG employees. Such policy, as may be amended from time to time, shall remain in effect at least until such time as any of the shares of the Senior Preferred are owned by UST. Any material amendments to such policy shall require the prior written consent of UST until such time as UST no longer owns any shares of Senior Preferred, and any material deviations from such policy, whether in contravention thereof or pursuant to waivers provided for thereunder, shall promptly be reported to UST. Such policy shall, at a minimum: (i) require compliance with all applicable law; (ii) apply to AIG and all of its subsidiaries; (iii) govern (a) the hosting, sponsorship or other payment for conferences and events, (b) the use of corporate aircraft, (c) travel accommodations and expenditures, (d) consulting arrangements with outside service providers, (e) any new lease or acquisition of real estate, (f) expenses relating to office or facility renovations or relocations and (g) expenses relating to entertainment or holiday parties; and (iv) provide for (a) internal reporting and oversight and (b) mechanisms for addressing non-compliance with the policy.
Restrictions on Lobbying:	AIG shall continue to maintain and implement its comprehensive

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	written policy on lobbying, governmental ethics and political activity and distribute such policy to all AIG employees and lobbying firms involved in any such activity. Such policy, as may be amended from time to time, shall remain in effect at least until such time as any of the shares of the Senior Preferred are owned by UST. Any material amendments to such policy shall require the prior written consent of UST until such time as UST no longer owns any shares of Senior Preferred, and any material deviations from such policy, whether in contravention thereof or pursuant to waivers provided for thereunder, shall promptly be reported to UST. Such policy shall, at a minimum: (i) require compliance with all applicable law; (ii) apply to AIG and all of its subsidiaries and affiliated foundations; (iii) govern (a) the provision of items of value to any government officials, (b) lobbying and (c) political activities and contributions; and (iv) provide for (a) internal reporting and oversight and (b) mechanisms for addressing non-compliance with the policy.
Reporting:	Except as otherwise agreed [and subject to UST entering into a customary confidentiality agreement], AIG shall provide UST (i) the information required to be provided by AIG to the FRBNY pursuant to Section 5.04 of the Credit Agreement and (ii) the notices required by Section 5.05 of the Credit Agreement, in each case within the time periods for delivery thereof specified in the Credit Agreement; provided that as of the time that the senior secured revolving credit facility governed by the Credit Agreement is repaid in full such informational and notice requirements as are provided in Section 5.04 and Section 5.05 of the Credit Agreement shall remain in full force and effect until such time as UST no longer owns any shares of Senior Preferred. In addition, AIG shall promptly provide UST such other information and notices as UST may reasonably request from time to time.
Executive Compensation:	[To Be Added – This will cover all of the provisions of TARP plus such additional limitations with respect to severance, bonuses and senior executive compensation for Systemically Significant Financial Institutions as may be reasonably requested by UST within [45] days of the date of this investment.]
Risk Management Committee:	AIG shall establish, within [30] days of the issuance of the Senior Preferred, and maintain, at least until UST ceases to own any shares of the Senior Preferred, a risk management committee of the Board of Directors that will seek to identify the major risks involved in AIG's business operations and review the quality of AIG's actions to mitigate and manage those risks.

APPENDIX B:

Systemic risks of AIG[1]

November 3, 2008

Introduction

In this memo, I discuss the possible systemic risks from a failure of AIG. The particular scenario considered is a bankruptcy filing by AIG, Inc., the parent holding company, and AIG Financial Products Corp. (AIGFP), with AIG's insurance subsidiaries entering a rehabilitation process overseen by domestic and foreign regulators. Much of the information used to prepare this memo was provided by management representations at AIG. In many cases, information is incomplete and the memo's conclusions should be viewed as preliminary.

Market confidence

The largest systemic risk at present is the risk to market confidence from a failure of AIG. Market confidence is in a fragile state after the intense financial turmoil of recent weeks. Treasury and the Federal Reserve have taken a range of actions, including the initial decision to lend to AIG. A broadening of government support for financial institutions has appeared to help stop the loss of market confidence in the financial system. A failure of AIG would call into question the ability of that broader government support to be sustained. This risk is impossible to quantify.

Exposures to AIGFP

AIGFP, AIG's capital markets and derivatives subsidiary, contains a number of systemic risks. I describe six of the important risks below. Given the range of risks present within AIGFP, there are undoubtedly some important risks that have been omitted from this list.

1. CDS written on ABS CDOs

AIGFP wrote credit protection on super-senior tranches of ABS CDOs and is exposed to the subprime mortgage-backed securities that the ABS CDOs own. The current notional amount of AIG's positions is $71 billion. AIG has taken $33 billion of writedowns on these positions as of September 30, 2008 and has posted collateral to its counterparties of $33 billion.

If AIG fails, its counterparties would face a loss on whatever uncollateralized exposure exists at that time. Counterparties have marked these positions down by $4 billion since September 30 (for a cumulative mark-to-market of $37 billion) and are

[1] This memo is a staff product and does not represent any formal finding by the Board about systemic risk effects.

currently asking for that amount of additional collateral. AIG is disputing those marks and has not posted the additional collateral. If AIG fails, its counterparties would bear the $4 billion loss.

Many of the counterparties own the underlying CDO securities against which AIG wrote credit protection or have other hedges. They would be left with up to $38 billion of unhedged super-senior ABS CDO risk if AIG failed. Because these positions are extremely sensitive to further house price declines, it would be expensive for AIG's counterparties to replace these positions. This would cause additional losses beyond the $4 billion described above.

At the time of the September 16 loan, the notional value of CDS written on ABS CDOs was $80 billion. AIG had taken $25 billion of writedowns as of June 30 and had posted $16 billion of collateral, leaving AIG's counterparties with an exposure of $9 billion. Systemic risk has fallen since September 16 because AIG has drawn on the Federal Reserve's $85 billion facility to post collateral against this $9 billion.

2. Regulatory capital arbitrage CDS

AIG wrote credit protection on super-senior tranches of corporate loan and prime mortgage exposures held by European banks in order to provide those banks with a regulatory capital reduction under their national implementations of Basel 1 capital standards.[2] AIG's largest counterparties are French, German, Dutch, Danish and Swedish banks. The notional amount outstanding has fallen from $379 billion at year-end 2007 to $240 billion at October 13, 2008. The portfolio is running off quickly because the counterparties have the option to terminate the trades when they go live onto Basel 2. The capital relief for AIG's European bank counterparties is currently estimated at between $2.4 and $11.1 billion, depending on where each bank's transition from Basel 1 to Basel 2 stands.[3] AIG's current mark-to-market loss is only $160 million, reflecting the fact that these trades were structured to transfer no credit risk, merely to provide regulatory capital relief.

If AIG fails, the Basel 1 risk-weighted assets reported by its counterparties would increase, resulting in a regulatory capital hole of up to $11.1 billion. Although the market knows this aggregate amount already from AIG's public disclosures, AIG's failure would reveal to the market which particular banks had shored up their Basel 1 capital ratios in this way.

Compared with the time of the September 16 loan, systemic risk is lower because the notional amount of trades is lower (it was $305 billion on June 30) and because European governments have put measures in place to guarantee bank liabilities and inject capital into banks.

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[2] These trades would not have provided capital relief under the U.S. implementation of Basel 1 capital standards.

[3] To avoid shouting "Fire!" in a crowded theater, we have not approached the European regulators to quantify the capital relief more precisely.

3. Intra-company exposures to AIGFP[4]

AIG's other subsidiaries have material exposures to AIGFP on OTC derivatives. The largest exposures are at finance company affiliates ($920 million) and the funds management affiliate ($441 million). Insurance affiliates are owed approximately $475 million. In addition, these affiliates would have to replace these hedges (primarily interest rate and foreign currency derivatives) at a time when markets are volatile.

A default of AIGFP would have a catastrophic impact on Banque AIG, a French bank that is a wholly-owned subsidiary of AIGFP and through which AIGFP executed many of its OTC derivative trades. For example, Banque AIG is the counterparty to the European banks' regulatory capital trades. All the exposures in Banque AIG's trades are hedged with back-to-back trades with AIGFP.

Systemic risk from these intra-company exposures is high. In particular, the failure of Banque AIG (a regulated bank) could have a more damaging effect on market confidence than the failure of AIGFP (an unregulated derivatives product subsidiary). Through the intra-company exposures, the failure of AIGFP would cause significant loss of value at AIG's other subsidiaries, many of which are expected to be sold to repay the Federal Reserve's loan.

4. Stable value wraps

AIGFP has provided stable value wraps, referred to as Benefit Responsive Options (BROs), for 401k plan participants. AIG guarantees that plan participants can receive book value for qualified withdrawals, although AIG is not required to make any payments until after a fund's assets are depleted through qualified withdrawals. AIG had a notional value of $36 billion of BROs at September 30, 2008 with 175 plan counterparties. The aggregate market-to-book ratio was estimated at 95.5 percent at September 30, leaving AIG with an exposure of $1.6 billion.

Systemic risk of these stable value wraps is high. Although the exposure amount is not large and it is unlikely that AIG will have to make any payments, market confidence would be affected if plan sponsors are forced to notify plan participants that their investments in stable value funds are no longer guaranteed (at the same time that turmoil in credit markets is pushing down the market value of the funds' investments). This risk is falling over time, as plan sponsors replace AIG as the stable value wrap counterparty when contracts are renewed. Deals with aggregate book value of $3.3 billion were terminated before September 30.

5. AIGFP's liabilities

Some of AIGFP's liabilities may pose a systemic risk. These include guaranteed investment contracts (GICs) and debt securities. GICs have been issued to a variety of

[4] This section relies on analysis done by John Kambhu.

counterparties including municipalities. AIGFP has $11.4 billion of GICs outstanding, of which $9.7 billion is collateralized. Much of AIGFP's $35 billion outstanding of debt securities was structured to provide a counterparty with a market risk exposure (to interest rate, equity, commodity, or foreign exchange rate risk). Some was sold to banks and institutional investors who passed the market risk through to individual high net worth investors, and some was sold directly to investors who are exposed to an AIG default.

Systemic risk on GICs has fallen considerably since September 16, when GICs outstanding were $19 billion, of which about $12 billion was uncollateralized. Only $1.7 billion of uncollateralized exposure on GICs remains. Systemic risk on debt securities is still high, as these have a longer maturity and no collateral requirements. If AIG defaults, AIGFP's counterparties on structured notes – banks and institutional investors – would suffer a direct loss of principal and would also be left with an open risk position vis-à-vis their customers to whom they passed through the market risk exposures. While AIG's counterparties have had ample opportunity to hedge their exposure to an AIG default, we do not know who the counterparties are or whether they have hedged.

6. OTC derivatives

Some of AIGFP's OTC derivatives counterparties have uncollateralized exposures that would result in a loss if AIG defaults. The most recent data available on derivatives payables as of September 23 showed the top 50 counterparty exposures summed to $4.5 billion. The largest exposures were to securitization trusts (for interest rate swaps that enable the trust to match the interest rate risk of its assets and liabilities), financial institutions, corporates, and sovereigns.

Systemic risk may be highest for the securitization trusts and financial institutions. Many investors in mortgage-backed securities or asset-backed securities would be surprised to learn that an AIG default could have an impact on their investment, since securitization trusts are designed to be "bankruptcy remote," which could have knock-on effects in broader securitization markets. Lehman Brothers also had OTC derivatives outstanding with a large number of securitization trusts. As a result of Lehman's bankruptcy, many of those transactions have been downgraded by rating agencies, and investors may suffer losses.

Financial institutions that reported a material loss to AIG on OTC derivatives could suffer a loss of market confidence. However, most of AIG's counterparties with large OTC derivatives exposures are European banks whose governments have already put in place extraordinary measures to support their national banking systems.

If AIG fails and its OTC derivatives book is unwound, counterparties would be forced to replace their positions with AIG or retain an unhedged risk position. When Lehman Brothers failed, this was a major concern, but rehedging of Lehman's OTC derivatives did not turn out to have systemic effects. Lehman's OTC derivatives book was ten times larger than AIG's (measured by notional amount) which suggests that this risk may not be large.

However, to the extent that AIG's book of OTC derivatives has a different character than Lehman's, there may be additional systemic risk concerns. Some of AIG's OTC derivatives trades are different because they were done solely to exploit AIG's AAA rating. For example, AIG is an intermediary on a set of 30-year natural gas swaps between Goldman Sachs and the Southern California Public Power Authority (which provides electricity to Los Angeles and other cities in Southern California). Presumably the Power Authority was uncomfortable with Goldman Sachs as counterparty on a 30-year trade and was willing to pay a premium for the comfort of an AAA-rated counterparty. AIG's failure would leave both counterparties with a large open risk position that they would need to rehedge (presumably they could rehedge with each other). In addition, AIGFP also has an exotic derivatives book whose positions could prove difficult for counterparties to replace in current market conditions.

Another systemic risk consideration is the operational burden on OTC derivatives markets of coping with the default of a large counterparty who is also a common reference entity in CDS. The Lehman Brothers default strained the market's operational capacity, but the fear that operational failures would cause systemic risks did not materialize. However, the market may not have had the capacity to simultaneously cope with an AIGFP bankruptcy and a Lehman Brothers bankruptcy. This aspect of systemic risk from AIG has fallen, since more than a month has passed since Lehman's bankruptcy.

Commercial paper

AIG, AIGFP, and two of AIG's finance subsidiaries have $6.9 billion of commercial paper outstanding as of October 22, 2008. Of the $6.9 billion, $4.2 billion is asset-backed commercial paper (ABCP) and the remainder is unsecured. The bankruptcy of Lehman Brothers demonstrated how commercial paper held by money market mutual funds could pose a systemic risk. We do not know who is holding AIG's commercial paper, but presumably this risk is still high.

However, the systemic risk from AIG's commercial paper has diminished since September 16, when AIG had $19.7 billion of CP outstanding. Of the $19.7 billion, $5.1 billion was ABCP. Since then, the Federal Reserve has established three lending facilities (AMLF, CPFF, and MMIFF) to reduce the systemic risk related to commercial paper and money market mutual funds.

Securities lending

AIG still has approximately $20 billion of borrowings from banks and broker-dealers remaining in its securities lending program. If AIG fails, the securities lending counterparties could receive ownership of the securities in lieu of receiving their cash.

These securities are high-grade corporate bonds and agency MBS, so credit losses are not expected, but this could have a material funding impact on those counterparties.

However, the systemic risk impact of the securities lending program is lower now than it was on September 16, when AIG had approximately $69 billion in liabilities and funding markets were under tremendous strain from the Lehman Brothers bankruptcy. The amount outstanding has fallen as counterparties have refused to roll over their securities lending transactions with AIG. A wider array of Federal Reserve lending facilities to support short-term funding markets is now available to help AIG's counterparties deal with the funding impact of an AIG default.

Insurance subsidiaries

AIG's regulated insurance subsidiaries, both domestic and foreign, would be affected by the default of the AIG parent holding company. State regulators have stated that the insurance companies they regulate are capitalized on a stand-alone basis and can maintain claims-paying ability to benefit policyholders. Conseco filed bankruptcy in 2002 due to losses in its consumer finance subsidiary, but its insurance companies continued to operate. If AIG's insurance subsidiaries are unable to continue operating following an AIG default, they could be seized by state regulators and put into rehabilitation.

It is possible that the failure of the AIG parent holding company could lead to additional losses at AIG's insurance subsidiaries. The intra-company exposures discussed above are one possible channel for this to occur. If an insurance company is found to be insolvent, its regulator may choose to liquidate it. In that event, a state guaranty fund will pay claims, up to a cap, and may provide for continuing coverage by transferring the policies to another insurance company.

Whether AIG's insurance subsidiaries are put into rehabilitation or whether they are liquidated, a potential systemic risk exists if the public loses confidence in insurance companies more broadly. For example, life insurance companies are vulnerable to a run by policyholders with cash value policies.

Direct credit exposures to AIG

On September 16, AIG reported that banks had $30 billion in exposure to it on various bank loan facilities and lines of credit, of which about $7 billion was to U.S. institutions. A more recent measure of direct credit exposure is not available.