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FCIC memo of staff interview with James Mahoney, Federal Reserve Bank of New York

James Mahoney

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MEMORANDUM FOR THE RECORD

Event: James M. Mahoney

Type of Event: Group interview, not taped

Date of Event: April 30, 2010

Team Leader: Dixie Noonan

Location: Federal Reserve Bank of New York, 33 Liberty Street, New York, NY

Participants - Non-Commission: James Mahoney, Shari Leventhal, Michael Patrick

Participants - Commission: Dixie Noonan, Chris Seefer *(by phone),* Al Crego *(by phone),* Jane Poulin *(by phone),* Clara Morain

Date of MFR: April 30, 2010

This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted except where clearly indicated as such.

Summary of the Interview or Submission:

Dixie opened the meeting by summarizing the FCIC's mandate and explaining that the FCIC is interested in learning about the causes of the problems at AIG. She said that the main focus of the interview was to learn about the Maiden Lane transactions, but first asked Mr. Mahoney to provide an overview of his educational and professional background.

Mr. Mahoney joined the Federal Reserve Bank of New York in 1993 after earning his PhD in finance at Wharton. For the following 11 years, he worked in research, focusing on capital markets and market risk. Starting in 2004, he worked in bank supervision and regulation, and examined the NY Fed's models as part of its effort to prepare for Basel II. In 2008, Mr. Mahoney took over responsibility for market and liquidity risk research. He said that he maintained responsibility for market and liquidity risk throughout 2008, but noted that the Bank's resources were stretched thin after the Primary Dealer Credit Facility was instituted following the Bear weekend.

Mr. Mahoney said that he first became involved with AIG was in September 2008 when he was asked to meet with AIG management about the company's liquidity problems. He, along with Bill Dudley and Trish Mosser (Senior VP in the Markets Group at FRBNY) met because AIG was "interested in expressing their problems to people who might be able to help," he said. Mr. Mahoney explained that AIG management first described its efforts to reach private sector solutions to AIG's problems, that the company had done a private equity raise in May of 2008 and was looking to do something similar in September. Mr. Mahoney said that AIG wanted to describe its plan to the New York Fed because the private equity raise was "their last resort."

Dixie asked if AIG approached the NY Fed or if the NY Fed approached the company. Ms. Leventhal said that she didn't believe Mr. Dudley initiated the meeting, and said that the NY Fed had no supervisory

role over the company, didn't lend directly to the company, and so effectively, AIG and the Fed had no official relationship.

Mr. Mahoney continued explaining his involvement with AIG, and said that although he took the lead on Maiden Lane 2, he has been on the AIG team since September 12, 2008. He said his responsibilities include looking at liquidity at AIG, going through cash flow needs of the company, its cash flow forecasts, and its upcoming needs.

Chris Seefer asked who Mr. Mahoney met with on September 12. Mr. Mahoney said several people attended the meeting, including Bob Gender, David Hertzog, and probably about six other people whom he could not remember. He said that minutes of the meeting would have been generated, and Ms. Leventhal agreed to make them available.

Chris asked Mr. Mahoney to describe what he recalled about the meeting. Mr. Mahoney said that AIG told the NY Fed about "the depth of their liquidity needs." He said that AIG "had been alerted by the rating agencies that a downgrade [of the company] was being considered, and the precipitating event would've been announced on Monday, so they [AIG] came to us and felt a need to work not just with private sector counterparties… but also wanted also to come to us in the official sector to express the magnitude of the problem, the timing of the problem, and inform us of the issue."

Dixie asked what would have immediately precipitated a ratings downgrade, and Mr. Mahoney said that in the second quarter of 2008, the company "had extraordinary losses in the order of $20 billion, which were announced I think August 6 and then in the subsequent days, each of the sell side analysts, from Merrill and Goldman to the banks and sell-side firms, issued reports to examine the losses - where they came from, was it a one-time event – and subsequently, the rating agencies put them on a watch for a downgrade." He said that after looking at the company's numbers and the causes of losses, the ratings agencies determined that they would convert the watch to a downgrade. "AIG got the call in the week of the 12th. Because there were lots of rating agency triggers in the CDS contracts where counterparties could demand more collateral in the event of a downgrade," AIG felt a need to explain its situation to the NY Fed, he said. He said that the securities lending program, which was already experiencing problems because counterparties were terminating trades, would have suffered greatly in the event of a downgrade because counterparties would terminate their trades in huge numbers. He also said that a downgrade would have triggered automatic cash demands, and would make it much harder for the company to roll commercial paper – "we heard this parade of horrible events," he said, noting that "lots of the things they discussed did end up happening."

Dixie asked if Mr. Mahoney had the impression from the September meeting that AIG had its arms around the problems facing the company. Mr. Mahoney said yes, "they competently laid out the contingencies that they'd identified and quantified. We didn't know the company then – we're a bank supervisor, not an insurance supervisor," so it was unclear how much assistance the NY Fed could provide. He said that another threat to the company was that conservative money managers leading pension funds that invested in Guaranteed Investment Contracts ("GICs") would sell their investments en masse in the event of a downgrade. He said that ultimately that did happen to a degree, but that "it could have been worse."

Dixie asked if Mr. Mahoney could help distinguish which consequences of a downgrade were caused by provisions in contracts between AIG and its counterparties, and which were behavioral. Mr. Mahoney said that the CDS triggers were contractual, and the problems with the securities lending division were behavioral. "Counterparties rely on collateral and ratings in securities lending, so if the rating falls in value, they will demand more collateral," he said. Dixie asked if the securities lending division depended on the rating of the insurance subsidiary, and Mr. Mahoney said that the rating of both entities was significant – "I wouldn't allow for too much of a difference between AIG-parent's rating and the subsidiary's ratings because these were large losses, half of which came from securities lending. And they ended up downgrading both parent and subsidiary," he said.

Dixie asked if Mr. Mahoney could explain the relationship between the problems in the securities lending business and AIG FP, and whether or not the problems at the two companies were triggered by the same things. "Well, I think they're both manifestations of turmoil in the market. These two very separate parts of the company invested in similarly risky products. FP had used derivatives contracts to guarantee multi-sector CDOs, including residential mortgages, commercial real estate, and other asset backs like credit cards. On the other side of organization, the domestic life insurance lending pool invested in a very similar set of securities - it was securities, not CDOs, but they were highly-rated securities that turned out would be downgraded below investment grade. And they also had commercial and RMBS securities and they actually bought through cash markets. So they were all risky assets, and they all suffered the same fate."

To clarify, Dixie said that there were two major sources of problems, one was the nature of the underlying assets, and the other was the possible ratings downgrade, which would precipitate a number of problems throughout AIG. "It was an accelerant to everything – everything that happened so far would be multiplied by a factor as a result of a downgrade. The assets fell a lot, so there was a downgrade. If assets fell more, that would've triggered additional collateral call," he said.

Dixie asked if Mr. Mahoney knew how much of the CDOs to which AIG had exposure were based on residential subprime assets. Mr. Mahoney said that he didn't know, but that Mike Alix, who led the Maiden Lane 3 transaction, might know.

Dixie asked what the size of the hole was at AIG when the NY Fed became involved in the company. Mr. Mahoney said that there was not a way to know the specific amount because each notch the company's rating dropped had different consequence. He said that estimates of the company's cash flow needs through the end of the year varied from $12-20 billion to $30-50 billion. Dixie asked where the $85 billion figure came from, and Mr. Mahoney said that "that came from a combination of lots of different analyses. Morgan Stanley had led the analysis for us." He said that none of the predictions were perfect because part of the problems were based on behavior in the market, how much GIC and CDO investors reacted to the downgrades. "There were a series of estimates, but we wanted the facility to be sufficient to ensure that the market would be confident [AIG] would - the thing was sized to give comfort to a counterparty that they needn't pull out of the company," he said.

Chris asked who at AIG was most knowledgeable about the company's problems. Mr. Mahoney said that the people he listed earlier provided the best information to his knowledge. They included Bob Gender, David Hertzog, and two other people whose name he could not remember who knew the most about the variety of liquidity needs at the company. Jane Poulin asked if AIG had a CFO in place who participated

in the meetings with Mr. Mahoney and the other NY Fed representatives. Mr. Mahoney said that he didn't remember and that he would have to go back and look at the list of attendees on the meeting minutes. He also said that AIG had a strategist who introduced the meetings and acted as a facilitator, and that person's name would be on the meeting minutes as well.

In addition to Mr. Dudley, Ms. Mosser, and Mr. Mahoney from the NY Fed, Dixie asked if anyone from the Treasury Department attended the meetings, and Mr. Mahoney said that there were none. Mr. Mahoney said that "people there didn't know the FP portfolio, so we set up a subsequent meeting with people who knew that better, and we went back to the company that night at 8 and brought in FP people and securities lending people and we had a nice, memorable four to five hour meeting at their headquarters to go over the FP portfolio and the sources of risk, although the focus was on the CDO portfolio, they had over $2 trillion in notional in derivatives in general." Dixie asked who attended that meeting, and Mr. Mahoney said that Elias Habayeb, the CFO of AIG FP attended, as did Jacob Frankel, a strategist who had introduced the issue. He said that Mr. Habayeb answered all of the questions at the meeting and was "very knowledgeable." He also said that Bill Dudley was very knowledgeable about the FP portfolio, which was surprising, given that he was in headquarters. Dixie asked who described the problems with the securities lending program. Mr. Mahoney said, "no particular representative sticks out in my mind as particularly knowledgeable about sec lending. I don't recall anyone from the sec lending area being particularly noteworthy, unlike the FP people who had clearly originated many details and knew well the various contracts, termination clauses etc.," he said.

Dixie asked Mr. Mahoney to go through the days following his initial meeting and describe the issues the NY Fed and AIG focused on, how the numbers were reached, and what conditions were placed on the on the company with respect to risk management. Ms. Leventhal said, "we've never taken the role of supervisor. We're a lender to AIG, we're not in control. We're not the management. In terms of AIG that weekend, the decisions to lend [were] made by much more senior people, and Tom Baxter is the person to speak to those issues." Mr. Mahoney said, "I and a small team of people were one team looking at AIG. There were separate legal people looking at authorizations, and there's lot of teams looking at other parts of the company… we spent the weekend at the company [trying] to understand the CDO portfolio and reg cap portfolio for European banks - and so that turned out to be not a big draw, but potentially it could have been much larger than the CDO [portfolio] given that housing prices in Europe had fallen and it had a much bigger notional value – $350 billion – it was just orders of magnitude larger… so a lot of work that weekend turned out to be not necessary on these two huge sources of liquidity drain in the following weeks." Mr. Mahoney said that there was a "tremendous amount of work" put in over the weekend and through Tuesday night to "understand in environment, [to look] for authorities for a wind down, how would that work with the types of reinsurance contracts they had, trying to understand the interlocking ownerships they had. Really it had to do with understanding the totality of organization's capital structure, risk profile, risks to counterparties, all of its creditors and stakeholders. So at that point we hadn't made the loan, we were feeding information to policymakers… because before then, no one had given authority to work on anything because we were not a lender or anything."

Al Crego asked if at any point during the weekend the OTS reached out to the NY Fed, given that the OTS was AIG's regulator. Mr. Mahoney said that he wasn't sure, and was not the right person to answer the question. "I never met anyone from the OTS, and they weren't there in person. There was a lot more interaction with state of New York insurance department - that's where the sec lending program problems

were… so there was lots of daily interaction with the Insurance Department, I'm not sure about interaction with the OTS, but as far as boots on the ground, I had no interaction with the OTS," he said.

Dixie asked whether or not by Wednesday morning when the NY Fed was a creditor to the company, Mr. Mahoney and his team received conflicting messages from different parts of the company. "Information was not flowing seamlessly," he said. "There was dislocation in the company. The treasury department area had information more as things changed, but they didn't seem to have an established process. For years, all areas of the company were profitable and all had liquidity, and so it didn't have a long, well established process for how to draw from a limited quantity of funds."

Dixie asked what Mr. Mahoney's job responsibilities were between September 16 and the November date when Maiden Lane 2 was announced. "Starting from day one, I met with the treasurer every day. We knew we needed a better understanding of the processes. So at that point… the treasurer, he had a ten-day forecast and a 17-week forecast he relied on as the two main mechanisms to understand the company's liquidity profile," he said. Mr. Mahoney said that three areas of focus were (1) maturing debt, (2) the fact that if CDOs deteriorated further, the company would face more collateral calls, and (3), the company was unable to roll its mature securities lending contracts." He said that the NY Fed was "able to maintain three counterparties out of a dozen from sec lending – Credit Suisse, Barclays, and Citi. Everyone else was turning securities back in." He explained that starting on October 8, the NY Fed instituted a temporary securities borrowing facility. "We said, 'these securities that counterparties are giving back are high quality corporate bonds – the kind of things we lend against,' so we could take in this high quality collateral, enhance our collateral position, and not have the parent facility used to make a direct loan to the insurance subsidiary. So we instituted a temporary secured borrowing facility so the company could take those securities, pledge against our debt window which was set up specifically for sec lending, for the 11 insurance subs."

Dixie asked if any of those insurance subsidiaries were in New York, and Mr. Mahoney said yes. Dixie asked if Mr. Mahoney personally interacted with representatives from the NY State Insurance Department. "Someone in legal is the point of contact [with the NY Insurance Department]. Given that the states had already approved the sec lending facility, they would be hard pressed to say the NY Fed wasn't an OK counterparty. So there was no friction there. It was well understood that this was a temporary solution to the problem," he said.

Dixie asked Mr. Mahoney to describe the terms of the securities borrowing facility. He said that there was a question of how to turn the NY Fed's temporary solution (the securities borrowing facility) into a more permanent resolution, which is where Maiden Lane 2 came in. "One big issue was that if the held securities still had lots of credit risk in holding corporate bonds, but the reinvestment pool was not something state regulators were looking at. So it was not viewed as viable that company would maintain ownership of residential-backed securities because prices were so volatile. They didn't get the type of capital credit when you calculate insurance companies' risk-based capital – they were not the type of assets they could keep holding. So it was clear these RMBS would experience defaults. So it was clear they would ultimately be downgraded. And a well known criticism of rating agencies [was that they were] using the same [ratings] scheme for corporations as for securities. You don't see AA and AAA firms failing, but they said AA is AA whether it's for a company or a structure. Turned out not to be true." He said that there was a "huge migration of ratings over that time period. It hadn't happened yet, but

everyone knew it was a matter of time before the ratings agencies would change. Prices already reflected it. People, traders in the market knew that risk was not reflected in the ratings themselves."

Dixie asked if he or his team conducted any analysis of how AIG got to the position where it found itself in the fall of 2008. "We did almost no looking back," he said. "We were really focused on stabilizing ratings, the earning stream, and allowing company to solve its manifest problems. We frankly didn't have time to look back." "It's also not our role to do that," Ms. Leventhal said. Mr. Mahoney continued that, "we required that governance be to our satisfaction, and of course we were a sizeable investor, but we're not a supervisor or regulator. Obviously we had interests, but they're different from a supervisory interest. Our interest was in protecting our collateral. We had extremely strong control rights. They can't enter into new activities, they can't do a lot of actions – anything that requires a new investment in new assets, etc. - so we have incredibly control rights where they're coming to seek our permissions. The normal credit rights are enhanced because of size and importance [of our investment]."

Dixie asked Mr. Mahoney what his primary role with Maiden Lane 2 is today. "After the facilities closed, those were separations of assets out of AIG – the performance of Maiden Lanes 2 and 3 has nothing to do with performance of AIG – those assets are held in LLCs and managed by separate teams, they were moved out of the bank and aren't managed by the AIG team. On the flip side, AIG's performance does depend in part on the performance of those facilities because there are future monies coming from those tranches to AIG." Dixie asked if the sec lending program has been shut down, and he said that the domestic sec lending program was shut down the day Maiden Lane was created.

Dixie asked if he was involved in decision about how to put a permanent solution in place. He said yes, that the Maiden Lane transactions were the permanent solutions. "There were lots of challenges to those decisions. Also, this has to be put in the context of all of the changes announced during that time – the TARP money, the de-risking as a result of Maiden Lane 2 and 3." Dixie asked what was done to set forth an analysis of exactly what was needed for the health of the company and what was needed for the health of the financial system. He said that a number of memos and internal reports set forth the case for the NY Fed's involvement in AIG. He also said that he and his team engaged many advisors: "Obviously, we don't structure things like this – we obviously relied heavily in the structuring on investment banking advice and outside counsel."

Dixie said that the FCIC may have follow up questions, thanked Mr. Mahoney for his time, and concluded the interview.