

September 2011

# FINANCIAL CRISIS

## Review of Federal Reserve System Financial Assistance to American International Group, Inc.

U.S. Government Accountability Office

GAO 90

YEARS

1921-2011

ACCOUNTABILITY ★ INTEGRITY ★ RELIABILITY

## Why GAO Did This Study

In September 2008, the Board of Governors of the Federal Reserve System (Federal Reserve Board) approved emergency lending to American International Group, Inc. (AIG)—the first in a series of actions that, together with the Department of the Treasury, authorized \$182.3 billion in federal aid to assist the company. Federal Reserve System officials said that their goal was to avert a disorderly failure of AIG, which they believed would have posed systemic risk to the financial system. But these actions were controversial, raising questions about government intervention in the private marketplace. This report discusses (1) key decisions to provide aid to AIG; (2) decisions involving the Maiden Lane III (ML III) special purpose vehicle (SPV), which was a central part of providing assistance to the company; (3) the extent to which actions were consistent with relevant law or policy; and (4) lessons learned from the AIG assistance.

To address these issues, GAO focused on the initial assistance to AIG and subsequent creation of ML III. GAO examined a large volume of AIG-related documents, primarily from the Federal Reserve System—the Federal Reserve Board and the Federal Reserve Bank of New York (FRBNY)—and conducted a wide range of interviews, including with Federal Reserve System staff, FRBNY advisors, former and current AIG executives, AIG business counterparties, credit rating agencies, potential private financiers, academics, finance experts, state insurance officials, and Securities and Exchange Commission (SEC) officials. Although GAO makes no new recommendations in this report, it reiterates previous recommendations aimed at improving the Federal Reserve System's documentation standards and conflict-of-interest policies.

View [GAO-11-616](#) or key components. For more information, contact Orice Williams Brown at (202) 512-8678 or [williamsor@gao.gov](mailto:williamsor@gao.gov).

## FINANCIAL CRISIS

### Review of Federal Reserve System Financial Assistance to American International Group, Inc.

## What GAO Found

While warning signs of the company's difficulties had begun to appear a year before the Federal Reserve System provided assistance, Federal Reserve System officials said they became acutely aware of AIG's deteriorating condition in September 2008. The Federal Reserve System received information through its financial markets monitoring and ultimately intervened as the possibility of bankruptcy became imminent. Efforts by AIG and the Federal Reserve System to secure private financing failed after the extent of AIG's liquidity needs became clearer. Both the Federal Reserve System and AIG considered bankruptcy issues, although no bankruptcy filing was made. Due to AIG's deteriorating condition in September 2008, the Federal Reserve System said it had little opportunity to consider alternatives before its initial assistance. As AIG's troubles persisted, the company and the Federal Reserve System considered a range of options, including guarantees, accelerated asset sales, and nationalization. According to Federal Reserve System officials, AIG's credit ratings were a critical consideration in the assistance, as downgrades would have further strained AIG's liquidity position.

After the initial federal assistance, ML III became a key part of the Federal Reserve System's continuing efforts to stabilize AIG. With ML III, FRBNY loaned funds to an SPV established to buy collateralized debt obligations (CDO) from AIG counterparties that had purchased credit default swaps from AIG to protect the value of those assets. In exchange, the counterparties agreed to terminate the credit default swaps, which were a significant source of AIG's liquidity problems. As the value of the CDO assets, or the condition of AIG itself, declined, AIG was required to provide additional collateral to its counterparties. In designing ML III, FRBNY said that it chose the only option available given constraints at the time, deciding against plans that could have reduced the size of its lending or increased the loan's security. Although the Federal Reserve Board approved ML III with an expectation that concessions would be negotiated with AIG's counterparties, FRBNY made varying attempts to obtain these discounts. FRBNY officials said that they had little bargaining power in seeking concessions and would have faced difficulty in getting all counterparties to agree to a discount. While FRBNY took actions to treat the counterparties alike, the perceived value of ML III participation likely varied by the size of a counterparty's exposure to AIG or its method of managing risk.

While the Federal Reserve Board exercised broad emergency lending authority to assist AIG, it was not required to, nor did it, fully document its interpretation of its authority or the basis of its decisions. For federal securities filings AIG was required to make, FRBNY influenced the company's filings about federal aid but did not direct AIG on what information to disclose. In providing aid to AIG, FRBNY implemented conflict-of-interest procedures, and granted a number of waivers, many of which were conditioned on the separation of employees and information. A series of complex relationships grew out of the government's intervention, involving FRBNY advisors, AIG counterparties, and others, which could expose FRBNY to greater risk that it would not fully identify and appropriately manage conflict issues and relationships.

As with past crises, AIG assistance offers insights that could help guide future government action and improve ongoing oversight of systemically important financial institutions. While the Dodd-Frank Wall Street Reform and Consumer Protection Act seeks to broadly apply lessons learned from the crisis in a number of areas, AIG offers other lessons, including identifying ways to ease time pressure by seeking private sector solutions sooner or compiling needed information in advance, analyzing disputes concerning collateral posting as a means to help identify firms coming under stress, and conducting stress tests that focus on interconnections among firms to anticipate financial system impacts.

The Federal Reserve Board generally agreed with GAO's findings and provided information on steps taken to address lessons learned that GAO identified.

---

# Contents

---

Letter		1
	Background	4
	The Possibility of AIG's Failure Drove Federal Reserve Aid after Private Financing Failed	12
	FRBNY's Maiden Lane III Design Likely Required Greater Borrowing, and Accounts of Attempts to Gain Concessions From AIG Counterparties are Inconsistent	56
	The Federal Reserve's Actions Were Generally Consistent With Existing Laws and Policies, but They Raised a Number of Questions	87
	Initial Federal Reserve Lending Terms Were Designed to Be More Onerous than Private Sector Financing	123
	The AIG Crisis Offers Lessons That Could Improve Ongoing Regulation and Responses to Future Crises	132
	Agency and Third Party Comments and Our Evaluation	137
Appendix I	Objectives, Scope, and Methodology	140
Appendix II	Comments from the Board of Governors of the Federal Reserve System	143
Appendix III	GAO Contact and Staff Acknowledgments	146
Tables		
	Table 1: Participants in First Phase of AIG Private-Financing Attempt, by Type	26
	Table 2: Estimates of AIG's First-Phase Liquidity Needs, September 2008	30
	Table 3: Sources of ML III Value Provided	63
	Table 4: Division of Earnings Considered for Maiden Lane III, as of October 26, 2008	66
	Table 5: Maiden Lane III Counterparty Concession Scenarios	70
	Table 6: Rates on Selected Federal Reserve AIG-Related Lending	90
	Table 7: ML III CDO Trustees that Were Also AIG Counterparties	115
	Table 8: Comparison of the Terms of the Private Lending Plan and Federal Reserve Revolving Credit Facility	125

---

---

Figures

Figure 1: Timeline of Events and Contacts Prior to Initial Federal Reserve Assistance in September 2008	14
Figure 2: Actual and Projected Cumulative Draws on Revolving Credit Facility, as of October 2, 2008	46
Figure 3: Maiden Lane III Structure and Alternatives	58
Figure 4: Differences in AIGFP Counterparty Collateralization, as of October 24, 2008	81
Figure 5: Differences in Expected Losses by Counterparty for Extreme Stress, as of November 5, 2008	83
Figure 6: Differences in CDO Credit Ratings by Counterparty, as of October 29, 2008	84
Figure 7: Roles and Relationships among the Federal Reserve, Its Advisors, and Other Parties	114

---

---

### Abbreviations

AIG	American International Group, Inc.
AIGFP	AIG Financial Products Corporation
Bear Stearns	Bear Stearns Companies, Inc.
CDO	collateralized debt obligations
CDS	credit default swaps
CTR	confidential treatment request
CUSIP	Committee on Uniform Securities Identification Procedures
Federal Reserve Board	Board of Governors of the Federal Reserve System
FHLB	Federal Home Loan Banking System
FRBNY	Federal Reserve Bank of New York
Lehman	Lehman Brothers Holdings, Inc.
LIBOR	London Interbank Offered Rate
ML II	Maiden Lane II
ML III	Maiden Lane III
NYSID	New York State Insurance Department
OTS	Office of Thrift Supervision
RMBS	residential mortgage-backed securities
SEC	Securities and Exchange Commission
SIGTARP	Special Inspector General for the Troubled Asset Relief Program
TARP	Troubled Asset Relief Program
Treasury	Department of the Treasury

This is a work of the U.S. government and is not subject to copyright protection in the United States. The published product may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.



G A O

Accountability \* Integrity \* Reliability

United States Government Accountability Office  
Washington, DC 20548

September 30, 2011

### Congressional Requesters

The financial crisis that reached a peak in 2008 was far-reaching, threatening the stability of the U.S. banking system as well as the U.S. and global economies. As the federal government responded to the crisis, one of its most significant actions was providing extraordinary assistance to American International Group, Inc. (AIG), the multinational insurer that was also a significant participant in the financial derivatives market. AIG was one of the largest recipients of government aid. The Board of Governors of the Federal Reserve System,<sup>1</sup> through its emergency powers under section 13(3) of the Federal Reserve Act, and the Department of the Treasury (Treasury), through the Emergency Economic Stabilization Act of 2008, which authorized the Troubled Asset Relief Program, collaborated to make available up to \$182.3 billion in assistance to AIG.<sup>2</sup> The assistance, which was made available in several stages beginning in September 2008, addressed large losses that threatened to bankrupt the company.<sup>3</sup> These losses stemmed from two

---

<sup>1</sup>In this report, we distinguish among the Federal Reserve Board, meaning the Board of Governors of the Federal Reserve System; the Federal Reserve System, meaning the Federal Reserve Board and at least one of its regional Reserve Banks; and the Federal Reserve Bank of New York, which is the regional Reserve Bank for the Second Federal Reserve District.

<sup>2</sup>Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008), codified at 12 U.S.C. §§ 5201 et seq.

<sup>3</sup>According to the Federal Reserve System, the elements of emergency lending approved for AIG were:

1. Revolving Credit Facility, September 2008, \$85 billion initially authorized; repaid and closed January 2011.
2. Securities Borrowing Facility, October 2008, \$37.8 billion authorized; terminated with Maiden Lane II.
3. Maiden Lane II, November 2008, \$22.5 billion authorized.
4. Maiden Lane III, November 2008, \$30 billion authorized.
5. Additional loans to securitize life insurance cash flows, March 2009, \$8.5 billion authorized; facility never implemented.

Not all amounts authorized were drawn, and not all programs operated concurrently. In addition, Treasury made investments in AIG:

1. \$40 billion for preferred stock, November 2008.
2. \$29.835 billion for preferred stock, warrant to purchase common stock, April 2009.

See background section for more detailed discussion of the elements of federal assistance to the company.

---

AIG businesses that involved the lending of securities and the provision of insurance-like guarantees on the value of bond instruments known as collateralized debt obligations (CDO). Largely due to the federal government's assistance, AIG's financial health has improved over time.

The government's unprecedented actions to save AIG from failure were controversial, raising questions in Congress and among the public about the federal government's intervention into the private marketplace. Federal Reserve System officials initially rejected offering assistance to the company. However, when the financial markets experienced extreme disruptions during the first 2 weeks of September 2008, and as AIG faced the prospect of even greater financial difficulty, the Federal Reserve System decided that providing assistance could avert a disorderly failure of the company, which officials believed would pose systemic risk to the financial system. Nonetheless, questions later arose about, for example, whether AIG should have instead filed for bankruptcy, whether the government assumed too much risk in rescuing the company, how the government arrived at its decisions in providing assistance, and how the government structured particular features of its assistance to the company.

Reflecting your interest in the nature and execution of government assistance to AIG, this report provides a detailed review of assistance extended by the Federal Reserve System, which was the first and largest provider of assistance to the company. In particular, this report examines (1) the sequence of events and key participants as critical decisions were made to provide the various elements of federal assistance to AIG; (2) decisions involving the Maiden Lane III (ML III) vehicle, which was a key part of AIG assistance that followed the government's initial aid to the company; (3) the extent to which key actions taken were consistent with relevant law or policy; (4) criteria that were used to determine the treatment of, or the terms of key assistance extended to, AIG, its various

---

creditors and counterparties, and other significant parties; and (5) lessons learned from the AIG assistance.<sup>4</sup>

To address our reporting objectives, we obtained and reviewed a wide range of AIG-related documents, primarily from the Federal Reserve System, including records provided by the Federal Reserve System to Congress. We also reviewed documents from the Securities and Exchange Commission (SEC). The documents we reviewed included e-mails, proposals and analyses of options for aid to AIG, research, memorandums, and other items. We conducted a wide range of interviews, including with Federal Reserve System staff, advisors to the Federal Reserve Bank of New York (FRBNY), current and former AIG executives, advisors to AIG, AIG counterparties, credit rating agencies, potential private-sector financiers, state insurance regulators, federal banking regulators, SEC staff, academic and finance experts, and others. We also reviewed our past work and the work of others who have examined the government's response to the financial crisis, including the Congressional Oversight Panel, the Special Inspector General for the Troubled Asset Relief Program, and the Financial Crisis Inquiry Commission. As agreed with your staff, our scope is generally limited to the Federal Reserve System's initial decision to provide assistance to AIG in September 2008 and the subsequent creation of ML III, because these two instances of aid involved the largest amount of funds and were of considerable interest. Our scope and methodology are detailed in appendix I.

We undertook this performance audit from March 2010 to September 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe

---

<sup>4</sup>For previous GAO reports on AIG assistance, see *The Government's Exposure to AIG Following the Company's Recapitalization*, [GAO-11-716](#) (Washington, D.C.: July 18, 2011); *Troubled Asset Relief Program: Third Quarter 2010 Update of Government Assistance Provided to AIG and Description of Recent Execution of Recapitalization Plan*, [GAO-11-46](#) (Washington, D.C.: Jan. 20, 2011); *Troubled Asset Relief Program: Update of Government Assistance Provided to AIG*, [GAO-10-475](#) (Washington, D.C.: Apr. 27, 2010); and *Troubled Asset Relief Program: Status of Government Assistance to AIG*, [GAO-09-975](#) (Washington, D.C.: Sep. 21, 2009). For our previous testimony on assistance to the company, see *Federal Financial Assistance: Preliminary Observations on Assistance Provided to AIG*, [GAO-09-490T](#) (Washington, D.C.: Mar. 18, 2009).



---

that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

---

## Background

AIG is an international insurance organization serving customers in more than 130 countries. As of June 30, 2011, AIG reported assets of \$616.8 billion and revenues of \$34.1 billion for the preceding 6 months. AIG companies serve commercial, institutional, and individual customers through worldwide property/casualty networks. In addition, AIG companies provide life insurance and retirement services in the United States.

---

## Regulation of the Company

Federal, state, and international authorities regulate AIG and its subsidiaries. Until March 2010, the Office of Thrift Supervision (OTS) was the consolidated supervisor of AIG, which was a thrift holding company by virtue of its ownership of the AIG Federal Savings Bank. As the consolidated supervisor, OTS was charged with identifying systemic issues or weaknesses and helping ensure compliance with regulations that govern permissible activities and transactions.<sup>5</sup> The Federal Reserve System was not a direct supervisor of AIG. Its involvement with the company was through its responsibilities to maintain financial system stability and contain systemic risk that may arise in financial markets.

AIG's domestic life and property/casualty insurance companies are regulated by the state insurance regulators in the state in which these companies are domiciled. The primary state insurance regulators include New York, Pennsylvania, and Texas. These state agencies regulate the financial solvency and market conduct of these companies, and they have the authority to approve or disapprove certain transactions between an insurance company and its parent or its parent's subsidiaries. These

---

<sup>5</sup>According to AIG, it has had no consolidated regulator since OTS regulation ceased. Since then, it has been in discussions with European regulators concerning consolidated regulation. The company also said the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (Dodd-Frank Act), now provides two ways in which the Federal Reserve Board could become AIG's federal regulator: (1) if AIG is recognized as a "savings and loan holding company" as defined by the Home Owners' Loan Act, or (2) if the legislation's newly created systemic risk regulator—the Financial Stability Oversight Council—designates AIG as a company whose material financial distress, or whose nature, scope, size, scale, concentration, interconnectedness, or mix of activities, could pose a threat to the financial stability of the United States.

---

agencies also coordinate the monitoring of companies' insurance lines among multiple state insurance regulators. For AIG in particular, these regulators have reviewed reports on liquidity, investment income, and surrender and renewal statistics; evaluated potential sales of AIG's domestic insurance companies; and investigated allegations of pricing disparities. Finally, AIG's general insurance business and life insurance business that are conducted in foreign countries are regulated by the supervisors in those jurisdictions.

---

## AIG's Financial Difficulties

AIG's financial difficulties stemmed primarily from two sources:

- *Securities lending.* Until 2008, AIG had maintained a large securities lending program operated by its insurance subsidiaries. The securities lending program allowed insurance companies, primarily AIG's life insurance companies, to lend securities in return for cash collateral, which was then invested in investments such as residential mortgage-backed securities (RMBS).
- *Credit default swaps.* AIG had been active, through its AIG Financial Products Corporation (AIGFP) unit, in writing insurance-like protection called credit default swaps (CDS) that guaranteed the value of CDOs.<sup>6</sup>

In September 2008, the Board of Governors of the Federal Reserve System (Federal Reserve Board), FRBNY, and Treasury determined that market events could cause AIG to fail.<sup>7</sup> According to officials from these entities, AIG's failure would have posed systemic risk to financial

---

<sup>6</sup>CDS are bilateral contracts, sold over-the-counter, that transfer credit risks from one party to another. A seller, which is offering credit protection, agrees, in return for a periodic fee, to compensate the buyer if a specified credit event, such as default, occurs. CDOs are securities backed by a pool of bonds, loans, or other assets.

<sup>7</sup>The Federal Reserve Board is a federal agency. A network of 12 Reserve Banks and their branches carries out a variety of functions, including operating a nationwide payments system, distributing the nation's currency and coin, and, under delegated authority from the Federal Reserve Board, supervising and regulating member banks and bank holding companies. The Federal Reserve Board oversees the operations and activities of the Reserve Banks and their branches. The Reserve Banks, which combine features of public and private institutions, are federally chartered corporations with boards of directors. As part of the Federal Reserve System, the Reserve Banks are subject to oversight by Congress.

---

markets.<sup>8</sup> Consequently, the Federal Reserve System and Treasury took steps to help ensure that AIG obtained sufficient funds to continue to meet its obligations and could complete an orderly sale of operating assets and close its investment positions in its securities lending program and AIGFP.

From July through early September in 2008, AIG faced increasing liquidity pressure following a downgrade in its credit ratings in May 2008, which was due in part to losses from its RMBS investments. The company was experiencing declines in the value and market liquidity of the RMBS assets that served as collateral for its securities lending operation, as well as declining values of CDOs against which AIGFP had written CDS protection. These losses in value forced AIG to use an estimated \$9.3 billion of its cash reserves in July and August 2008 to provide capital to its domestic life insurers following losses in their RMBS portfolios and to post additional collateral required by the trading counterparties of AIGFP.

AIG attempted to secure private financing in September 2008 but was unsuccessful. On September 15, 2008, credit rating agencies downgraded AIG's debt rating, which resulted in the need for an additional \$20 billion to fund its added collateral demands and transaction termination payments. Following the credit rating downgrade, an increasing number of counterparties refused to transact with AIG for fear that it would fail. Also around this time, the insurance regulators decided they would no longer allow AIG's insurance subsidiaries to lend funds to the parent company under a credit facility that AIG maintained, and they demanded that any outstanding loans be repaid and that the facility be terminated.

In September 2008, another large financial services firm—Lehman Brothers Holdings, Inc. (Lehman)—was on the brink of bankruptcy. As events surrounding AIG were developing over the weekend of September 13–14, 2008, Federal Reserve System officials were also addressing

---

<sup>8</sup>In our March 2009 testimony on credit default swaps, we noted that no single definition exists for systemic risk. Traditionally, systemic risk was viewed as the risk that the failure of one large institution would cause other institutions to fail. This micro-level definition is one way to think about systemic risk. Recent events have illustrated a more macro-level definition: the risk that an event could broadly affect the financial system rather than just one or a few institutions. See GAO, *Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps*, [GAO-09-397T](#) (Washington, D.C.: Mar. 5, 2009).

---

Lehman's problems. On September 15—the day before the Federal Reserve Board voted to authorize FRBNY to make an emergency loan to AIG—Lehman filed for bankruptcy.<sup>9</sup> Stock prices fell sharply, with the Dow Jones Industrial Average and the Nasdaq market losing 504 points and 81 points, respectively.<sup>10</sup>

---

## Federal Assistance to AIG

Because of concerns about the effect of an AIG failure, in 2008 and 2009, the Federal Reserve System and Treasury agreed to make \$182.3 billion available to assist AIG. First, on September 16, 2008, the Federal Reserve Board, with the support of Treasury, authorized FRBNY to lend AIG up to \$85 billion through a secured revolving credit facility that AIG could use as a reserve to meet its obligations.<sup>11</sup> This debt was subsequently restructured in November 2008 and March 2009 to decrease the amount available under the facility, reduce the interest charged, and extend the maturity date from 2 to 5 years, to September 2013. By January 2011, AIG had fully repaid the facility and it was closed.

In October 2008, the Federal Reserve Board approved further assistance to AIG, authorizing FRBNY to borrow securities from certain AIG domestic insurance subsidiaries. Under the program, FRBNY was authorized to borrow up to \$37.8 billion in investment-grade, fixed-income

---

<sup>9</sup>A U.S. Bankruptcy Court Examiner's report summarized the failure of Lehman this way: "Lehman failed because it was unable to retain the confidence of its lenders and counterparties and because it did not have sufficient liquidity to meet its current obligations. Lehman was unable to maintain confidence because a series of business decisions had left it with heavy concentrations of illiquid assets with deteriorating values[,] such as residential and commercial real estate. Confidence was further eroded when it became public that attempts to form strategic partnerships to bolster its stability had failed. And confidence plummeted on two consecutive quarters with huge reported losses, \$2.8 billion in second quarter 2008 and \$3.9 billion in third quarter 2008, without news of any definitive survival plan."

<sup>10</sup>In written comments to us, the former FRBNY President summed up the environment: "The collapse of Lehman Brothers contributed to an escalating run on banks, including a broad withdrawal of funds from money market funds. The run on these funds, in turn, severely disrupted the commercial paper market, which was a vital source of funding for many financial institutions. Financial firms responded by shoring up their balance sheets through selling risky assets, reducing exposure to other financial institutions, and guarding their cash positions."

<sup>11</sup>The Federal Reserve Board announced that, as a condition of establishing the initial \$85 billion credit facility, a trust established for the sole benefit of the U.S. Treasury would become the majority equity investor in AIG.

---

securities from AIG in return for cash collateral. These securities were previously lent by AIG's insurance company subsidiaries to third parties. This assistance was designed to allow AIG to replenish liquidity used to settle securities lending transactions, while providing enhanced credit protection to FRBNY in the form of a security interest in the securities. This program was authorized for up to nearly 2 years but was terminated in December 2008.

In late 2008, AIG's mounting debt—the result of borrowing from the Revolving Credit Facility—led to concerns that the company's credit ratings would be lowered, which would have caused its condition to deteriorate further. In response, the Federal Reserve Board and Treasury in November 2008 announced the restructuring of AIG's debt. Under the restructured terms, Treasury purchased \$40 billion in shares of AIG preferred stock (Series D), and the cash from the sale was used to pay down a portion of AIG's outstanding balance from the Revolving Credit Facility. The limit on the facility also was reduced to \$60 billion, and other changes were made to the terms of the facility. This restructuring was critical to helping AIG maintain its credit ratings.

To provide further relief, FRBNY also announced in November 2008 the creation of two new facilities to address some of AIG's more pressing liquidity issues. AIG's securities lending program continued to be one of the greatest ongoing demands on its working capital, and FRBNY announced plans to create an RMBS facility—Maiden Lane II (ML II)—to purchase RMBS assets from AIG's U.S. securities lending portfolio. The Federal Reserve Board authorized FRBNY to lend up to \$22.5 billion to ML II; AIG also acquired a subordinated \$1 billion interest in the facility, which would absorb the first \$1 billion of any losses. In December 2008, FRBNY extended a \$19.5 billion loan to ML II to fund its portion of the purchase price of the securities. The facility purchased \$39.3 billion face value of the RMBS directly from AIG subsidiaries (domestic life insurance companies). As part of the ML II transaction, the \$37.8 billion Securities Borrowing Facility established in October before was repaid and terminated. As of August 17, 2011, ML II owed \$7.3 billion in principal and interest to FRBNY.<sup>12</sup>

---

<sup>12</sup>According to FRBNY, the maximum draw on the Securities Borrowing Facility was \$20.5 billion.

---

In addition, FRBNY announced plans to create a second facility—ML III—to purchase multisector CDOs on which AIGFP had written CDS contracts.<sup>13</sup> This facility was aimed at facilitating the restructuring of AIG by addressing one of the greatest threats to AIG’s liquidity position. In connection with the purchase of the CDOs, AIG’s CDS counterparties agreed to terminate the CDS contracts, thereby eliminating the need for AIG to post additional collateral as the value of the CDOs fell.<sup>14</sup> The Federal Reserve Board authorized FRBNY to lend up to \$30 billion to ML III. In November and December 2008, FRBNY extended a \$24.3 billion loan to ML III. AIG also paid \$5 billion for an equity interest in ML III, which would absorb the first \$5 billion of any losses. As of August 17, 2011, ML III owed \$11.2 billion in principal and interest to FRBNY.

When the two AIG Maiden Lane facilities were created, FRBNY officials said that the FRBNY loans to ML II and ML III were both expected to be repaid with the proceeds from the interest and principal payments, or liquidation, of the assets in the facilities. The repayment is to occur through cash flows from the underlying securities as they are paid off. Accordingly, FRBNY did not set a date for selling the assets; rather, it has indicated that it is prepared to hold the assets to maturity if necessary. In March 2011, FRBNY announced it declined an AIG offer to purchase all ML II assets, and said that instead, it would sell the assets in segments over an unspecified period, as market conditions warrant, through a competitive sales process.

In March 2009, the Federal Reserve Board and Treasury announced plans to further restructure AIG’s assistance. Among other items, debt owed by AIG on the Revolving Credit Facility would be reduced by up to about \$26 billion in exchange for FRBNY’s receipt of preferred equity interests in two special purpose vehicles (SPV) created to hold the outstanding common stock of two AIG life insurance company

---

<sup>13</sup>A multisector CDO is a CDO backed by a combination of corporate bonds, loans, asset-backed securities, or mortgage-backed securities.

<sup>14</sup>In this report, unless otherwise noted, we use “CDS counterparties,” or more generally “counterparties,” to refer to the group of 16 counterparties from which ML III purchased CDOs. This original group of 16 subsequently changed following corporate acquisitions.

---

subsidiaries—American Life Insurance Company (ALICO) and AIA Group Limited (AIA).<sup>15</sup>

Also in March 2009, the Federal Reserve Board and Treasury announced plans to assist AIG in the form of lending related to the company's domestic life insurance operations. FRBNY was authorized to extend credit totaling up to approximately \$8.5 billion to SPVs to be established by certain AIG domestic life insurance subsidiaries. As announced, the SPVs were to repay the loans from the net cash flows they were to receive from designated blocks of existing life insurance policies held by the insurance companies. The proceeds of the FRBNY loans were to pay down an equivalent amount of outstanding debt under the Revolving Credit Facility. However, in February 2010, AIG announced that it was no longer pursuing this life insurance securitization transaction with FRBNY.

Treasury also has provided assistance to AIG. As noted, in November 2008, Treasury's Office of Financial Stability announced plans under the Troubled Asset Relief Program (TARP) to purchase \$40 billion in AIG preferred shares. AIG entered into an agreement with Treasury whereby Treasury agreed to purchase \$40 billion of fixed-rate cumulative preferred stock of AIG (Series D) and received a warrant to purchase approximately 2 percent of the shares of AIG's common stock.<sup>16</sup> The proceeds of this sale were used to pay down AIG's outstanding balance on the Revolving Credit Facility.

In April 2009, AIG and Treasury entered into an agreement in which Treasury agreed to exchange its \$40 billion of Series D cumulative preferred stock for \$41.6 billion of Series E fixed-rate noncumulative preferred stock, allowing for a reduction in leverage and dividend requirements. The \$1.6 billion difference between the initial aggregate liquidation preference of the Series E stock and the Series D stock represents a compounding of accumulated but unpaid dividends owed by AIG to Treasury on the Series D stock. Because the Series E preferred stock more closely resembles common stock, principally because its

---

<sup>15</sup>A special purpose vehicle is a legal entity, such as a limited partnership, created to carry out a specific financial purpose or activity.

<sup>16</sup>Cumulative preferred stock is a form of capital stock in which holders of preferred stock receive dividends before holders of common stock, and dividends that have been omitted in the past must be paid to preferred shareholders before common shareholders can receive dividends.

---

dividends were noncumulative, rating agencies viewed the stock more positively when rating AIG's financial condition.

Also in April 2009, Treasury made available a \$29.835 billion equity capital facility to AIG whereby AIG issued to Treasury 300,000 shares of fixed-rate noncumulative perpetual preferred stock (Series F) and a warrant to purchase up to 3,000 shares of AIG common stock. The facility was intended to strengthen AIG's capital levels and improve its leverage.

On January 14, 2011, with the closing of a recapitalization plan for AIG, the company repaid \$47 billion to FRBNY, including the outstanding balance on the original \$85 billion Revolving Credit Facility. With that, AIG no longer had any outstanding obligations to FRBNY.<sup>17</sup>

---

## AIG's Federal Securities Filings

As a publicly traded company, AIG makes regular filings with SEC. In December 2008, AIG filed two Form 8-K statements related to ML III. These filings included ML III contract information and did not initially include a supporting record known as "Schedule A"—a listing of CDOs sold to ML III, including names of the counterparties, valuations, collateral posted, and other information.<sup>18</sup> Questions arose about FRBNY's role in AIG's filings and the degree to which the Reserve Bank may have influenced the company's filing decisions, as well as whether the company's filings satisfactorily disclosed the nature of payments to the counterparties.

---

## AIG's Crisis Came Amid Overall Market Turmoil

AIG's financial difficulties came as financial markets were experiencing turmoil. A sharp decline in the U.S. housing market that began in 2006 precipitated a decline in the price of mortgage-related assets—particularly mortgage assets based on subprime loans—in 2007. Some institutions found themselves so exposed that they were threatened with failure, and

---

<sup>17</sup>At this time, the trust established in connection with the Revolving Credit Facility exchanged its shares of AIG's Series C preferred stock for about 562.9 million shares of AIG common stock. The trust subsequently transferred the shares to Treasury. Although the original Revolving Credit Facility extended to AIG was repaid, FRBNY continued to have loans outstanding for AIG assistance that were not made to AIG directly, through ML II and ML III.

<sup>18</sup>Schedule A was an attachment to a contract known as the Shortfall Agreement, which provided a process for making final collateral adjustments as part of the ML III process.



---

some failed because they were unable to raise capital or obtain liquidity as the value of their portfolios declined. Other institutions, ranging from government-sponsored enterprises such as Fannie Mae and Freddie Mac to large securities firms, were left holding “toxic” mortgages or mortgage-related assets that became increasingly difficult to value, were illiquid, and potentially had little worth. Moreover, investors not only stopped buying private-label securities backed by mortgages but also became reluctant to buy securities backed by other types of assets. Because of uncertainty about the liquidity and solvency of financial entities, the prices banks charged each other for funds rose dramatically, and interbank lending conditions deteriorated sharply. The resulting liquidity and credit crunch made the financing on which businesses and individuals depend increasingly difficult to obtain. By late summer 2008, the effects of the financial crisis ranged from the continued failure of financial institutions to increased losses of individual savings and corporate investments to further tightening of credit that would exacerbate an emerging global economic slowdown.

---

## The Possibility of AIG’s Failure Drove Federal Reserve Aid after Private Financing Failed

A year before the first federal assistance to AIG, warning signs of the company’s financial difficulties began to appear. Over the following months, the Federal Reserve System received information about AIG’s deteriorating condition from a variety of sources and contacts, and it stepped in to provide emergency assistance as possible bankruptcy became imminent in mid-September 2008. Attempts to secure private financing, which would have precluded or limited the need for government intervention, failed as the extent of AIG’s liquidity needs became clearer. Both the Federal Reserve System and AIG considered bankruptcy issues, with AIG deciding independently to accept federal assistance in lieu of bankruptcy. Because of urgency in financial markets by the time the Federal Reserve System intervened, officials said there was little opportunity to consider alternatives before extending the initial assistance in the form of the Revolving Credit Facility. When AIG’s financial troubles persisted after the Revolving Credit Facility was established, the company and the Federal Reserve System considered a range of options for further assistance. Throughout the course of AIG assistance, the company’s credit ratings were a critical consideration, according to Federal Reserve System officials, as downgrades would have triggered large new liquidity demands on the company and could have jeopardized government repayment. As a result, Federal Reserve System assistance reflected rating agency concerns, although both FRBNY and the rating agencies told us the rating agencies did not participate in the decision-making process.

---

The Federal Reserve  
Monitored AIG's  
Deteriorating Condition in  
2008 and Took Action as  
Possible Bankruptcy Was  
Imminent

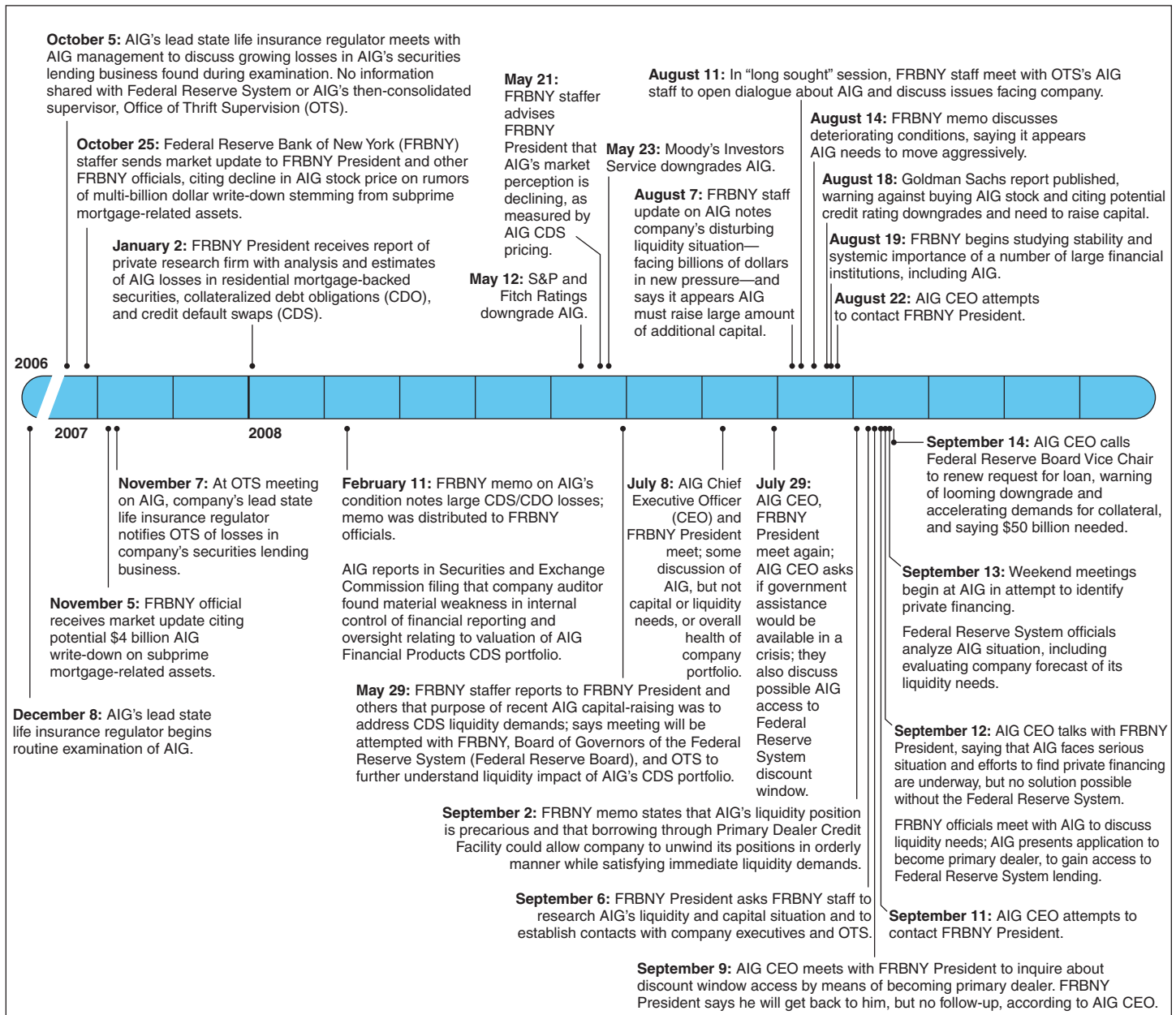
The difficulties that culminated in AIG's crisis in September 2008 began to draw financial regulators' attention in 2007, when issues arose relating to the company's securities lending program and the CDS business of its AIGFP subsidiary (see fig. 1). In December 2006, AIG's lead state insurance regulator for the company's domestic life insurers ("lead life insurance regulator") began a routine examination of AIG in coordination with several other state regulators.<sup>19</sup> During the examination, the state regulators identified issues related to the company's securities lending program. Prior to mid-2007, state regulators had not identified losses in the securities lending program, and the lead life insurance regulator had reviewed the program without major concerns. As the examination continued into the fall of 2007, the program began to show losses resulting from declines in the value of its RMBS portfolio. The lead life insurance regulator told us the program had become riskier as a result of how AIG had invested cash collateral it received from its lending counterparties—in RMBS rather than in safer investments. The RMBS investments were declining in value and had become less liquid, AIG told us.<sup>20</sup>

---

<sup>19</sup>State insurance regulators oversee domestic life and property/casualty insurance companies domiciled in their states. One state insurance regulator coordinated state regulatory efforts for AIG's domestic life insurance operations, which we refer to as the "lead life insurance regulator."

<sup>20</sup>AIG told us that at the time the investments were made, however, RMBS were not seen as more risky than other investments, as RMBS were highly rated and highly liquid.

**Figure 1: Timeline of Events and Contacts Prior to Initial Federal Reserve Assistance in September 2008**



Source: GAO.

---

Regulators recognized that left unaddressed, AIG's practices in the securities lending program, including the losses they observed, could create liquidity risks for AIG. In particular, these declines could lead AIG's securities lending counterparties to terminate their borrowing agreements, thereby requiring AIG to return the cash collateral the counterparties had posted, which AIG had invested in the RMBS. According to the lead life insurance regulator, about 20 percent of the funds AIG had collected as collateral remained in cash, indicating a potentially large liquidity shortfall if the counterparties terminated their transactions. The lead life insurance regulator also noted that AIG was disclosing relatively little information in its regulatory filings about the program and its losses, which were off-balance sheet transactions.<sup>21</sup> Another state insurance regulator told us that as part of its review, it noted that AIG life insurance companies engaging in securities lending were not correctly providing information in annual statements or taking an appropriate charge against capital for the securities lending activities. This regulator said it began discussions with the company about securities lending in 2006. AIG told us it was unaware of the regulator's concerns.

The lead life insurance regulator met with AIG management in October and November 2007 and presented the securities lending issues it had noted at a "supervisory college" meeting held by AIG's then-consolidated regulator, OTS.<sup>22</sup> The lead life insurance regulator told us it did not share with all participants that it had identified off-balance-sheet losses but that it privately advised OTS that it saw unrealized losses building in AIG's securities lending portfolio, with the total reaching an estimated \$1 billion

---

<sup>21</sup>According to AIG, these were off-balance sheet transactions under then-current disclosure requirements and guidelines, as compared to public SEC filings and investor presentations.

<sup>22</sup>OTS told us it began convening these meetings for AIG in 2005 as part of its consolidated supervisory program for the company. U.S. state insurance regulators, plus key foreign supervisory agencies, participated in these conferences. During a part of the meeting devoted to presentations from the company, attendees had an opportunity to question the company about supervisory or risk issues.

---

by November 2007. It also told us this was the first time OTS learned about issues in the company's securities lending program.<sup>23</sup>

At the time, OTS had concerns about a different matter at AIG. According to OTS, in late 2007, it began to have concerns about AIGFP's practices for valuing the CDOs on which the company wrote CDS protection, in particular whether the company's valuations corresponded to market values. Part of the concern was that AIGFP's CDS counterparties were seeking collateral from the company based on their own valuations. Thus, in general, there were difficulties in assessing the value of the CDOs behind the company's CDS contracts.<sup>24</sup> According to AIG's lead life insurance regulator, OTS did not communicate its concerns about AIGFP to state insurance regulators at the supervisory college meeting in November 2007.<sup>25</sup> As a result, the lead life insurance regulator told us it did not understand the extent of potential risks AIGFP posed to the AIG parent company that in turn could have created risks for the regulated insurance subsidiaries.<sup>26</sup>

AIG executives and advisors told us that the company made thorough disclosures about securities lending program issues, including losses and the manner in which collateral was being invested, by the third quarter of

---

<sup>23</sup>Because the role and actions of OTS with respect to AIG were beyond the scope of this report, we do not elaborate on OTS's receipt or handling of this information. Effective July 21, 2011, pursuant to provisions of the Dodd-Frank Act, OTS was abolished, integrated with the Office of the Comptroller of the Currency, and its functions transferred to various federal banking regulators.

<sup>24</sup>See *Hearing on Troubled Asset Relief Program Assistance for American International Group*, Congressional Oversight Panel, May 26, 2010.

<sup>25</sup>As AIGFP was not an insurance company, state insurance regulators did not regulate the subsidiary's CDS and CDO activities.

<sup>26</sup>The lead life insurance regulator told us that following the supervisory college meeting in November 2007, it did not follow up with OTS regarding AIG, although in hindsight, it may have been useful to do so. The regulator's main issue, however, was reporting of AIG securities lending matters in insurance company financial statements, not the derivatives issue, the lead life insurance regulator said.

---

With Losses Growing,  
Regulators Step Up Oversight

---

2007.<sup>27</sup> They said that state regulators did not identify issues of which the company was not aware and disclosing publicly.

AIG notified regulators in early 2008 that the securities lending program had experienced significant losses as of December 2007, at which time the lead life insurance regulator told us it began efforts to coordinate regular communication among the states.<sup>28</sup> Results of the examination of the securities lending program provided greater disclosure of information to regulators, such as credit ratings of underlying securities in the pool of securities in which AIG had invested its counterparties' collateral. By February 2008, regular meetings were being held among AIG and state insurance regulators.

As the monitoring continued into 2008, state insurance regulators held a number of in-person and phone meetings with AIG executives, as the company took steps to increase its liquidity and improve cash-flow management within the securities lending program.<sup>29</sup> The lead life insurance regulator told us that prior to the stepped-up monitoring, the

---

<sup>27</sup>In particular, AIG told us that in response to the growing RMBS crisis, the company disclosed in public filings and presentations to investors for the second quarter 2007 (released in the third quarter) all of its RMBS investments, including investments of the securities lending program. The company said it also disclosed a growing differential between its liability to return cash collateral to borrowers of securities and the fair value of the securities lending cash collateral investments, which had begun to decline due to the deteriorating market. Further, the company said it disclosed in its second quarter 2007 SEC Form 10-Q filing that the securities lending liability to borrowers was more than \$1 billion greater than the fair value of the securities lending collateral. The company made a similar disclosure for its third quarter, AIG told us.

<sup>28</sup>AIG told us that in February 2008, in its SEC Form 10-K filing, the company reported a net unrealized loss on securities lending collateral of \$5 billion and a realized loss of \$1 billion, plus a growing differential—then about \$6.3 billion—between its liability to borrowers and the fair value of the securities lending collateral. AIG said it also warned investors of potential liquidity risks stemming from the securities lending program, such as if counterparties demanded their cash back on short notice.

<sup>29</sup>According to the lead life insurance regulator, as events unfolded in September 2008, it tried unsuccessfully to meet with AIG in order to receive a briefing on the company's financial condition and liquidity needs. According to the regulator, in a meeting with AIG management on August 12, 2008, officials advised they were becoming concerned with liquidity of the AIG parent company, but no AIG executive present was able to address the concern. Given that officials were relying upon a parent company guarantee to cover losses in the securities lending program, the regulator said it advised AIG that for the next in-person meeting—expected in October—it wanted AIG executives to present information on the parent company's finances, its liquidity position, all guarantees and possible collateral calls, and plans to fund those guarantees and collateral calls if necessary.

---

company's limited disclosure about the program did not allow the regulators to understand the extent of the problem. Overall, the lead life insurance regulator said, the consensus among the state regulators was that securities lending issues, while of concern, did not present imminent danger as long as AIG's counterparties did not terminate their lending transactions.<sup>30</sup> Meanwhile, AIG management had already taken steps to bolster liquidity and cash flow management—beginning in August 2007, AIG told us—and the regulators hoped the company would recover investment losses as market conditions improved. Moreover, the lead life insurance regulator had a guarantee from the AIG parent company to cover up to \$5 billion in losses stemming from the program. The lead life insurance regulator said this provided some comfort as a backstop, but it was not certain that the company had the money to fulfill that agreement.

Our review indicated that neither OTS nor state insurance regulators communicated with the Federal Reserve System about AIG's problems before the summer of 2008. FRBNY officials told us they monitored financial institutions not regulated by the Federal Reserve System, including AIG, based on publicly available information, as part of monitoring overall financial market stability. In particular, FRBNY e-mails from late 2007 and January 2008 indicated that staff were monitoring AIG's exposure and potential losses related to the subprime mortgage market. For instance, market updates were circulated to FRBNY officials in October and November 2007 highlighting multibillion dollar write-downs in AIG's subprime mortgage portfolio. Additionally, in January 2008, an FRBNY staffer sent a market report of a private research firm to the then-FRBNY President that included analyses and estimates of AIG's losses for its RMBS, CDO, and CDS activities. In February 2008, FRBNY staff wrote a memorandum on AIGFP's CDS portfolio, which FRBNY officials said was prepared as part of FRBNY's regular monitoring of market events. The report, circulated to some FRBNY staff, noted unrealized losses related to the CDS portfolio and AIG's exposure to the subprime

---

<sup>30</sup>The lead life insurance regulator told us it began discussions with AIG management in February 2008 about plans to wind down the securities lending program over a 12–24 month period. By September, AIG had already begun unwinding the program, which was down in value by 25 percent from a peak of approximately \$94 billion—as reported to us by AIG—the regulator said. In September, as the crisis was unfolding, the regulator said it began formulating a plan that would allow for a full wind-down of the program as lending transactions terminated, which would generally have been over a period of less than 90 days. However, the regulator said it never discussed this plan with AIG management because the Federal Reserve System stepped in.

---

mortgage market. During the spring and summer of 2008, internal FRBNY e-mails show that FRBNY officials circulated information on a range of AIG issues, including reports about the company's earnings losses, widening CDS spreads, potential credit rating downgrades, and worsening liquidity and capital positions.<sup>31</sup> FRBNY officials told us that the level of monitoring and internal reporting conducted for AIG was consistent with that of other institutions not regulated directly by the Federal Reserve System.

Under financial pressure, AIG raised \$20 billion in new capital in May 2008 and also considered additional private financing options. AIG raised the capital through three sources: common stock, hybrid securities, and debt financing. The purpose, according to communication between FRBNY staff and the then-FRBNY President, was to address liquidity demands stemming from AIGFP's requirements to post cash collateral to its CDS counterparties.<sup>32</sup> In addition, FRBNY intended to have discussions with OTS to further understand the liquidity impact of AIGFP's CDS portfolio. This meeting occurred 3 months later in August 2008. Also during the summer of 2008, AIG considered joining the Federal Home Loan Bank System (FHLB) via the company's insurance subsidiaries. Such membership could have allowed AIG's insurance operations to pledge some of their qualified assets against an extension of credit.<sup>33</sup> AIG executives told us the company discarded the idea after learning that funds its subsidiaries might have received would not have been accessible to the parent company.

#### AIG and FRBNY Shared Concerns about a Liquidity Crisis at the Company

By July 2008, AIG's then-chief executive officer had concerns that the company's securities lending program could generate a liquidity crisis, according to interviews we conducted. He shared these concerns with AIG's Board of Directors, telling them the only source from which the company could secure enough liquidity if such a crisis occurred was the government. He thought it was unlikely the company could approach the

---

<sup>31</sup>A "CDS spread" is a premium that a buyer pays to a seller of protection. The size of a CDS spread serves as an indicator of market perception of risk. An increasing CDS spread indicates a heightened perception of risk.

<sup>32</sup>AIG described the purpose as "general corporate purposes."

<sup>33</sup>FHLBs are regional cooperatives owned by members that include community banks, credit unions, community development financial institutions, and insurance companies. FHLBs make loans to members known as "advances."



---

capital markets again after raising \$20 billion only 2 months before. On July 29, the chief executive officer approached the then-FRBNY President seeking government assistance. During the meeting, the chief executive officer said he explained AIG's liquidity situation and requested access to the Federal Reserve System discount window.<sup>34</sup> According to the chief executive officer, the President did not think Federal Reserve System officials could or would do that because if the discount window was made available to AIG, it would likely precipitate the liquidity crisis the company wanted to avoid. The chief executive officer noted that the Federal Reserve System had allowed other nondepository institutions to borrow from the discount window after the failure of Bear Stearns Companies, Inc. (Bear Stearns), but said the argument failed to alter the FRBNY President's position.

In the weeks following this meeting, FRBNY officials and staff continued to gather information on AIG's condition and liquidity issues and to circulate publicly available information. For instance, an e-mail sent in the first week of August 2008 to FRBNY officials highlighted the concerns of one rating agency about AIG's deteriorating liquidity situation due to strains from its securities lending program and CDS portfolio. The message concluded that AIG needed to raise a large amount of additional capital. On August 11, 2008, FRBNY officials held their first meeting with OTS staff regarding AIG. According to a subsequent FRBNY e-mail, the meeting was an introductory discussion about AIG's situation and other issues that could affect companies like AIG, such as problems facing monoline insurance companies.<sup>35</sup> Topics discussed relating to AIG included the company's raising of capital in May 2008, its liquidity and capital positions, liquidity management, rating agency concerns, and problems associated with AIGFP and the securities lending program. In addition, a report on August 14 from an FRBNY staff member who attended the meeting warned staff about AIG's increasing capital and liquidity pressures, asset and liability mismatches, and the potential for credit rating downgrades, saying AIG needed to take action on these

---

<sup>34</sup>The Federal Reserve System's discount window extends credit to generally sound depository institutions as a short-term source of funds and as a means to ensure adequate liquidity in the banking system.

<sup>35</sup>A monoline insurer also provides protection against credit defaults, as AIG did, but typically is involved only in that line of business.

---

issues.<sup>36</sup> FRBNY officials told us that previously, OTS staff had not communicated information about AIG that FRBNY staff would have flagged as issues to raise with FRBNY management.

While FRBNY continued monitoring AIG's situation into September 2008, FRBNY staff also raised concerns internally about the company's ability to manage its liquidity problems. On August 18, 2008, FRBNY staff circulated a new research report on AIG by a large investment bank, which highlighted concern that AIG management may be unable to accurately assess its exposures or losses given the complexity of the company's businesses. In its own memorandum on September 2, FRBNY noted that AIG's liquidity position was precarious and that the company's asset and liability management was inadequate given its substantial liquidity needs. Further, a memorandum circulated among FRBNY officials on September 14, which discussed possible lending to AIG, stated that one rating agency's rationale for potentially downgrading the company stemmed from concerns about AIG's risk management, not its capital situation. A private research report, also circulated that day, further detailed the view of the rating agency that even if AIG were to raise capital, it might not offset risk management concerns. FRBNY officials told us AIG had fragmented and decentralized liquidity management before the government intervention. Liquidity management became the responsibility of the AIG holding company in early 2008. As one official stated, AIG understood corporate-level liquidity needs but not the needs of subsidiaries, including AIGFP.

Leading up to the weekend of September 13–14, 2008, AIG made renewed attempts to obtain discount window access while also initiating efforts to identify a private-sector solution. On September 9, AIG's then-chief executive officer met again with the then-FRBNY President in another attempt to obtain relief, this time by means of becoming a primary dealer.<sup>37</sup> According to the AIG chief executive, the President said he had not considered this option and would need to respond later. The chief executive told us that he did not receive a response and that he made

---

<sup>36</sup>In August 2008, AIG made a successful \$3.25 billion debt offering, according to the company's lead life insurance regulator.

<sup>37</sup>Primary dealers are banks and investment dealers authorized to buy and sell government securities directly with FRBNY. Under the Federal Reserve's Primary Dealer Credit Facility announced in March 2008, primary dealers could borrow from the Federal Reserve System at the FRBNY discount rate by pledging eligible collateral.

---

another effort to contact the FRBNY President on September 11 but was unsuccessful. Meanwhile, AIG also made an inquiry about federal aid to Federal Reserve Board staff, according to a former member of the Federal Reserve Board. According to the former FRBNY President, at the time, a variety of firms, including AIG, were inquiring about discount window access, and he did not recall in his meetings with the AIG chief executive that the AIG chief executive conveyed any evidence or concern about an acute, impending liquidity crisis at the company.

On Friday, September 12, 2008, AIG began assembling private equity investors, strategic buyers, and sovereign wealth funds to discuss funding and investment options. Also, AIG's then-chief executive officer said he spoke with the then-FRBNY President again about the company's liquidity problems, saying that although the company was pursuing private financing, any solution would require assistance from the Federal Reserve System. Federal Reserve System officials and AIG executives held a meeting, during which the company provided details about its liquidity problems and actions it was considering to address them. According to the FRBNY President, September 12 was the first time the Federal Reserve System received nonpublic information regarding AIG, which indicated AIG was facing "potentially fatal" liquidity problems.<sup>38</sup>

One option discussed at that meeting was whether AIG could borrow from the discount window through its thrift subsidiary. FRBNY officials told us, however, that the thrift only had \$2 billion in total assets and only millions of dollars in assets that could be used to collateralize a loan, which would have been small relative to AIG's overall liquidity needs. According to an FRBNY summary of the meeting, AIG mentioned its plan to become a primary dealer over a 6- to 12-month period, but FRBNY officials determined this was not viable because its liquidity needs were immediate. On the morning of September 13, according to an internal communication, AIG executives asked Federal Reserve System officials about how to obtain an emergency loan under the authority provided in section 13(3) of the Federal Reserve Act. Officials responded that the company should not to be optimistic about such assistance.

---

<sup>38</sup>See testimony for the House Committee on Oversight and Government Reform, January 27, 2010.

---

Over the September 13–14, 2008, weekend, FRBNY officials conducted various analyses related to AIG, including an evaluation of the company’s systemic importance, before the Federal Reserve Board ultimately decided to authorize government assistance on September 16.<sup>39</sup> We found at least one instance of quantitative analysis of the systemic risk AIG posed to the financial system. In this analysis, historical equity returns of AIG were assessed, with a conclusion that the company was not systemically important. However, FRBNY officials told us that this analysis was conducted prior to the September 15 bankruptcy of Lehman and did not take into account market conditions that followed that event. Beyond this example, officials could not say whether any other quantitative analyses were conducted regarding systemic risk posed by AIG. Internal correspondence and documents indicate that officials’ assessment of AIG’s systemic risk relied primarily on qualitative factors. For instance, documents show that officials assessed the potential impact on subsidiaries of the AIG parent company filing for bankruptcy, the potential response of state insurance regulators in that situation, and differences between a failure of AIG and Lehman.

Officials told us the Lehman bankruptcy was a key factor in how they assessed the systemic risk of an AIG failure, given what they believed would be the strain AIG’s bankruptcy would place on financial markets. Officials told us that had the Federal Reserve System prevented failure of Lehman Brothers, they would have reassessed the potential systemic impact of an AIG bankruptcy. A former senior AIG executive expressed a similar idea to us, saying that had AIG’s crisis occurred before that of Lehman Brothers, the Federal Reserve System would have not provided

---

<sup>39</sup>While this report focuses on how the Federal Reserve Board determined AIG posed a systemic risk, in our September 2009 report on TARP ([GAO-09-975](#)), we discussed why the Federal Reserve Board made such a determination. Specifically, the Federal Reserve Board and Treasury said that financial markets and financial institutions were experiencing unprecedented strains resulting from the placing of Fannie Mae and Freddie Mac under conservatorship; the failure of financial institutions, including Lehman; and the collapse of the housing market. The Federal Reserve Board said that in light of these events, a disorderly failure of AIG could have contributed to higher borrowing costs, diminished availability of credit, and additional failures. They concluded that a collapse of AIG would have been much more severe than that of Lehman because of AIG’s global operations, large and varied retail and institutional customer base, and different types of financial service offerings. The Federal Reserve and Treasury said that a default by AIG would have placed considerable pressure on numerous counterparties and triggered serious disruptions in the commercial paper market. Moreover, AIGFP counterparties would no longer have had protection or insurance against losses if AIGFP, a major seller of CDS contracts, defaulted on its obligations and CDO values continued to decline.

---

any assistance to AIG, which would have led to its failure. On September 16, a day after Lehman filed for bankruptcy, an FRBNY official sent a memorandum to the then-FRBNY President and other officials assessing the expected systemic impacts of an AIG failure, including an analysis of the qualitative factors previously discussed. Officials decided that a disorderly failure of AIG posed systemic risk to the financial system, and on that basis, the Federal Reserve Board approved the \$85 billion Revolving Credit Facility.<sup>40</sup> They said the only other viable outcome besides the assistance package would have been bankruptcy.

Although the Federal Reserve System had various contacts and communications about AIG's difficulties in the months preceding aid to the company, officials appear to have not acted sooner for various reasons. FRBNY's then-President has said that because the Federal Reserve System was not AIG's regulator, it could not have known the full depth of the company's problems prior to AIG's September 12 warning. In addition, FRBNY officials told us that from March to September 2008, following the collapse of Bear Stearns, they were intensively involved in monitoring the remaining four large investment banks (Merrill Lynch, Lehman, Goldman Sachs, and Morgan Stanley) not then supervised by the Federal Reserve System. They said the concern was the possibility of another collapse like that of Bear Stearns, and this unusual effort consumed a significant amount of management attention.

---

<sup>40</sup>AIG's lead life insurance regulator also played a role in the final events leading up to the emergency Federal Reserve loan on September 16, 2008. On September 12, the regulator told us, AIG moved about \$1 billion from its life insurance companies to the parent company, under a preapproved agreement for transferring funds throughout the company. By September 15, however, the regulator called a halt to further transfers, saying it needed to better understand the situation. At that point, AIG discussed needing another \$5–7 billion from the life insurance companies. With a company executive saying AIG was at risk of default, the regulator told us it reluctantly approved transfer of \$5 billion on September 16. The regulator told us that this transfer provided AIG with several hours of relief while arrangements on Federal Reserve System assistance were being finalized. The money was later returned, following approval of the Revolving Credit Facility, the regulator said.

---

## As AIG's Needs Became Clearer, Private Financing Failed, Prompting the Federal Reserve to Become More Involved

Following AIG's unsuccessful requests for discount window access, the company and the Federal Reserve System pursued what became a two-phase private-financing effort in advance of the ultimate government intervention.<sup>41</sup> In the week beginning September 15, 2008, AIG faced pressing liquidity needs, and expected to receive rating agency downgrades. The company anticipated this would result in \$13 billion to \$18 billion in new liquidity demands, primarily stemming from collateral postings on AIGFP CDS contracts. The ability to raise private financing was a key issue for AIG because private funding could have reduced or eliminated the company's need for government assistance.<sup>42</sup> Further, as discussed later, the inability to obtain private financing was a condition for Federal Reserve System emergency lending. For the first phase of attempts to secure private financing, which AIG led, the company had developed a three-part plan that envisioned raising equity capital, making an asset swap among its insurance subsidiaries, and selling businesses. In the second phase of attempts to secure private financing, which began on September 15, 2008, FRBNY assembled a team of bankers from two large financial institutions to pursue a syndicated bank loan.<sup>43</sup>

## AIG Attempted to Obtain Private Financing Several Ways

For the first phase, AIG assembled private equity investors, strategic buyers, and sovereign wealth funds over the weekend of September 13–14. These parties considered scenarios ranging from equity investments in AIG life insurance subsidiaries to purchases of AIG assets. In all, we identified at least 14 entities as participating in the first phase (see table 1). This effort identified at least \$30 billion in potential financing—well short of estimated needs that ran as high as \$124 billion.

---

<sup>41</sup>In this discussion, “private” financing refers to nongovernment sources. We do not mean the term in the context of private-versus-public financing in securities markets or securities regulation; for example, a private-versus-public offering of securities.

<sup>42</sup>According to AIG executives, a limiting factor as the company sought private financing was that it had no active securities registration statement, having exhausted its shelf registration capacity when raising capital in May 2008. This meant AIG's range of solutions as its crisis peaked could not include public market offerings. The executives told us, however, that as a practical matter, this may not have been a real constraint because it was not clear that public markets would have been receptive to a debt or equity offering at the time.

<sup>43</sup>A syndicated bank loan is a loan made by a group of banks to one borrower.

**Table 1: Participants in First Phase of AIG Private-Financing Attempt, by Type**

Type of participant	Number
Private equity firms	4
Strategic buyers	4
Investment banks <sup>a</sup>	3
Sovereign wealth funds	2
Advisor <sup>b</sup>	1
<b>Total</b>	<b>14</b>

Source: GAO interviews with private-sector participants.

Note: A private equity firm typically raises capital from investors and borrows from banks to invest in companies for majority or complete control and seeks to improve operations so that the investment can be sold at a gain. A strategic buyer typically invests in a company to complement or expand existing businesses.

<sup>a</sup>One of these investment banks also acted as an advisor to AIG.

<sup>b</sup>The advisor's investment arm considered making an investment.

Throughout the September 13–14, 2008, weekend, private equity firms and strategic buyers weighed investments in AIG's life insurance subsidiaries, although they had concerns about the parent company's solvency and liquidity needs. On September 12, AIG asked an investment bank advisor to assist in contacting potential investors and to provide financial information to these entities to assist in their assessments of whether and under what terms they could invest in AIG.<sup>44</sup> Also on September 12, AIG engaged two investment banks and an advisor to research and identify options to raise \$20 billion in private financing. According to the advisor, it was not certain at the time whether AIG was facing a problem of insolvency or liquidity.<sup>45</sup>

According to participants with whom we spoke, the process at AIG over the weekend consisted of a series of formal and informal meetings, during

<sup>44</sup>In the several weeks preceding September 12, 2008, AIG engaged the investment bank to assist in assessing the company's financial condition. According to investment bank executives, part of their work included developing financial scenarios for AIG based on the impact of different credit rating downgrades. In addition, the executives told us that from September 12–14, the investment bank briefed Federal Reserve System and Treasury officials on AIG's situation.

<sup>45</sup>Solvency is having a positive (or zero) net worth, in which the value of assets exceeds (or equals) liabilities. Liquidity is the ability to convert assets to cash quickly and readily without significant loss.

---

which they discussed potential investments and received briefings from AIG about its financial condition and estimates of its liquidity shortfall. Participants in the process told us there was uncertainty whether any private investment could satisfy AIG's liquidity needs and what those specific needs were. One private equity firm told us that AIG did not provide an agenda for the weekend, and although it said the process became more organized on September 14, the firm did not receive data it ordinarily obtains when considering an investment. According to another private equity firm, AIG did not provide clear direction amid what the private equity firm described as a chaotic environment. This private equity firm added that some bankers expressed frustration that the process could have been less hurried had AIG started it earlier.

As noted, one element of AIG's three-part plan during the first phase contemplated raising equity capital from commercial sources. We identified two proposals the company received. First, on September 14, a private equity firm, a sovereign wealth fund, and an insurance company together made a \$30 billion proposal to AIG. The offer included a private equity investment totaling \$10 billion in exchange for a 52 percent stake in two life insurance subsidiaries. In addition, according to our review, the potential investors included four other elements in their plan.

1. The proposal would have created \$20 billion in liquidity from an exchange of assets between AIG's property/casualty and life insurance subsidiaries. This swap required approval of the New York State Insurance Department (NYSID).
2. The proposal relied on the Federal Reserve System granting AIG access to its discount window for a \$20 billion line of credit, to be secured by bonds from the asset swap.
3. The proposal required that rating agencies commit to maintaining the company's credit rating at AA-.
4. The proposal required replacement of AIG senior management, including the chief executive officer.

A former senior AIG executive said AIG's Board of Directors rejected the proposal because it was an inadequate bid with insufficient private equity contribution and many conditions.



---

Another private equity firm told us that it also made an offer to AIG, proposing to buy an AIG insurance subsidiary at a discounted price of \$20 billion.<sup>46</sup> Like other firms participating in the first phase, the private equity firm determined that investing in one of AIG's life insurance subsidiaries, rather than the parent company, posed less financial risk. AIG rejected the proposal, according to the private equity firm.<sup>47</sup> Our review showed that other private equity firms present over the weekend considered investing in AIG, but no formal proposals resulted. For instance, one private equity firm contemplated a \$10 billion investment in AIG life insurance subsidiaries in exchange for a 30 percent ownership interest, contingent upon additional financing from commercial banks or the Federal Reserve System. Another private equity firm said it considered an investment in AIG but was unable to make an offer given time pressure and its available investment capacity.

The second part of AIG's three-part plan during the first phase was an asset swap. In addition to being incorporated into one of the plans discussed earlier, the asset swap was also a standalone option. The company contemplated an exchange of assets between AIG property/casualty and life insurance subsidiaries to make available \$20 billion in securities to pledge for cash, but this plan was contingent upon approval from NYSID. AIG executives told us they first contacted the then-Superintendent of NYSID late on September 12, 2008, in an effort to assess whether such a swap was feasible. According to our review, NYSID assisted AIG in developing the idea, although it never reached final approval. A condition for approval was that the swap would be part of a comprehensive solution that would include raising equity capital and selling assets—conditions that ultimately were not met. Additionally, state insurance regulators wanted to ensure that the property/casualty companies that would be involved in the plan would still have sufficient capital to protect policyholders after the asset swap occurred. According to a former senior AIG executive, the asset swap would have generated \$20 billion in securities for AIG to use as security for borrowing, yielding the company \$16 billion to \$18 billion in cash proceeds. Toward that end, the company explored repurchase agreements, secured by assets from

---

<sup>46</sup>The private equity firm, as well as one former AIG executive, said the deal also included participation of another private equity firm whose involvement we were unable to confirm.

<sup>47</sup>In our discussions with AIG executives, they recalled that the private equity firm was present, but they could not recall the specific proposal.

---

the swap, with two investment banks.<sup>48</sup> One of the investment banks committed to \$10 billion in such repurchase financing, and it noted that another investment bank was contemplating an additional \$10 billion in repurchase financing. This second investment bank told us, however, that it considered providing the full \$20 billion in repurchase financing to the company. According to executives of the bank, the deal never materialized because certain assets they thought AIG would post as collateral for the financing were unavailable.

For the third part of its plan, AIG or its advisor contacted strategic buyers in an effort to generate cash from asset sales. On September 12, AIG offered to sell its property/casualty business for \$25 billion to another insurance company. However, according to the potential buyer, the deal proved to be too expensive given time pressure. In another potential deal with the same company, AIG revived previous discussions regarding a guarantee of \$5.5 billion of guaranteed investment contracts that AIGFP had written.<sup>49</sup> The guarantee would have allowed AIG to avoid posting \$5.5 billion in collateral in the event of a credit rating downgrade in exchange for a one-time fee. The fee contemplated was in the form of a transfer of life settlement policies from AIG to the insurance company. According to an executive of the insurance company, negotiations surrounding the fee continued until September 15, but the parties could not reach an agreement.

An FRBNY e-mail also showed internal discussions about two other asset sales to other insurance companies—potential purchase of AIG’s Variable Annuity Life Insurance Company for \$8 billion and potential purchase of another AIG subsidiary for \$5 billion. In addition to these possible sales, an AIG advisor told us about a potential \$20 billion deal with a sovereign wealth fund that was considering asset purchases. According to the advisor, the fund’s primary interest was in purchasing tangible assets, such as real estate.

By late in the day on September 14, the first phase of efforts to identify private financing had failed, for reasons including financing terms, time

---

<sup>48</sup>A repurchase agreement is a form of short-term collateralized borrowing.

<sup>49</sup>A guaranteed investment contract is an investment vehicle offered by insurance companies to pension and profit-sharing plans that guarantees the principal and a fixed rate of return for a specified period.

constraints, and uncertain AIG liquidity needs, according to those involved. Two private equity firms indicated that a private solution was not possible without assistance from the Federal Reserve System to assure AIG's solvency. Similarly, according to a former senior AIG executive, potential investors wanted assurances of solvency before making any investments, and the Federal Reserve System was the only entity in a position at the time to provide such assurances. AIG executives with whom we spoke acknowledged that any investments in the parent company would have been risky. In addition, two would-be investors also told us that a weekend was too little time to construct a deal that would usually take at least 4 weeks. As these participants and AIG executives noted, there was not enough time or money to assist the company. Moreover, participants said the company lacked an understanding of its own liquidity needs, and there was insufficient data to support would-be investors' decision making. As table 2 shows, AIG's liquidity needs grew as analysis of the company's financial situation progressed over the weekend.

**Table 2: Estimates of AIG's First-Phase Liquidity Needs, September 2008**

<b>Date</b>	<b>Estimate (dollars in billions)</b>
September 11–12	\$20–40
September 13	30–40
September 14	35–124 <sup>a</sup>

Source: GAO analysis based on review of Federal Reserve System and public records and interviews with participants.

<sup>a</sup>According to FRBNY records, \$124 billion represented the worst-case scenario if all securities lending, repurchase funding, and maturing guaranteed investment contracts became due the week of September 15–19, 2008.

The Federal Reserve System  
Initially Limited Its  
Involvement to Monitoring  
Developments at AIG

Over the weekend of September 13–14, 2008, as AIG attempted to secure private financing, the Federal Reserve System avoided actions that could have signaled to companies or other regulators that it would assist AIG. Officials received AIG requests for Federal Reserve System assistance on at least five occasions during approximately the week leading up to September 14. As noted, one of these instances occurred during a meeting between Federal Reserve System officials and AIG executives on the morning of September 13. A Federal Reserve System internal communication documenting the meeting shows that during a discussion about emergency lending under section 13(3) of the Federal Reserve Act, officials indicated to AIG that an emergency loan would send negative signals to the market. Officials told us that during the meeting, they discouraged AIG from relying on a section 13(3) loan.

---

Meanwhile, an e-mail from an FRBNY official communicated to staff that they should avoid conveying to firms or other regulators that the Federal Reserve System was taking responsibility for AIG.

Although Federal Reserve System officials were downplaying assistance to AIG, records we reviewed show they began considering the merits of lending to AIG as early as September 2 and continuing through the September 13–14 weekend. One communication we reviewed noted that allowing AIG to borrow through the Federal Reserve System’s Primary Dealer Credit Facility could support an orderly unwinding of the company’s positions but questioned whether such assistance was necessary for AIG’s survival.<sup>50</sup> In addition, e-mails on September 13 show officials considering the operational aspects of lending to AIG through the Primary Dealer Credit Facility, including an evaluation of the collateral available for AIG to post against a loan. Reflecting other concerns, a September 14 communication discussed the merits and drawbacks of lending to AIG. The merits included the possibility that Federal Reserve System lending could prevent an AIG bankruptcy and the potential impacts on global markets that could follow. The drawbacks included that such a loan could diminish AIG’s incentives to pursue private financing to solve its problems. Similarly, some staff preliminarily discussed reasons why the Federal Reserve System should not lend to AIG. These staff were concerned that although there could be short-term benefits, such as helping to stabilize the financial system, the potential moral hazard costs would be too great, according to information we reviewed.<sup>51</sup> Federal Reserve Board officials told us that, given insufficient information and the speed at which events unfolded, no written staff recommendation on whether to lend to AIG was ever finalized or circulated to the Federal Reserve Board.

While Federal Reserve System officials considered implications of lending to AIG, they also analyzed the company’s financial condition, including its liquidity position and risk exposures. FRBNY officials told us that staff

---

<sup>50</sup>The Primary Dealer Credit Facility was in effect from March 16, 2008 to February 1, 2010. As noted, it provided loans to primary dealers against eligible collateral.

<sup>51</sup>Moral hazard is, generally, when a party insulated from risk behaves differently than it would behave if it were exposed to the risk. More specifically here, it means that market participants would be encouraged to expect similar emergency actions in future crises, thereby weakening their incentives to properly manage risks and also creating the perception that some firms are too big to be allowed to fail.

---

were instructed to “understand” the nature and size of AIG’s exposures. According to internal correspondence, officials established a team to develop a risk profile of the AIG parent company and its subsidiaries and to gather information, such as financial data. They also worked on a series of memorandums over the weekend highlighting issues at AIG. Much of the analysis focused on the exposures of AIGFP. In addition, records from the weekend show that officials evaluated AIG’s asset-backed securities and CDS portfolio, the company’s systemic importance, and bankruptcy-related issues. According to FRBNY officials, a team from FRBNY’s Bank Supervision Group looked at public information to assess AIG’s condition and, in particular, whether the company’s insurance subsidiaries were a source of financial strength for the company. Officials also met with AIG executives to discuss the company’s liquidity risks. The company provided information detailing the financial institutions with the largest exposures to the company, including credit, funding, derivatives and CDS exposures.

The Federal Reserve System also monitored AIG’s discussions with potential investors and NYSID on September 13–14. As noted, Federal Reserve System officials met with AIG executives on September 13. According to minutes from the meeting, although the company needed financing immediately, asset sales could require 6–12 months to complete. For that reason, as noted in the summary of the meeting, AIG expressed interest in Federal Reserve System lending facilities to support its liquidity needs as it sold assets.

Federal Reserve System records also indicate uncertainty among officials about whether a private-sector solution would be forthcoming over the weekend. For example, on the morning of September 13, Federal Reserve Board and FRBNY officials discussed telling AIG that it could not rely on the Federal Reserve System for financing, so that the company would focus on its own actions to solve its problems. On the night of September 14, a Federal Reserve Board official described two private equity plans under consideration, both of which were conditioned on Federal Reserve System assistance. After AIG had rejected one plan, a question was raised on what would prompt AIG to consider restructuring or a strategic partnership. Further, an e-mail from September 14 shows the view of one official that AIG was unwilling to sell assets it thought would offer profit-making potential in the future, while at the same time attempting to use the situation to its advantage to convince the Federal Reserve System to offer discount window access. According to the official who wrote the e-mail, AIG was avoiding difficult but viable options to secure private financing.

---

As part of its weekend monitoring of private-sector efforts, officials also had discussions with NYSID and AIG about the status of plans being considered. In addition, one FRBNY official told us of a meeting with a private equity firm over the weekend in order to assess whether its plans to finance AIG were genuine. Overall, FRBNY officials told us that they acted as observers to the events unfolding at AIG over September 13–14 and did not participate in any negotiations on private financing. Rather, they told us their primary focus was addressing the Lehman crisis occurring that same weekend. Officials had meetings throughout the weekend with senior executives of various financial institutions about the Lehman situation. During these meetings, the issue of AIG arose. FRBNY officials told us they received assurances from chief executive officers of three financial institutions present that they were working on AIG’s problems and would address the company’s liquidity needs. Although the Federal Reserve System’s own monitoring of the situation that weekend showed AIG was unable to arrange private financing, an FRBNY official told us there was no information calling into question the financial institutions’ assurances that they would handle the AIG situation. Rather, the Lehman bankruptcy on September 15 and its effect on financial markets eventually called the assurances into question, the official told us.

A related issue arose regarding assurances and AIG’s regulators. FRBNY officials said in Congressional testimony that state insurance regulators and OTS had assured them over the September 13–14 weekend that a private-sector solution was available for AIG, and that officials had no basis to question those assurances.<sup>52</sup> State insurance regulators, however, told us no such assurances were given. According to Federal Reserve System officials, they did not consult OTS about AIG’s condition, given the time pressure of events. Further, records we examined indicate that AIG and Federal Reserve System officials themselves communicated the difficulties the company encountered in attempting to obtain private financing over the weekend.

---

<sup>52</sup>See *The Federal Reserve Bank of New York’s Involvement with AIG*, joint written testimony of Thomas C. Baxter, Executive Vice President and General Counsel, and Sarah J. Dahlgren, Executive Vice President, before the Congressional Oversight Panel, May 26, 2010.

---

---

Private-Financing Efforts  
Shifted to a Syndicated Loan

Following the failure of the AIG-led weekend efforts, FRBNY began what became the second phase of the private-financing effort on Monday, September 15, 2008. This attempt moved away from equity investments or asset sales and instead focused on syndicating a loan. FRBNY records we reviewed show that some officials continued to believe on September 15 that AIG had options to solve its problems on its own. Nonetheless, FRBNY called together a number of parties and urged them to come up with a private loan solution. According to our review, participants in the meeting included AIG, Treasury, three investment banks, an AIG advisor, an FRBNY advisor, and NYSID. The then-FRBNY President initiated this effort late in the morning of September 15 and requested that the two investment banks identify a commercial bank loan solution for AIG. According to investment banks we interviewed, the FRBNY President did not specify any deadlines or provide special instructions to the financial institutions but asserted that government assistance was not an option.

One of the investment banks told us that participants focused on four areas during the second phase—assessing liquidity needs, valuing assets, creating loan terms, and identifying potential lenders. Participants contemplated a \$75 billion syndicated loan, consisting of \$5 billion contributions from 15 financial institutions. According to FRBNY, the banks envisioned that AIG would need 6 months to sell assets and repay the loan. While the banks worked to create a loan package, FRBNY focused on assessing the exposures to AIG of regulated financial entities, nonbank institutions, and others. Late on September 15, according to our review, the participants reported to the then-FRBNY President about difficulties in securing a loan, to which the President responded with a request that they continue—but this time, also considering a potential government role. According to a former Treasury official, the then-FRBNY President said the Federal Reserve System would provide \$40 billion in financing for AIG, but the participants would have to find the remainder. This was the first instance we identified in which officials indicated externally that they would consider government assistance. According to an investment bank, the participants then continued discussions. Nonetheless, the loan effort failed. By the night of September 15, officials concluded private firms could not find the resources to solve the problem, the former FRBNY President told us. The next day, the then-FRBNY President ended the second phase of attempts to find private financing for AIG. The former President told us he could not recall the first mention of government intervention, but that he believed the possibility of government assistance was discussed with the Federal Reserve Board and Treasury on the night of September 15.

---

Participants and FRBNY officials provided varying explanations for why the second phase failed. According to one of the investment banks, AIG's liquidity needs at the time exceeded the value of any security to back a loan. Therefore, the participants on September 15 did not attempt to line up syndication partners. In addition, one senior AIG executive expressed the view that the Federal Reserve System waited too long to understand and act on the company's problems. FRBNY officials, however, cited a desire by the banks to protect their finances amid general market turmoil that was exacerbated by the Lehman bankruptcy. They added that private-sector collateral concerns notwithstanding, the collateral AIG used to back the \$85 billion Revolving Credit Facility fully secured the Federal Reserve System to its satisfaction, a condition of section 13(3) emergency lending. On the morning of September 16, 2008, the then-Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the then-FRBNY President held a conference call regarding AIG. According to an FRBNY official on the call, the three agreed that the Federal Reserve Board should approve lending to the company. The former FRBNY President told us nothing more could have been done to secure private financing, as the extent and severity of AIG's liquidity needs, coupled with mounting panic in financial markets that was accelerated by the failure of Lehman, meant private firms had no capacity to satisfy AIG's needs. Later that day, after the two failed efforts at private financing, the Federal Reserve Board authorized FRBNY to enter into the Revolving Credit Facility with AIG to avoid what officials judged to be unacceptable systemic consequences if AIG filed for bankruptcy.

---

### The Federal Reserve Offered AIG Help in Avoiding Bankruptcy, and AIG Made the Final Decision to Accept Government Assistance

By September 12, 2008, as AIG headed into the weekend meetings aimed at identifying private financing, the company had also begun considering bankruptcy issues, as it faced possible failure during the week of September 15. According to a former senior AIG executive, around September 12, the company engaged legal counsel to begin preparations for a possible bankruptcy. As noted, AIG also gave a presentation to FRBNY officials on September 12, which included information about possible impacts of bankruptcy. After AIG's presentation, FRBNY officials began their own assessment of the prospect and possible effects of AIG's failure, focusing on the systemic consequences of bankruptcy and how the legal process of filing might unfold. On September 14, FRBNY held a discussion about AIG with risk managers of an investment bank as well as the Office of the Comptroller of the Currency. According to a meeting record, AIG would have been forced to file for bankruptcy on September 15, absent private financing to meet its liquidity demands.



---

Officials' concern about the systemic effect of an AIG bankruptcy included whether such a filing would have prompted state insurance commissioners to seize AIG insurance subsidiaries. According to FRBNY officials, regulatory seizures of AIG's insurance subsidiaries following a bankruptcy filing would have complicated any efforts to rescue the company because AIG's businesses were interconnected in areas such as operations and funding. Therefore, according to the officials, discrete seizures by individual state insurance regulators would have made bankruptcy unworkable. In addition, foreign authorities were becoming concerned, and bankruptcy could have resulted in insurance regulators worldwide seizing hundreds of AIG entities. According to the officials, they looked at the experience of previous insurance company failures, but none were comparable to AIG's situation.

According to our review, both AIG executives and a number of government officials expressed concerns about possible seizures of AIG assets shortly before the Federal Reserve Board authorized the Revolving Credit Facility. For example, at an AIG Board meeting on September 16, an AIG executive stated that NYSID would seize the company's New York insurance units if AIG went into bankruptcy. A former senior AIG executive told us that on September 16, at least three state insurance regulators said they would seize AIG insurance subsidiaries in their states if the parent company filed for bankruptcy. In a number of records we examined, government officials also stressed the likelihood that insurance subsidiaries would be seized, particularly those experiencing financial difficulties.<sup>53</sup>

State insurance regulators were less certain of the likelihood of seizure, according to our review. A former state insurance official told us that he cautioned FRBNY officials that seizures were highly likely. AIG's lead life insurance regulator told us it considered the possibility of intervention, but added that states generally have an incentive not to place insurance

---

<sup>53</sup>Among them, a memorandum sent to the then-FRBNY President on September 16 from an FRBNY official noted that in the event of bankruptcy of the AIG parent company, state insurance regulators would likely act to liquidate or rehabilitate the company's regulated insurance subsidiaries in financial distress. The former President said in written testimony January 27, 2010, for the House Committee on Government Oversight and Reform that an AIG bankruptcy filing would have led insurance regulators worldwide to seize the company's insurance subsidiaries. In another written testimony, for the Congressional Oversight Panel on May 26, 2010, a Treasury official highlighted that an AIG bankruptcy filing would have resulted in seizure of AIG's insurance subsidiaries, with severe effects.

---

companies into receivership, as that has negative connotations that could diminish companies' value. Several state insurance officials overseeing AIG's property/casualty and life insurance businesses told us that bankruptcy of the AIG parent company would not have required them to act as long as the insurance subsidiaries were solvent, and they did not foresee insolvency. Two state insurance regulators also told us they did not communicate to the Federal Reserve System or AIG that they would intervene in the company's subsidiaries. State insurance officials said that in the past, their approach has been to monitor the situation when a parent company filed for bankruptcy—for example, Consecro, Inc.—because statutory provisions protected insurance company assets.<sup>54</sup>

In offering to assist AIG, the Federal Reserve Board sought specifically to give the company the means to avoid a bankruptcy filing because of concerns about systemic risk, officials told us. Our review showed that beyond offering a way to avoid such a filing, the Federal Reserve Board had no direct role in the AIG board's consideration of bankruptcy on September 16. On that day, an AIG board meeting had already been scheduled at 5 p.m. to discuss the possibility of bankruptcy, according to a former senior AIG executive. After the Federal Reserve Board offer earlier in the day, the meeting became a discussion about government assistance versus filing for bankruptcy, the former executive said, which was described as the only available alternative. According to information we reviewed, the AIG board's view was that the terms of the government's offer were unacceptable, given a high interest rate and the large stake in the company—79.9 percent—the government would take at the expense of current shareholders. AIG executives telephoned FRBNY officials during the AIG board meeting in an effort to negotiate terms of the Revolving Credit Facility, but the FRBNY officials said the terms were

---

<sup>54</sup>Consecro, Inc., was a holding company for a group of insurance companies operating throughout the United States, which developed, marketed, and administered supplemental health insurance, annuities, individual life insurance, and other insurance products. On December 17, 2002, the company and certain of its noninsurance subsidiaries filed for voluntary bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. The company emerged from bankruptcy protection on September 9, 2003, as CNO Financial Group, Inc. For the year ended December 31, 2002, Consecro reported a net loss of \$7.8 billion on revenues of \$4.5 billion.

---

nonnegotiable and that the company had no obligation to accept the offer.<sup>55</sup>

During the AIG board meeting, AIG's advisors also discussed implications of a potential bankruptcy filing. This discussion included the value of potential future asset sales and the value of the company's subsidiaries generally, as well as legal advice on what the company's fiduciary duties were in any such event. As part of its bankruptcy issues consideration, AIG's board also contemplated debtor-in-possession financing from an investment bank.<sup>56</sup> But AIG told us its financial adviser believed such financing would have been difficult in light of then-current market conditions, and a former senior AIG executive told us AIG would have required debtor-in-possession funding of unprecedented size at a time when markets were volatile.

The AIG board decided that government assistance was the best option because that would best protect AIG's value, according to records we reviewed. Additionally, a former senior AIG executive told us that AIG accepted the Federal Reserve System's offer of assistance because of uncertainty about how bankruptcy proceedings would unfold. Ultimately, 10 of the 11 directors voted to accept the federal loan offer.

AIG executives and advisors stressed to us that the only matter presented for consideration that day was whether to accept the Federal Reserve System's loan offer. As part of that, however, directors considered issues and implications that might arise from a bankruptcy filing, they said. The executives said that at that point, the company was not prepared to file for bankruptcy if it did not accept the loan, and no bankruptcy petition had been prepared for filing or directed to be prepared.

AIG executives told us that after accepting the Federal Reserve System loan, they did not consider bankruptcy issues again but rather focused on devising solutions to the company's problems. FRBNY officials told us

---

<sup>55</sup>Records we reviewed indicate the call spanned 10 minutes. During the call, FRBNY officials told AIG that it must decide before 8 p.m. that day whether to accept the offer, so that funds could be advanced immediately to avoid defaults the following day.

<sup>56</sup>According to the American Bankers Association, debtor-in-possession financing in bankruptcy proceedings is new debt issued for operating purposes that is senior to all other debt issued before the firm entered Chapter 11.

---

that as a practical matter, AIG's acceptance of the Revolving Credit Facility had effectively precluded bankruptcy as an option, at least in the short term, because it would have immediately put the funds that FRBNY had loaned to AIG at risk. Nevertheless, FRBNY continued to examine bankruptcy as an alternative to additional government assistance over the next several months following the establishment of the Revolving Credit Facility, according to records we examined. For instance, in briefing slides circulated to FRBNY officials on October 7, one FRBNY staff member argued that bankruptcy was the least-cost resolution for AIG, even though the company continued to pose systemic risk. Also, Federal Reserve Board staff began gathering data on the systemic implications of an AIG bankruptcy and devising a contingency plan to protect the banking system.

A bankruptcy advisor to FRBNY told us that officials continued to discuss bankruptcy in lieu of federal assistance throughout the fourth quarter of 2008 and into early 2009. Internal FRBNY briefing slides from February 2009 show consideration of the consequences and costs of bankruptcy versus further government assistance, including restructuring of the government's TARP investment in AIG and additional capital commitments for AIG's subsidiaries. The assessment concluded that bankruptcy costs would reflect loss of the government's TARP investment in preferred stock, plus any additional losses from unpaid portions of the Revolving Credit Facility.<sup>57</sup> It further noted that AIG would be more likely to repay the government if it received more assistance than if it filed for bankruptcy. Moreover, due to AIG's interconnections with other financial institutions, bankruptcy had other potential costs to the government, such as the possibility that other institutions with exposure to AIG would need subsequent government support. There could also be a run on the life insurance industry, the assessment noted. The Federal Reserve Board also weighed effects of bankruptcy when considering additional government assistance, according to minutes of a Federal Reserve Board meeting on February 19, 2009. The minutes show that given the potential costs of bankruptcy to AIG's insured parties, the governors generally agreed that stabilizing AIG with more government aid was the only option at that point, notwithstanding concerns over potentially increased taxpayer exposure.

---

<sup>57</sup>There would have been losses on the Revolving Credit Facility to the extent collateral FRBNY had taken was insufficient to cover any amounts AIG had borrowed but not repaid, officials told us.

---

In addition to these concerns, FRBNY, its bankruptcy advisor, and state insurance regulators also cited other factors that complicated the viability of bankruptcy for either the AIG parent company or its subsidiaries. First, according to the advisor, AIG's Delaware-based federal savings bank, as well as the company's foreign and domestic insurance subsidiaries, could not file for bankruptcy protection because they were not eligible to be Chapter 11 debtors. State insurance regulators told us that if AIG failed, then the parent company, its AIGFP unit, and other entities would have filed for bankruptcy, but that state insurance laws prevented the parent company from accessing insurance subsidiary assets to satisfy claims of any entities other than policyholders.<sup>58</sup> FRBNY's advisor told us that the legal limitations on any partial bankruptcy were as important to assessing whether to provide assistance to AIG as the issues concerning the company's close connections with other entities.

Second, AIG's parent company had guaranteed many liabilities of its subsidiaries. For example, AIGFP relied on the strength of the parent company's finances and credit ratings. As a result, according to FRBNY's bankruptcy advisor, a bankruptcy of either the parent or AIGFP would have constituted a default under AIGFP's CDS contracts, potentially leading to termination of the contracts and additional demands for liquidity. As noted in a document circulated among FRBNY officials on October 7, 2008, a default on AIGFP's CDS contracts could have involved a large number of the company's counterparties. Moreover, according to an advisor, the CDS contracts were defined as agreements that would have been exempt from automatic stay under the U.S. bankruptcy code.<sup>59</sup> As a result, AIGFP's CDS counterparties could have terminated their contracts notwithstanding an AIG bankruptcy filing, obligating AIG to pay the counterparties early

---

<sup>58</sup>As to whether there was any actual consideration or analysis of which AIG entities might have filed for bankruptcy, FRBNY's bankruptcy advisor told us that in a corporate family filing, each eligible entity files unless there is a strong reason not to. In AIG's case, this would have included both the parent company and AIGFP. However, a debtor-in-possession lender as well as a Chapter 11 budget are needed before determining which entities would file. According to the bankruptcy advisor, this is because solvent subsidiaries ideally would not file.

<sup>59</sup>"Automatic stay" prohibits a creditor from acting to collect a debt, repossess collateral, or perfect its security interest (protect against competing claims) after a borrower has filed a bankruptcy petition. See GAO, *Bankruptcy: Complex Financial Institutions and International Coordination Pose Challenges*, [GAO-11-707](#) (Washington, D.C.: July 19, 2011).

---

termination amounts on those transactions.<sup>60</sup> FRBNY's bankruptcy advisor told us that neither AIGFP nor the parent company, as guarantor of AIGFP's obligations, would have had the funds to pay the cost of early terminations of all such positions in AIGFP's derivatives portfolio, including CDS and other types of derivatives. As discussed earlier, FRBNY briefing slides indicated that AIG's bankruptcy at the time would have resulted in \$18–24 billion in funding needs. Also, because some of the company's CDS counterparties were European banks, the potential economic loss from a default could have affected the global banking system.

Another concern underlying officials' bankruptcy considerations was whether refusing to provide additional support for AIG beyond the original aid would have hurt the government's reputation or market confidence, according to records we reviewed. For instance, one memorandum notes that allowing AIG to fail after providing the Revolving Credit Facility would have caused loss of market confidence in government support, which could have had systemic consequences. FRBNY officials told us that a similar concern existed about preserving confidence in policymakers and that withdrawing from the Federal Reserve System's strategy only weeks after the Revolving Credit Facility was extended would have been extraordinary.

There were similar confidence issues with respect to AIG that contributed to decisions on assistance. An FRBNY advisor told us there were questions of whether AIG could survive a bankruptcy proceeding because the company had built its business model on long-term customer confidence. For example, the advisor noted that during the fall of 2008, customers were saying they would not renew their coverage without a solution in place to address AIG's problems. Another advisor opined that if AIG filed for bankruptcy, officials could have avoided moral hazard and criticism over use of additional public funds. However, bankruptcy also could have led to further market deterioration at a time when there was already uncertainty about Lehman and other financial issues, the advisor said.

---

<sup>60</sup>According to FRBNY's bankruptcy advisor, any early termination of AIGFP's CDS contracts following bankruptcy of AIGFP or the AIG parent company were subject to the terms of the International Swap Dealers Association (ISDA) Master Agreements. ISDA is the trade association for the swap industry, which among other things, promotes the standardization of terminology, contracts, and practices. An event of default, like bankruptcy, would have given each counterparty the right, but not the obligation, to terminate early. In the event of early termination, the ISDA Master Agreement provides guidance on determining an early termination amount.

---

FRBNY officials told us they continued to consider contingency plans for AIG, including the desirability of bankruptcy, until around August 2009, by which time new board members and a new chief executive had been named. According to officials, the contingency planning reflected overall concerns about financial market stability that persisted beyond the September 2008 weekend of the Lehman bankruptcy and AIG crisis. For example, officials told us that between September 16, 2008, and January 2009, insurance companies other than AIG lost approximately \$1 trillion in market value, and many of them were on the verge of bankruptcy. By the end of 2009, however, the company's situation had improved to a point that bankruptcy ceased to be a focus in consideration of options, according to the officials.

---

**Given the Crisis, There Was Little Time to Consider Alternatives for Initial Aid, but AIG and the Federal Reserve Considered a Range of Options for Later Assistance**

FRBNY officials told us that overwhelming pressure to act quickly at the time the Revolving Credit Facility was established prevented them from thoroughly considering other options. They said this pressure was the result of three factors:

- They did not understand the size and nature of AIG's liquidity needs until AIG's presentation on September 12, 2008.
- AIG, as noted, faced a potential credit rating downgrade on September 15 or 16 that would have generated large demands for cash.
- The company was unable to roll over commercial paper at maturity, so large cash commitments would have been due on September 17.<sup>61</sup>

Officials told us that given these constraints, there was no time to engage advisors and fully explore options. Still, records we examined show that some alternatives were considered. An FRBNY staff memorandum from September 13, 2008, cited two alternatives to the Revolving Credit Facility. One was to lend to AIG through an intermediary to which a Reserve Bank had the authority to lend, such as a commercial bank or primary dealer. Officials told us the problem with this idea was uncertainty whether an intermediary would execute any plan and under what terms. The other idea

---

<sup>61</sup>Commercial paper refers to short-term obligations, with maturities ranging from 2 to 270 days, that corporations or other institutional borrowers issue to investors. Commercial paper is generally paid by rolling-over into new short-term paper.

---

was to provide financing to AIG from Treasury or NYSID. Officials told us, however, that at that time, Treasury had no authority to offer assistance and NYSID did not have the necessary funds.

There was also discussion before the Revolving Credit Facility of potential financing through the FHLB system. FRBNY e-mails on September 15, 2008, show consideration of whether AIG could secure FHLB financing through its insurance subsidiaries, which as noted earlier, AIG itself had contemplated over the summer of 2008. The e-mails note that AIG's federal savings bank was a member of the FHLB of Pittsburgh and indicate that the FHLB of Dallas was willing to lend to AIG against high-quality collateral.<sup>62</sup> Nevertheless, FRBNY officials said the time constraints prevented meaningful exploration of solutions other than to either let AIG fail or to provide the emergency loan.

In the week following establishment of the Revolving Credit Facility, officials began their own assessment of AIG's condition before considering options for additional assistance. Previously they had relied on information from AIG and those involved in private financing efforts. Records we reviewed show that on September 17, 2008, the day after AIG accepted the Revolving Credit Facility, FRBNY had a team at AIG to monitor collateral valuation practices, risk management, and exposures of various subsidiaries. According to FRBNY officials, there were two main objectives during that first week: (1) to forecast AIG's liquidity situation to better understand the company's needs moving forward and (2) to verify that the Revolving Credit Facility was secured and that AIG's draws against it did not exceed the value of posted collateral. FRBNY officials said that they wanted to develop their own views on these matters and engaged three advisors for assistance during that week.

---

<sup>62</sup>We found inconsistent accounts on the FHLB matter. The e-mail also notes that AIG had a longstanding application for three insurance subsidiaries to become members of the FHLB of Dallas. AIG executives with whom we spoke said that they did not know if AIG ever formally approached the FHLB system. An official of the FHLB of Dallas told us there had been on-and-off discussions with the AIG parent company over several years about membership. The contacts began before the crisis and continued until early 2009, when both AIG and the bank agreed not to pursue membership. In any case, FHLB was never a strong option, FRBNY officials told us. In general, FHLB lending was meant to target a particular subsidiary, and was not intended to assist something like the entire AIG complex. In addition, in AIG's case, the base of capital to support any loan was small. Thus, FHLB credit would not have been an alternative solution to Federal Reserve System lending but would have added complications, the officials said.



---

Following initial assessments, FRBNY and its advisors shifted attention to considering additional options for AIG. According to FRBNY officials, they already had begun to think about other ways to provide aid they believed AIG would need while still in the process of drafting documents for the Revolving Credit Facility. For that reason, officials said, they drafted a credit agreement for the facility that would allow them to make changes in government support for AIG without the company's consent.<sup>63</sup> FRBNY officials said their general approach in considering options was to have AIG bear a cost for any benefit received, so that the company had a strong economic incentive to repay assistance. According to these officials, FRBNY had no interest in providing funds beyond the initial Revolving Credit Facility unless the clear purpose was to stabilize the company.<sup>64</sup> Also, the officials said they did not want aid to create negative incentives in the company that could create reliance on government protection, and they were mindful of rating agencies' concerns. Further, avoiding arrangements that created a continuing relationship with AIG was important.

An FRBNY advisor told us that this approach also included trying to contain the problems at AIGFP. FRBNY officials told us that in general, the process for developing options, given the objectives cited previously, was to brainstorm ideas while taking note of applicable constraints or barriers. In the end, the available options narrowed to essentially the plans that were implemented.

As a Number of Options were Considered, Planning Relied on AIG Asset Sales

FRBNY officials said that in developing options, one element remained constant—the expectation that AIG's source of repayment for its emergency lending would be through liquidation or sale of whole subsidiaries, rather than through company earnings. Officials did not consider company earnings alone to be sufficient in light of AIG's needs to reduce its size and stabilize itself through recapitalization. Further, the

---

<sup>63</sup>For example, section 8.17 of the agreement, *Alternative Financing Structure*, provides that “[i]f, following the Closing Date, the Lender identifies to the Borrower an alternative financing structure which provides benefits to the Borrower equivalent to those provided under this Agreement without material detriment to the Borrower, and complies in all material respects with applicable limitations imposed by law or agreement, the Borrower will, and will cause its Subsidiaries to, take such steps as the Lender may reasonably request to implement such alternative structure.”

<sup>64</sup>According to FRBNY officials, this approach followed a number of requests for funds AIG made in the days following extension of the Revolving Credit Facility.

---

officials told us that while the private-sector lending plan of September 15, 2008, contemplated liquidating the company in 6 months, they were doubtful that could be achieved.<sup>65</sup> According to these officials, liquidation over a short period would have led to additional credit rating downgrades, furthering concerns about AIG's rating-sensitive business model.<sup>66</sup>

After the initial provision of aid, AIG's liquidity problems remained and the original terms of the Revolving Credit Facility contributed to higher debt costs. Officials were concerned the company's credit ratings would be lowered, which would have caused its condition to deteriorate further. There were also continuing concerns about AIG's solvency. As discussed in October 2008, market doubts about solvency stemmed from concerns about liquidity, the company's exposure to RMBS and asset-backed securities (via its CDS transactions), and the impact of AIG's difficulties on the business prospects of its insurance subsidiaries. FRBNY officials noted that in addition to its own particular problems, AIG also was facing the same difficulties as other financial institutions at the time, such as the loss of access to the commercial paper market.

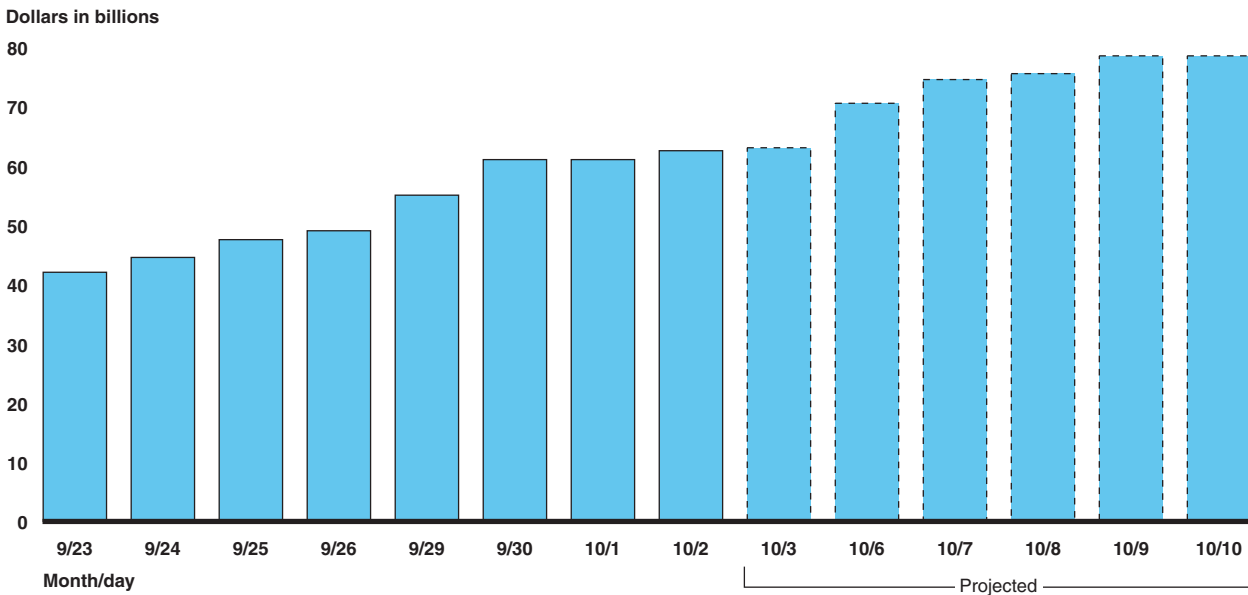
In the weeks following the announcement of the Revolving Credit Facility, AIG's actual and projected draws on the facility grew steadily (see fig. 2). AIG used almost half the facility by September 25 and was projected to begin approaching the \$85 billion limit by early October. Ultimately, AIG's actual use of the facility peaked at \$72.3 billion on October 22, 2008.

---

<sup>65</sup>FRBNY officials told us that after the Revolving Credit Facility, they neither considered private equity financing as an option to assist AIG nor contacted any of the firms that participated in the first phase of efforts to identify a private-sector solution for AIG. They said FRBNY advisors reported it was unlikely a private-sector entity would replace a portion of the FRBNY's commitment without demanding that FRBNY release its liens on a substantial portion of collateral held. Officials told us that this view was borne out when a commercial bank offered a letter of credit conditioned on unencumbering significant AIG assets.

<sup>66</sup>According to FRBNY officials, the rating agencies would not maintain A-rated debt for a company planning to liquidate in 6 months. As a result, they said, planning always contemplated there being a surviving company that could be rated. This is what allowed the rating agencies to maintain their ratings on a company that was substantially over-leveraged, the officials said.

**Figure 2: Actual and Projected Cumulative Draws on Revolving Credit Facility, as of October 2, 2008**



Source: FRBNY.

In response to AIG’s continuing difficulties, FRBNY officials told us that they considered a range of options leading up to the November 2008 restructuring of government assistance.<sup>67</sup> However, our review identified that the first possibility for modifying assistance to AIG came from the private-sector. We found that on September 17, 2008, a consultant contacted the Chairman of the Federal Reserve Board and the then-FRBNY President to raise an idea, suggested by a client, to form an investor group that was willing to purchase about \$40 billion of the \$85 billion Revolving Credit Facility. The client said such a purchase would be advantageous to the Federal Reserve System because it would provide a positive signal to financial markets and could transfer some of the risk of the loan to the private parties, whose involvement would also demonstrate that the Revolving Credit Facility had commercial appeal. Federal Reserve Board officials told us that this idea, which came only days after the failure to obtain private financing for AIG, did not develop further. Earlier, as AIG’s board contemplated government assistance on

<sup>67</sup>According to one FRBNY advisor, the Revolving Credit Facility did not provide enough liquidity to fully address AIG’s needs, so the choice presented was increasing the amount available under the facility or considering other approaches.

---

September 16, the former FRBNY President told the company he was willing to consider an offer for private parties to take over the credit facility. The President characterized the idea as a preliminary offer and told us he understood one feature was to make the investors' \$40 billion investment senior to the government's interest. That would have significantly increased the risk of the FRBNY loan, making the Reserve Bank more vulnerable to a loss, the former President said. He said allowing FRBNY's interest to become subordinate to that of private investors would not have been in the best interest of taxpayers.

During October 2008, the Federal Reserve System considered options that included what became ML II and ML III, as well as an accelerated asset sales process and government purchases of AIG's life insurance subsidiaries. As discussed earlier, officials expected that AIG would have to divest assets to generate cash to repay the government's loan. Toward that end, the Federal Reserve Board asked staff to encourage AIG to sell assets with greater urgency, according to information we reviewed from October 2008. In addition, as FRBNY briefing slides from October 2, 2008, show, officials contemplated other options, including financial guarantees on the obligations of AIGFP and its CDS portfolio, increasing the \$85 billion available under the Revolving Credit Facility, and becoming the counterparty to the company's securities lending portfolio (the latter of which was acted upon, with the Securities Borrowing Facility). FRBNY officials also considered a proposal to directly support AIG's insurance subsidiaries, to preserve their value, according to the October 2 slides. The presentation notes that these potential support actions would include "keepwell" agreements and excess-of-loss reinsurance agreements, which would ultimately terminate upon sale of the subsidiary.<sup>68</sup> It further noted that this approach would have allowed officials to address credit rating concerns by severing the link between the ratings of AIG's parent and its subsidiaries.

---

<sup>68</sup>According to the document, in a keepwell agreement, the Federal Reserve System would agree to maintain a minimum level of net worth, risk-based capital or other appropriate measure, to ensure insurance company credit ratings remained at their existing levels. An excess-of-loss reinsurance agreement would provide coverage, subject to a specified limit, if the insurance subsidiary failed to make a payment on a claim.

---

## Some Potential Options Were Not Possible

When considering options for AIG, FRBNY officials said they also took into account legal barriers, which eliminated some of the alternatives contemplated, such as guarantees, keepwell agreements, and ring-fencing of AIG's subsidiaries.<sup>69</sup> Under section 13(3) of the Federal Reserve Act, a Reserve Bank's authority did not extend beyond making loans authorized by the Federal Reserve Board that were secured to the Reserve Bank's satisfaction. Moreover, officials told us they had no authority to issue a guarantee. In mid-October, Federal Reserve Board and FRBNY staff discussed options, such as a guarantee or keepwell agreement, with Federal Reserve Board staff being opposed to these options. The staffs also discussed the possibility of Treasury providing such arrangements and whether these options were important in case of a credit rating downgrade. The issues were whether the government could protect the value of the AIG insurance subsidiaries that collateralized the FRBNY credit facility and prevent the abrupt seizure of those companies by state insurance regulators. As for ring-fencing, officials told us it was not viable due to time constraints and the lack of a legal structure to facilitate it. An FRBNY advisor told us that Treasury may have been able to provide a guarantee to AIG but that the amount of any guarantee would have been subject to limitations. The advisor added that the guarantee also raised moral hazard issues.

As Federal Reserve System officials continued to consider the best approach for AIG, other relief became available. In late October 2008, some AIG affiliates began to access the Federal Reserve System's newly created Commercial Paper Funding Facility. The Emergency Economic Stabilization Act of 2008, enacted the same month, gave Treasury the authority to make equity investments, which it used to make its \$40 billion investment in AIG in November 2008. Meanwhile, according to records and interviews with FRBNY officials, AIG proposed plans—including the provision of additional government funds to purchase CDOs that were the subject of the company's CDS contracts and a repurchase facility with the government—in which AIG would purchase assets in a transaction similar to what ML III did. The officials told us that while they aimed to stem AIG's liquidity drains, they also wanted to limit erosion of the company's capital, and a repurchase facility would have jeopardized that objective. In addition, the repurchase facility would have placed FRBNY in a

---

<sup>69</sup>Ring-fencing is a strategy used to isolate specific assets, thus creating a protective "ring" around them.

---

continuing relationship with AIG, which FRBNY officials told us was generally an unwanted outcome for any option. Ultimately, the assistance provided to AIG in the 2 months following the Revolving Credit Facility included the Securities Borrowing Facility, ML II and ML III, restructuring of the Revolving Credit Facility's terms, the Commercial Paper Funding Facility, and assistance from Treasury under TARP.<sup>70</sup>

Before the March 2009 restructuring of government assistance, FRBNY and its advisors continued to consider more possibilities for assisting AIG, in particular, for helping it sell assets. According to one advisor, AIG faced a number of challenges in the months leading up to this second restructuring of government assistance. For example, AIG was expecting a loss for the fourth quarter of 2008 of \$40 billion, which was \$15 billion more than its loss in the previous quarter. (The actual loss AIG reported was \$61.7 billion, which was reported at the time as being the largest quarterly loss in U.S. corporate history.) In addition, AIG's asset-sale plan was under pressure from low bids, delays, and limited interest from buyers who lacked financing in a fragile credit market. As a result of these and other issues, FRBNY officials expected AIG to receive a credit rating downgrade. In response, both the company and FRBNY considered a number of new options. According to company records, AIG considered a package of options that included asset and funding guarantees, a debt exchange to reduce the Revolving Credit Facility, and recapture of fees the company paid on the Revolving Credit Facility worth \$1.7 billion plus interest. Ideas of FRBNY or its advisors included additional TARP investments by Treasury, \$5 billion in guaranteed financing for AIG's International Lease Finance Corporation, and nationalization of the company. The latter, as noted in the records of an advisor, included provisions for winding down AIGFP, converting Treasury's preferred stock investment under TARP into common stock, and providing government guarantees of all AIG obligations.<sup>71</sup>

---

<sup>70</sup>FRBNY officials told us that there were mixed reactions from AIG regarding ML II and ML III. Some at AIG did not want to lose the profit-making potential of certain assets they viewed as valuable, while others were relieved that the Federal Reserve System provided the solutions.

<sup>71</sup>The advisor noted in briefing slides from February 23, 2009, that although nationalization posed a number of risks and issues, it simplified certain aspects of the AIG situation. For instance, it would have provided a solution for AIGFP, prevented credit ratings downgrades, and addressed complex restructuring issues that would no longer have been relevant.

---

FRBNY and its advisors continued to develop options after the restructuring on March 29, 2009, but that was the last time the Federal Reserve Board formally authorized assistance for AIG, as the company's prospects began to stabilize.<sup>72</sup> According to records we reviewed, these options included creation of a derivatives products company with a government backstop to engage in transactions with AIGFP's derivative counterparties and separating AIGFP from the AIG parent company to mitigate risks the subsidiary posed.

According to FRBNY officials, their general attitude toward AIG and consideration of options in the months following the Revolving Credit Facility was to listen and observe, trying to see how the firm was attempting to solve its problems. This approach sometimes meant they did not share information or plans with AIG—for example, when they were considering details for ML III or expected contingencies if the government decided not to provide additional support for the company. AIG executives described their relationship with FRBNY as collaborative and said that FRBNY officials did not deter the company from proposing solutions. They also noted there was frequent contact between the company and FRBNY.

Overall, FRBNY officials told us that they led the development of options, while relying on three advisors for expertise in designing structures and analyzing scenarios. FRBNY engaged advisors primarily for evaluation of technical details, as staff did not have the expertise to conduct the depth of analysis and modeling required, for example, in creating ML II and ML III. FRBNY officials also told us they gave guidance to AIG while focusing on options that would stabilize the company and provide repayment of the government assistance—although those goals were not always aligned. In mid-October 2008, for instance, AIG approached officials about the company's idea for the repurchase facility noted earlier. FRBNY officials said they told the company not to pursue that course but to continue

---

<sup>72</sup>Although the Federal Reserve Board authorized additional lending for the March 2009 restructuring, the plan was not implemented. It involved securitizing cash flows from certain AIG domestic life insurance companies. According to FRBNY officials, the insurance companies were valuable, but AIG had difficulties finding buyers amid a volatile market. The plan contemplated long-term notes and partial repayment of the Revolving Credit Facility from FRBNY's extension of credit to the insurance companies. FRBNY officials told us they had concerns about maturity of the notes, but as markets began recovering by the summer of 2009, there was less of a need for this option.

---

attempts to negotiate terminations with its CDS counterparties.<sup>73</sup> Officials said that they were in a good position to assess ideas AIG proposed because they had begun work related to ML II and ML III in the weeks after the establishment of the Revolving Credit Facility.

---

### Credit Ratings Were a Key Consideration in AIG Assistance

Although the performance of credit rating agencies during the financial crisis has drawn criticism, Federal Reserve System officials said AIG's credit ratings were central to decisions about assistance because rating downgrades could have triggered billions of dollars in additional liquidity demands for the company.<sup>74</sup> Downgrades could also have jeopardized AIG's asset sales plan and repayment of government aid, if a downgrade led to events that significantly reduced the value of AIG assets. As a result, FRBNY joined with AIG to address rating agency concerns throughout the course of government assistance to the company.

Beginning in late 2007, AIG's exposure to the subprime mortgage market and its deteriorating derivatives portfolio raised concerns among rating agencies, rating agency executives told us. In February 2008, AIG announced a material weakness in the valuation of its CDS portfolio, leading Moody's Investors Service to lower its ratings outlook for AIG

---

<sup>73</sup>In the end, AIG was not successful in negotiating a resolution to its CDS crisis with the counterparties. At the time, asset values were falling, and in order to protect themselves from falling values and general market turmoil, the counterparties did not terminate their CDS contracts with AIG. We spoke with one large AIG counterparty about attempts to cancel its CDS contracts. The counterparty said that beginning in 2007 and continuing to before the time of ML III, it had been exploring CDS terminations with AIG. The counterparty said it was interested in unwinding the CDS contracts, but at market value, and without any concessions. According to the counterparty, the discussions were unsuccessful, and no terminations took place, because when AIG produced asset valuations, they were still at initial par value, or significantly above current market values. In the counterparty's view, the valuations showed an unwillingness on AIG's part to recognize economic realities.

<sup>74</sup>Rating agencies drew criticism for various reasons, including complaints they assigned ratings to structured financial products, RMBS in particular, based on flawed methodologies. As a result, critics said, investors and financial institutions had a lower perception of actual risks when making decisions on matters such as investments or capital requirements.



---

senior debt from stable to negative.<sup>75</sup> In the same month, other rating agencies also placed AIG on negative outlook, suggesting the possibility of a future downgrade. As 2008 progressed, AIG executives met with rating agencies to discuss the company's situation. Following reviews of AIG's deteriorating condition and the announcement of losses for the first quarter of 2008, Moody's Investors Service, Standard & Poor's, Fitch Ratings, and A.M. Best Company all downgraded AIG's ratings in May 2008.

Over the summer of 2008, AIG communicated with rating agencies about its development of a strategic plan to address its problems. The company expected to announce the plan at the end of September, a former AIG executive told us. On August 6, AIG announced a second quarter loss of \$5.36 billion. Rating agencies initially said they would hold off action until the company's chief executive officer presented the new strategic plan, the former executive told us. By late August, however, rating agencies had indicated to AIG that they would review the company and probably downgrade its rating, the executive said. This development, the senior executive added, was ultimately responsible for the company's liquidity crisis in September 2008.

In the weeks leading up to AIG's crisis weekend of September 13–14, rating agencies cited concerns about mounting problems in AIG's CDS portfolio and indicated they would lower AIG's credit ratings unless the company took actions to prevent the move. Other rating agency concerns included AIG's declining stock price, its liquidity position in general, and its risk management practices above and beyond capital needs. One rating agency said that during the second week of September, concerns about AIG's financial condition increased greatly over a short period of time.

Immediately after the Federal Reserve Board authorized the Revolving Credit Facility, the potential for downgrades following the announcement of an expected quarterly loss effectively established a deadline for the Federal Reserve System as it worked to restructure its assistance to the company. FRBNY officials told us they timed restructuring plans to

---

<sup>75</sup>AIG's auditor, Pricewaterhouse Coopers LLC, concluded that, as of December 31, 2007, AIG had "a material weakness in its internal control over financial reporting and oversight relating to the fair value valuation of the AIGFP super senior credit default swap portfolio." AIG filed an 8-K report with SEC on February 11, 2008, making this announcement and clarifying its procedures for valuing the portfolio.

---

coincide with AIG's release of its third quarter results on November 10, 2008, because they expected that an announcement of a quarterly loss would result in a downgrade without a strategy to further stabilize the company.<sup>76</sup> By early October, Federal Reserve Board staff identified forestalling a ratings downgrade as the priority because a downgrade would hurt AIG subsidiaries' business, among other problems. Although the Federal Reserve System's Securities Borrowing Facility implemented earlier had helped to prevent downgrades, rating agencies wanted to see additional measures taken. FRBNY also considered asking rating agencies to take a "ratings holiday," whereby the rating agencies would agree not to downgrade AIG.

Information we reviewed further indicates that leading up to the announcement of restructuring of government assistance in November 2008, FRBNY and Federal Reserve Board officials were concerned about ratings and whether options they were considering would prevent a downgrade. October 26 briefing slides from an FRBNY advisor detailed various rating agency concerns, including ongoing liquidity and capital problems at AIGFP, the parent company's debt levels following the Revolving Credit Facility, and risks associated with executing AIG's asset sales plan. When the Federal Reserve Board considered authorization of the restructuring package, a key factor was rating agency concerns.

Ratings implications continued to factor into officials' decisions leading up to the second restructuring of government assistance in March 2009 but with a greater focus on AIG's asset sale plans and the performance of its insurance subsidiaries. According to an FRBNY advisor, potential losses, combined with AIG's deteriorating business performance, difficulties selling assets, and a volatile market environment, meant that a ratings downgrade was likely unless the government took additional steps to assist the company. FRBNY officials told us a main rating agency concern was whether AIG could successfully execute its restructuring plan over the multiyear period envisioned.

---

<sup>76</sup>FRBNY officials told us that had there not been dates for expected ratings actions, they might not have announced the restructuring plan by November 10. Nonetheless, government action would still have been necessary, because markets would have punished AIG when it released its earnings report, the officials said. In effect, that would have accomplished what a downgrade would have done.

---

Both rating agency executives and FRBNY officials told us they had no contact with one another concerning AIG before September 16.<sup>77</sup> After the establishment of the Revolving Credit Facility, FRBNY officials began to develop a strategy for communicating with the rating agencies to address their concerns. They told us that they implemented this approach after the rating agencies contacted them in the week following September 16, 2008, seeking to understand what the government had planned. FRBNY officials also said there was a rating agency concern that the FRBNY loan was senior to AIG's existing debt. As a result, according to the officials, it became clear early that the rating agencies would play a key role, because further downgrades would have a serious impact on AIG and cause further harm to financial markets. In response to rating agency issues, officials said they provided information about the Revolving Credit Facility in the 2 weeks following authorization of the lending, but not about AIG or potential future government plans. FRBNY engaged three advisors to develop its strategy for rating agency communications. As part of the effort, FRBNY officials began participating in discussions between AIG and the rating agencies about the implications of government assistance on AIG's ratings.

FRBNY officials told us they generally met with AIG and rating agencies together, but that officials had some independent discussions with the rating agencies, along with a Treasury official, to confirm details of federal plans to assist the company. These separate sessions were not, however, related to what AIG itself was doing or intended to do, the officials said. In general, interacting with rating agencies in this way was new for FRBNY officials, who told us they were concerned that talking to the rating agencies without AIG present could influence the ratings without allowing AIG to have any input. They also noted that the proper relationship was between the rating agencies and the company, as FRBNY was not managing AIG.

FRBNY officials said that they viewed the rating agencies as a limiting factor in considering options but not necessarily a driving force, as restructuring efforts focused on stabilizing AIG and not necessarily on preventing a downgrade. AIG's business partners, brokers, and bank distribution channels had concerns about the company's ratings, because

---

<sup>77</sup>There were government-rating agency contacts on September 15, according to a former senior AIG executive, when the executive and a Treasury official called several rating agencies in unsuccessful attempts to delay decisions on rating downgrades.

---

a specified credit rating can be required to transact business, the officials said. But FRBNY's policy objective was to prevent a disorderly failure of AIG, and FRBNY officials said they did not believe that would have been possible if AIG was downgraded to the levels rating agencies were considering. The rating agencies, FRBNY officials said, were an indicator of how the market would view AIG upon implementation of various solutions. They added that the rating agencies wanted to hear solutions and that the government was flexible and committed to helping AIG but did not wish to participate in decision making.

Several rating agencies told us they did not see their role in discussions with AIG executives and FRBNY officials as becoming involved in decision making or management of AIG. Instead, meetings with AIG were standard in nature, whereby the agencies would gather information, react to plans, or share perspectives on potential ratings implications of contemplated actions.<sup>78</sup> Representatives from one rating agency described, for example, meetings at which AIG presented its plans and the agency commented about the potential implications on ratings in general without mentioning a specific rating that would result. Similarly, another agency told us that it would ask questions about options AIG presented but did not offer input or recommendations regarding individual plans. The agency added that legal barriers prevented it from suggesting how to structure transactions so that a company could improve its rating.

FRBNY officials concurred with the rating agencies' description of their role. They said the agencies did not indicate what they considered acceptable or provide detailed feedback on government plans. To the contrary, FRBNY officials told us that they would have liked for the rating agencies to provide instructions on minimum actions needed to maintain AIG's ratings. But the agencies frequently pointed out that they did not want to be in the position of effectively running the company by passing judgment on various plans. FRBNY officials said that they generally understood the rating agencies' concerns, but did not make specific changes to the restructured Revolving Credit Facility, ML II, or ML III based on rating agency feedback.

---

<sup>78</sup>Three rating agencies told us they each met with FRBNY and AIG approximately six times after establishment of the Revolving Credit Facility.

---

## FRBNY's Maiden Lane III Design Likely Required Greater Borrowing, and Accounts of Attempts to Gain Concessions From AIG Counterparties are Inconsistent

After the first extension of federal assistance to AIG—the Revolving Credit Facility—ML III was a key part of the Federal Reserve System's continuing efforts to stabilize the company. We found that in designing ML III, FRBNY decided against plans that could have reduced the size of its lending or increased the loan's security, as it opted against seeking financial contributions from AIG's financial counterparties. We also found that the Federal Reserve Board approved ML III with an expectation that concessions would be negotiated with the counterparties, but that FRBNY made varying attempts to obtain these discounts, which could have been another way to provide greater loan security or to lower the size of the government's lending commitment. FRBNY officials told us, however, that the design they pursued was the only option available given constraints at the time, and that insistence on discounts in the face of counterparty opposition would have put their stabilization efforts at serious risk. In creating ML III, FRBNY sought to treat the counterparties alike, with each of them receiving full value on their CDO holdings. However, because the circumstances of individual counterparties' involvement with AIGFP varied, the counterparties' perception of the value of ML III participation likely varied as well.

---

## Need to Resolve Liquidity Issues Quickly Drove the Federal Reserve's Decision Making on Maiden Lane III

The financial pressures on AIGFP arose primarily from collateral calls on approximately 140 CDS contracts on 112 mortgage-related, multisector CDOs with \$71.5 billion in notional, or face, value for about 20 financial institution counterparties.<sup>79</sup> To address AIGFP's difficulties, FRBNY had three broad approaches it could take, according to the then-FRBNY President: (1) let AIG default on the CDS contracts that were causing its liquidity problems; (2) continue to lend to AIG, so it could meet its obligations under those CDS contracts; or (3) restructure the CDS contracts to stop the financial pressure. FRBNY chose the third approach, and officials said that in the subsequent design of a specific structure for ML III, time pressure was a key factor.

---

<sup>79</sup>According to AIG, most of AIGFP's CDS contracts were subject to collateral posting provisions, but specific provisions differed among counterparties and asset classes. Collateral calls happen when the value of assets being protected declines, and under terms of a "credit support annex" accompanying the CDS contract, a party makes a call for payments—collateral—to reflect the decline. In AIG's case, the company's posting of collateral with its CDS counterparties reduced the counterparties' exposure to AIG, mitigating the impact if AIG could not honor its CDS contracts.

---

Collateral figured prominently in ML III assistance. Shortly prior to ML III's creation in November 2008, AIGFP had posted approximately \$30.3 billion in collateral to its counterparties. AIG faced the prospect of being required to post still more collateral if there were further declines in the market value of the CDOs being covered, which could have created significant additional liquidity demands for the company.

In addressing AIGFP's liquidity risk from additional collateral calls, FRBNY contracted with financial advisors in September and October 2008.<sup>80</sup> These advisors, among other things, developed alternatives, forecasted scenarios of macroeconomic stress to be used in decision making, calculated the value of CDOs that would be included in ML III, and helped develop messages to describe ML III to AIG's rating agencies. According to FRBNY and its advisors, the process of considering options was collaborative, with FRBNY providing guiding principles and direction and the advisors developing detailed designs.

FRBNY's goal was to have a structure in place before AIG's quarterly earnings announcement on November 10, 2008, when AIG was expected to report a large loss that likely would have resulted in a credit rating agency downgrade, which in turn, would have caused additional CDS collateral calls for AIGFP.<sup>81</sup> FRBNY and its advisors considered three alternatives designed to halt AIGFP's liquidity drain, each of which contemplated differing funding contributions and payments to AIGFP's CDS counterparties. As illustrated in figure 3, the alternatives were:

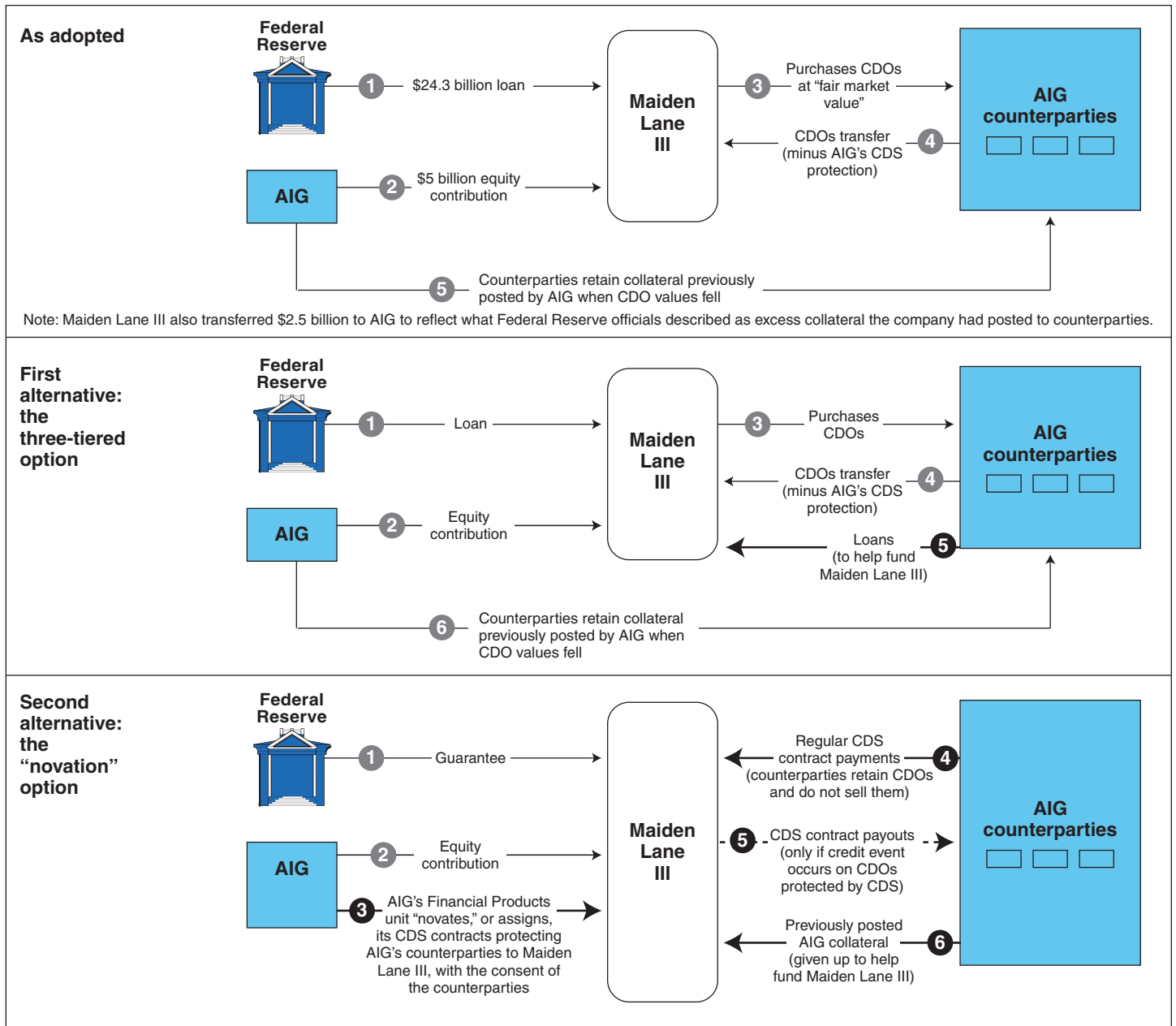
- the as-adopted ML III structure, in which FRBNY loaned and AIG contributed funds to the ML III vehicle;
- a "three-tiered" structure, in which AIG and FRBNY, plus AIGFP's counterparties, would have contributed funds to the structure; and
- a "novation" structure, in which AIGFP's CDS contracts would have been transferred to a new vehicle funded by FRBNY, AIG, and collateral previously posted to AIGFP's counterparties.

---

<sup>80</sup>See GAO, *Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance*, [GAO-11-696](#) (Washington, D.C.: July 21, 2011).

<sup>81</sup>FRBNY officials told us the goal was that when the company announced its earnings, they could say that although AIG's performance was weak, the government had solved the main problems that drove the company to the brink of failure.

**Figure 3: Maiden Lane III Structure and Alternatives**



Source: GAO.

---

**The as-adopted structure.** Under the as-adopted ML III structure, AIG's counterparties received essentially par value—that is, the notional, or face, value—for their CDOs (or close to par value after certain expenses).<sup>82</sup> They did so through a combination of receiving payments from ML III plus retaining collateral AIG had posted to them under the company's CDS contracts. In return, the counterparties agreed to cancel their CDS contracts with AIG. The as-adopted ML III structure was financed with a \$24.3 billion FRBNY loan in the form of a senior note and a \$5 billion AIG equity contribution, resulting in an 83/17 percent split in total funding, respectively.<sup>83</sup> ML III used these funds to purchase the CDOs from AIG counterparties at what were determined to be then-fair market values. The AIG equity contribution was designated to absorb the first principal losses the ML III portfolio might incur.

**The three-tiered structure.** Under the three-tiered alternative, the counterparties choosing to participate would have received less than par value for their CDOs. This would have been through a combination of retaining collateral AIG had posted and receiving payment from ML III for the sale of their CDOs, but also making funding contributions to ML III. In return, as in the as-adopted structure, the counterparties would have canceled their CDS contracts with AIG and transferred the CDOs to the structure. The three-tiered structure would have been financed with an FRBNY loan in the form of a senior note and an AIG equity contribution, as in the as-adopted structure, plus loans from AIGFP counterparties in the form of "mezzanine" notes.<sup>84</sup> As under the as-adopted structure, the AIG equity contribution would have absorbed the first principal losses. In contrast to the chosen model, however, the counterparties' mezzanine contribution would have covered losses exceeding the AIG equity amount. Thus, under the three-tiered option, FRBNY's loan would have been more secure because it would have had both the AIG and the mezzanine contributions to absorb principal losses. The mezzanine contribution could

---

<sup>82</sup>According to FRBNY, the total amount received was somewhat less than par value, as the counterparties paid financing charges and had to forego some interest earnings. In this report, we generally use "par" or "par value" to refer to this near-par value, except as otherwise indicated.

<sup>83</sup>A senior note is a loan that has first priority for repayment before other debt.

<sup>84</sup>A mezzanine note has an intermediate priority for repayment after senior financing; here, the counterparties' mezzanine loans would have been second in priority to FRBNY's senior note.



---

have reduced the size of FRBNY's loan to ML III. However, the potential size of FRBNY's loan under this plan was not known, FRBNY officials told us. It would have depended on the size of the mezzanine contribution and hence the counterparties' willingness to participate, they said.

**The novation structure.** Under this structure, the counterparties choosing to participate would have kept their CDOs, rather than selling them to the ML III vehicle. The CDS protection on the CDOs would have remained, except that losses protected by the CDS contracts would be paid by the ML III vehicle and not AIG. Counterparties would have consented to AIGFP novating, or transferring, their CDS contracts to the vehicle. In return, the counterparties would have received par payment from ML III only if a CDO credit event occurred, such as bankruptcy or failure to pay. The counterparties would also have continued to pay CDS premiums, but to the vehicle rather than to AIGFP, which had initially sold them the protection.<sup>85</sup> The novation structure would have been financed with an FRBNY guarantee; the collateral AIG had previously posted to the counterparties, which the counterparties would have remitted to the vehicle; and an AIG equity contribution. Overall, novation would have meant that the counterparties would not have initially received par value in return for canceling their CDS contracts. Instead, the CDS coverage would have continued. Even assuming that legal issues, discussed in the following section, could have been resolved, FRBNY would have needed to fully fund the vehicle, essentially lending an amount equal to the difference between par value and collateral already posted by AIG to the counterparties, FRBNY officials told us.<sup>86</sup>

## FRBNY's Evaluation of the ML III Alternatives

FRBNY and its advisors identified a number of merits and drawbacks for each of the three ML III options. The as-adopted ML III structure had lower execution risk than the other structures, FRBNY officials told us, meaning there was lower risk that the vehicle would ultimately not be implemented after the parties agreed to terms. It was also the simplest

---

<sup>85</sup>CDS premiums, or spreads, are the periodic fees that counterparties pay in return for CDS protection.

<sup>86</sup>According to FRBNY officials, this funding likely would have been necessary because the counterparties might reasonably have objected to novation of the AIG CDS contracts to a vehicle that had insufficient capital to cover collateral calls in the event of future rating agency downgrades or CDO defaults. Thus, it might have been necessary to pre-fund the vehicle with the difference between par value and the amount of collateral already posted by AIG, in order to persuade counterparties to participate. FRBNY was viewed as the only realistic funding source to meet this need, the officials said.

---

structure. However, it could have required a greater FRBNY financial commitment, and after the AIG equity contribution, there were no other funds contributed to offset potential losses.<sup>87</sup>

The three-tiered structure, with its counterparty contributions, could have required a smaller FRBNY loan and provided FRBNY greater protection because the counterparty funding would have absorbed any principal losses that exceeded AIG's equity contribution. This added protection would have been a major benefit in providing more security for the FRBNY loan, according to FRBNY officials, because at the time, financial markets were in turmoil and it was difficult to know when declines would end. However, according to FRBNY, the three-tiered structure would have required complex, lengthy negotiations with the counterparties, including pricing of individual securities in the portfolio. An FRBNY advisor told us those negotiations could have taken a year or longer. The structure also would have required discussion on how potential losses would be shared among the counterparties. Under this option, credit rating agencies might also have had to rate notes issued by ML III to the counterparties, which would have required time. Further, the structure would have created ongoing relationships between counterparties and FRBNY, which an advisor said created the potential for conflicts due to the Federal Reserve System's supervisory relationships. In particular, FRBNY officials told us, the key feature of the three-tiered structure was that it would have forced the counterparties into a new position: being required to absorb losses on their own assets and perhaps those of other counterparties participating in the vehicle. It would have been a significant undertaking—lengthy negotiations with no assurance of success—to persuade the counterparties to take that risk, the officials said, although they did not have any such discussions with counterparties before rejecting this option. However, they told us that they were aware of difficulties in AIG's efforts to negotiate with its counterparties during this time, and that these negotiations factored into their expectations about the three-tiered option.

The novation option could also have reduced the amount of ML III payments made to the counterparties. However, according to FRBNY, the chief factor against novation was that officials did not think they had the legal authority to execute this kind of structure because it likely would not

---

<sup>87</sup>The as-adopted vehicle purchased the counterparties' CDOs at what were determined to be then-current fair market values, using the FRBNY funding and the AIG equity contribution, but FRBNY officials said their analysis provided sufficient assurance of repayment.

---

have met the Federal Reserve System's requirement to lend against value.<sup>88</sup> In addition, according to FRBNY and an advisor, any novation structure would have been complex; would have required counterparty consent, including agreement to give up the collateral if the structure was to be fully funded; could have caused concern among credit rating agencies; and would have required giving up the opportunity for potential future gains in CDO value because the vehicle would not have owned the CDO assets. An advisor also cited concern that a novation structure would drain liquidity from the financial system during a time of market weakness because the counterparties would give up collateral AIG had already provided to them to the new vehicle, where it would no longer be available to the counterparties for their own uses. In all, there would have been considerable execution risk while under great time pressure, FRBNY officials said.

FRBNY and its advisors assessed the three structures against their goals of both meeting policy objectives and stabilizing AIG. Policy objectives included lending against assets of value; ensuring that FRBNY funding would be repaid, even in a stressed economic environment; speed of execution; and avoiding long-term relationships with counterparties. AIG stabilization objectives included eliminating AIGFP's liquidity drain stemming from CDS collateral calls while limiting the burden on the company through the contribution AIG would make to ML III. Other stabilization objectives were avoiding accounting rules that would have required AIG to consolidate any ML III structure onto its own books and also enabling AIG to share in potential gains once the federal lending and the company's equity position were repaid.<sup>89</sup>

---

<sup>88</sup>The concern about lending against value related to a novation vehicle potentially guaranteeing CDO notional values, because the Federal Reserve System does not have the authority to issue guarantees, FRBNY officials told us. A form of guarantee, which would be fully collateralized, could be possible, but there would be practical problems in implementation, the officials said. Among the problems would be that such a guarantee would need to be capped, which could create market perception issues.

<sup>89</sup>Consolidation means combining all assets, liabilities, and operating accounts of a parent company and its subsidiaries into a single set of financial statements. In this case, consolidation of ML III would have meant reflecting ML III's operations in AIG's financial statements. Consolidation of ML III was a key concern, and FRBNY officials sought to avoid it, because it could have injected volatility into AIG's operations at a time when the Federal Reserve System was trying to accomplish the opposite and stabilize the company. According to our review, the main ML III design feature influenced by the consolidation issue was the residual cash flow allocation; see discussion in the following paragraphs. Ultimately, ML III was consolidated into Federal Reserve System financial statements.

FRBNY officials told us they ultimately chose the as-adopted ML III structure because it was the only one that worked, given the constraints at the time. According to FRBNY, time to execute was the most important objective, and compared to the other alternatives, the as-adopted ML III structure was simpler, could be executed more quickly, and had lower execution risk.

As noted, the value the counterparties received under the as-adopted ML III structure came from two sources—retaining the collateral AIGFP had already posted to them, plus payments from ML III to purchase their CDOs. By the time of ML III in November 2008, much of the collateral the counterparties had received from AIG had been funded with proceeds from FRBNY’s Revolving Credit Facility. Accounting for use of these loan proceeds, of the \$62.1 billion in value the counterparties received through the process of establishing the ML III vehicle, about 76 percent came from FRBNY, as shown in table 3.

**Table 3: Sources of ML III Value Provided**

<b>Value Received by Counterparties</b>	
<i>Collateral posted by AIGFP</i>	
Funded by AIG	\$14.8 billion
Funded by FRBNY Revolving Credit Facility	\$20.2 billion
<i>ML III payments to purchase CDOs</i>	
Funded by FRBNY loan proceeds	\$27.1 billion
<b>Total value received by counterparties</b>	<b>\$62.1 billion</b>
<b>Total funded by FRBNY</b>	<b>\$47.3 billion</b>
Percentage funded by FRBNY	Approximately 76%

Source: GAO analysis of Federal Reserve System information.

Note: According to FRBNY, figures are indicative, but not precise.

### ML III’s Design Focused on Three Major Features

FRBNY officials designed the as-adopted ML III with a focus on three main features: (1) the debt and equity structure of the vehicle, (2) the different interest rates to be used to calculate payments to FRBNY and AIG on their respective contributions, and (3) a division of future earnings between FRBNY and AIG.

The first key design feature involved establishing the debt and equity structure of the total funding provided to ML III so that the FRBNY loan would be repaid even under conditions of extreme economic stress and so that AIG’s equity contribution would be sufficient to protect the FRBNY

---

loan. The Federal Reserve Board authorized FRBNY to extend a loan of up to \$30 billion to ML III, secured with the CDOs that ML III would be purchasing. The actual amount of the loan was \$24.3 billion, which, coupled with a \$5 billion AIG equity contribution, provided total funding of \$29.3 billion to ML III. The allocation between the FRBNY loan and the AIG equity contribution was a balance between providing safety for the loan and knowledge that FRBNY's previously approved Revolving Credit Facility would fund the AIG contribution, FRBNY officials said. As part of its consideration, FRBNY took into account potentially extreme ML III portfolio losses. During this process, FRBNY directed an advisor to examine a larger AIG contribution than initially proposed, in the interest of providing stronger protection for its loan, and that examination produced the \$5 billion figure eventually selected.

In November 2008, using three economic stress scenarios, an FRBNY advisor estimated that CDO losses on a portfolio close to what became the ML III portfolio could be 32 percent, 46 percent, and 54 percent of notional, or face, value under a base case; a stress case; and an extreme stress case, respectively.<sup>90</sup> In particular, based on expected losses during extreme stress, our analysis of FRBNY advisor information showed the ML III portfolio was expected to lose 57 percent of its notional value of \$62.1 billion, leaving a value of about \$27 billion. That amount, however, was still expected to be \$2.7 billion greater than FRBNY's \$24.3 billion loan. Thus, the stress tests indicated that the CDO collateral held by ML III would be sufficient to protect the FRBNY loan under the extreme stress scenario indicated.

Likewise, AIG's equity contribution of \$5 billion to ML III was designed to protect FRBNY's loan during extreme economic stress. As noted, the equity position absorbs first principal losses in the ML III portfolio. Under the extreme stress case, ML III's CDO recovery value would be \$2.6 billion less than ML III's total funding, according to our analysis. That is, after the projected loss of 57 percent, as noted previously, the assets

---

<sup>90</sup>The portfolio on which this analysis was based had about \$4.8 billion, or about 8 percent, greater assets than what ultimately became the ML III portfolio. The base case scenario assumed housing prices would decline 36 percent nationally and 59 percent in California from their peak. The stress case assumed declines of 48 percent and 68 percent nationally and in California, respectively. The extreme case assumed 56 percent and 75 percent price declines nationally and in California, respectively.

---

would have a value of \$26.7 billion.<sup>91</sup> That would be less than the \$29.3 billion in ML III funding provided by the combination of FRBNY's \$24.3 billion loan and AIG's \$5 billion in equity financing. However, if such a \$2.6 billion shortfall occurred, the loss would be applied first against AIG's \$5 billion equity investment. Thus, the structure would allow AIG's equity position to provide protection for FRBNY's loan.

Although AIG made an equity contribution to ML III, the company funded its investment using proceeds from the Revolving Credit Facility. FRBNY officials said they knew that AIG would need to borrow to fund its contribution, but they preferred that the company borrow from the Revolving Credit Facility as they did not want AIG to take on expensive debt to make its contribution. Nevertheless, this situation presented FRBNY with a trade-off when determining the size of AIG's contribution to ML III. On one hand, a higher contribution would have provided more protection to FRBNY. On the other, a higher contribution would have required AIG to borrow more under the Revolving Credit Facility, and officials wanted to minimize use of that facility. FRBNY officials also said they did not want the size of AIG's contribution to undermine the company if the contribution was entirely lost in a worst-case scenario. Our review showed that FRBNY also considered other methods for AIG to fund its contribution, such as a quarterly payments plan or financing the AIG equity contribution with a secured loan from ML III.

The second key ML III design feature was the interest rate used to calculate payment on FRBNY's loan and AIG's equity contribution. The Federal Reserve Board approved an interest rate on FRBNY's loan of 1-month London Interbank Offered Rate (LIBOR) plus 100 basis points, with the rate paid on AIG's equity position set at 1-month LIBOR plus 300 basis points.<sup>92</sup> Proceeds from the ML III CDO portfolio were to be applied first to FRBNY's senior note until the loan was paid in full and then to AIG's equity until it was also repaid in full. According to internal correspondence,

---

<sup>91</sup>This figure neglects transaction costs and assumes a functioning marketplace for the assets.

<sup>92</sup>The London Interbank Offered Rate is a reference interest rate published by the British Bankers' Association, based on a daily survey of major banks, in which they are asked to provide the interest rate at which they believe they could borrow funds unsecured for a particular maturity in the wholesale London money market. Basis points are the smallest measures commonly used in quoting interest rates. One basis point is one-hundredth of a percentage point, so that 100 basis points equals 1 percentage point.

FRBNY chose LIBOR as the base rate because LIBOR was also the base rate for a number of the assets in the ML III portfolio. As for the add-ons to the base rate, an FRBNY advisor judged the 100 and 300 basis point spreads to be normal market terms a year prior to the financial crisis. In addition, FRBNY officials told us that they wanted to leave open the option of selling the FRBNY loan in the future and thus wanted to include features that might be appealing to a potential future investor. The spread might be attractive to an investor as a form of profit-sharing.

The final design feature addressed allocation of residual cash flow—that is, any income received by ML III from CDOs in its portfolio after repayment of the FRBNY loan and the AIG equity contribution. The adopted structure split residual cash flows between FRBNY and AIG on a 67 percent and 33 percent (67/33) basis, respectively. As of November 5, 2008, just before ML III was announced, residual cash flows to FRBNY and AIG were estimated to total \$31.8 billion and \$15.7 billion, respectively, under the base economic scenario. The division of residual cash flows was determined based on the proportion of funding contributed to ML III and what FRBNY officials deemed would be a fair return for its loan and AIG’s equity position. Table 4 shows the divisions of residual cash flows that FRBNY and its advisors considered based on variations in the size of AIG’s equity contribution, as of October 26, 2008.

**Table 4: Division of Earnings Considered for Maiden Lane III, as of October 26, 2008**

Size of AIG equity contribution (dollars in billions)	Funding split, FRBNY loan/AIG equity	Division of residual cash flow, FRBNY vs. AIG
\$5 (adopted)	85%/15%	67%/33%
3	91/9	83/17
1	97/3	95/5

Source: GAO analysis of FRBNY records.

Under these alternatives, as AIG’s equity position increased, its residual cash flow allocation also increased, but at a disproportionately higher rate. Conversely, as FRBNY’s contribution decreased because AIG would be contributing more, FRBNY’s share of residual cash flow decreased at a higher rate.

Another factor that influenced the choice of the residual split was the issue of consolidation of ML III onto AIG’s books. FRBNY requested that one of its advisors determine how much ML III could increase AIG’s allocation of residual cash flows before consolidation became an issue.

---

FRBNY officials said they determined that FRBNY would need to take at least a 55 percent share of the residual cash flows to avoid AIG having to consolidate. That, however, would have provided a 45 percent share for AIG, which in turn would have produced an extraordinarily high rate of return on the company's \$5 billion contribution, FRBNY officials told us. As a result, FRBNY chose the 67/33 division, which also had the advantage of being a more conservative position for the FRBNY loan.

Rating agency concerns also played a role in the allocation of the residual cash flows, according to FRBNY officials. The agencies told FRBNY that in assessing AIG for rating purposes, they would have concerns if there was no benefit for the company via the residual cash flow, because that could leave the company in a weaker position. FRBNY officials told us they viewed the rating agencies' position as a constraint to be considered in their design, along with such factors as tax considerations and market perceptions. As a result, FRBNY included a residual share for AIG, although officials said that was not necessarily for the sake of the rating agencies alone. According to advisor estimates as of November 5, 2008, FRBNY could have expected to receive an additional \$15.7 billion in residual cash flows had it decided not to provide AIG with a share.

In general, according to FRBNY officials, they were not looking to earn large returns from the residual earnings. Instead, they said their primary interest was ensuring FRBNY would be repaid even in a highly stressed environment, while also seeking to stabilize AIG. The primary driver of repayment was the size of the AIG first-loss contribution. FRBNY wanted a bigger first-loss piece, to protect its loan, and in return, was willing to provide AIG with a bigger share of the residual earnings. Although the 67/33 split favored FRBNY, its focus was not on the residual earnings per se, officials told us.

As part of the ML III process, ML III and AIGFP also executed another agreement, known as the Shortfall Agreement, under which ML III transferred about \$2.5 billion to AIGFP. This amount was based on what FRBNY officials described as excess collateral that AIGFP had posted to the counterparties, based on fair market values determined for the CDOs in question. As described later, a portion of the Shortfall Agreement became an issue with AIG securities filings and disclosure of information about AIG counterparties participating in ML III.



---

## While the Federal Reserve Expected Concessions Would Be Negotiated, Accounts of FRBNY's Attempts to Obtain Them Are Inconsistent

The Federal Reserve Board authorized ML III with an expectation that concessions, or discounts, would be obtained on the par value of AIGFP counterparties' CDOs. Our review found that FRBNY made varying attempts to obtain concessions and halted efforts before some of the counterparties responded to the Bank's request for the discounts. The counterparties opposed concessions, we found, and FRBNY officials told us that insistence on discounts in the face of that opposition would have put their stabilization efforts at serious risk.

The business rationale for seeking concessions from AIG's CDS counterparties was similar to the logic for the option—not adopted—of having counterparties contribute to the three-tiered ML III structure—namely, to provide an additional layer of loss protection for FRBNY's ML III loan. Some Federal Reserve Board governors also raised concerns that the counterparties receiving par value on CDOs could appear too generous, noting that the counterparties would receive accounting benefits from the transaction and no longer be exposed to AIG credit risk. Concessions would be a way for the Federal Reserve System to recover some of the benefits the counterparties had obtained through its intervention in AIG.

According to FRBNY officials, discounts were justified because the counterparties would benefit from participation in ML III, while at the same time, such concessions would better protect FRBNY's risk in lending to the vehicle. Under ML III, the theory of concessions was that counterparties would be relieved of a risk early, and be provided additional funding they would not otherwise get. Because the counterparties themselves were facing a risky partner in AIG, they should have been willing to accept concessions, officials told us. In particular, according to FRBNY and an advisor, ML III could have benefited AIG CDS counterparties in several ways:

- *Liquidity benefits.* The counterparties would receive ML III cash payments immediately for purchase of their CDOs.
- *Financial statement benefits.* Sale of CDOs would allow release of any valuation reserves previously booked in connection with the CDS transactions, which reflected potential exposure to AIG. Upon cancellation of AIG's CDS contracts, the counterparties would no longer need to hold reserves against these exposures, and the reserves could be released into earnings.
- *Capital benefits.* The counterparties would receive a capital benefit, by reducing risk-weighted assets on their balance sheets.

- 
- *Risk of future declines in value.* By participating in ML III, counterparties would avoid the risk of exposure to AIG on potential future declines in the value of CDOs protected by the company's CDS contracts.

In addition, we identified other potential benefits of counterparty participation in ML III. According to our review, before the government's intervention, AIG and some of its CDS counterparties collectively had billions of dollars of collateral in dispute under the CDS contracts. Sale of the CDOs and termination of the CDS contracts would eliminate those disputes and their cost. Also, some counterparties had obtained hedge protection on their CDS contracts with AIG. Likewise, termination of the contracts would eliminate the costs of that protection.<sup>93</sup>

Prior to discussions with counterparties on concessions, FRBNY asked an advisor to estimate potential concession amounts. The advisor developed three scenarios, with total concessions ranging from \$1.1 billion to \$6.4 billion, representing 1.6 percent to 9.6 percent of CDO notional value. Individual counterparty discounts ranged from \$0 to \$2.1 billion (see table 5). The advisor also prepared an analysis of factors seen as affecting individual counterparties' willingness to accept discounts. For instance, the analysis identified one counterparty as resistant to deep concessions because a significant portion of its portfolio was high quality with little expectation of losses.

---

<sup>93</sup>FRBNY officials' position was that after the initial government assistance, such protection was no longer necessary.

**Table 5: Maiden Lane III Counterparty Concession Scenarios**

<b>Concession option</b>	<b>Total concessions (dollars in billions)</b>	<b>Range of individual concessions</b>	<b>Method</b>
1	\$1.1	\$2 million to \$322 million	Discount of 50 basis points annually on notional value of CDOs until projected credit event under extreme economic stress scenario, up to maximum of 300 basis points. Weighted average concession for all the counterparties would have been 1.6 percent.
2	\$1.3	\$2 million to \$328 million	Discount of 2 percent on CDO notional value.
3	\$6.4	\$0 to \$2.1 billion	Discount calculated as 50 percent of collateral received up to close of ML III transaction. Total discounts would have been 9.6 percent on entire CDO portfolio.

Source: GAO analysis of FRBNY records.

Note: Figures reflect slightly different CDO portfolio than what ML III ultimately acquired.

At the time the Federal Reserve Board authorized ML III, the understanding was that concessions would be negotiated with the counterparties. We found differing accounts of the request for, and consideration of, counterparty concessions. FRBNY officials told us that they made a broader outreach effort to the counterparties, while counterparties described a more limited effort.

---

FRBNY officials told us that in seeking concessions, they contacted 8 of the 16 counterparties, representing the greatest exposure for AIG, in discussions on November 5 and 6, 2008.<sup>94</sup> According to FRBNY officials, their initial calls were typically made to the chief executive officers or other senior management of the counterparty institutions. In the initial calls, FRBNY officials explained the ML III structure generally, and the institutions identified the appropriate internal contacts for detailed discussions. FRBNY officials said that they conveyed a sense of urgency about working out pricing details and concessions.

FRBNY officials said that counterparties' initial reactions to these requests were negative, and that FRBNY officials asked the counterparties to reconsider. After the initial contacts, some counterparties called FRBNY to obtain more information on the transaction, but these conversations did not include concessions, according to the officials. FRBNY gave the counterparties until the close of business Friday, November 7, to make an offer. Only one of the eight counterparties indicated a willingness to consider concessions and provided a concession offer, FRBNY officials told us. This willingness was conditioned on all other counterparties agreeing to the same concession, the counterparty told us.

---

<sup>94</sup>Initially, FRBNY officials told us they contacted all 16 counterparties. A script prepared for FRBNY calls to the counterparties read in part:

"We have asked to meet with you in order to give you an opportunity to substantially reduce your counterparty exposure to AIG and assist in promoting the long-term viability of the company....As evidenced by recent government actions, the viability of AIG is an important policy objective given the firm's systemic importance. As we are sure you can appreciate, a collapse of AIG... would have jeopardized the financial system in general, and your financial institution in particular....[Market developments highlight] the significant economic costs that would have been bourn by AIG's counterparties had the government not intervened and the sizable counterparty exposure that your firm continues to retain with AIG.

For these reasons, it is clear to us that we have a common objective in ensuring the firm's long-term viability....[W]e would propose that you make us a compelling offer to unwind all your outstanding CDS contracts with AIG [at a discount].... Of course, we are open to other proposals you might have that would lead to a final resolution of this complex portfolio and therefore satisfy our common objectives.

[Your] assessments should also reflect the cost of the considerable direct and indirect benefits counterparties have derived from the Federal Reserve's support of AIG and market stability more broadly....Of course, participation is entirely voluntary...."

---

Counterparties we spoke with provided a different account of FRBNY's effort to obtain concessions. As a starting position, they generally said they opposed a request for concessions because their CDS contracts gave them the right to be paid out in full if CDOs defaulted. As a result, they said they had no business case to accept less than par. Counterparties also cited responsibilities to shareholders, saying that accepting a discount from par would run counter to these duties. According to our interviews with 14 of the 16 counterparties, FRBNY appears to have started the process of seeking discounts with attempts of varying degrees of assertiveness to obtain concessions from five counterparties.<sup>95</sup>

In particular, according to our interviews, FRBNY requested a discount from two counterparties, which said they needed to consult internally before replying. These two counterparties said that FRBNY implied they might not receive financial crisis assistance or discount window access in the future if they did not agree to a discount.<sup>96</sup> FRBNY officials disputed these accounts. However, FRBNY made contact soon afterward seeking to execute an ML III agreement without a discount, and FRBNY officials did not provide any explanation for their change in position, according to the counterparties we interviewed. Our interviews also indicated that FRBNY requested "best offer" of a discount from two other counterparties, and briefly referenced seeking a discount from another counterparty, before similarly withdrawing its request with little or no explanation, according to our interviews. Before that, one of the counterparties asked to make an offer told us it was still considering a range of possible discounts. The other said that it told FRBNY it would accept a 2 percent concession, but at that point, FRBNY officials told the counterparty they had decided against concessions, and that they would provide par value instead. The remaining counterparties we contacted indicated that FRBNY did not seek concessions from them. According to

---

<sup>95</sup>We spoke with the remaining two counterparties—Bank of America and Merrill Lynch—but they were unable to provide information on whether FRBNY sought concessions. At the time of ML III, these companies were independent, but Bank of America has acquired Merrill Lynch in the interim.

<sup>96</sup>On numerous occasions in 2008 and 2009, the Federal Reserve Board invoked emergency authority under the Federal Reserve Act of 1913 to authorize new programs and financial assistance to individual institutions to stabilize financial markets. Loans outstanding for the emergency programs peaked at more than \$1 trillion in late 2008. The Federal Reserve Board directed FRBNY to implement most of these emergency actions. See [GAO-11-696](#).

---

FRBNY officials, however, the same message had been delivered to each counterparty contacted. Similarly, the former FRBNY President said in congressional testimony that a majority of all 16 counterparties had rejected concessions.

Following discussions with counterparties, the then-FRBNY President and Federal Reserve Board Vice Chairman, upon staff recommendation, decided to move ahead with ML III without concessions. In making the recommendation on the evening of Friday, November 7, 2008, FRBNY officials described the challenges to obtaining concessions and their concerns about continued negotiations. FRBNY officials told us that taking additional time to press further for discounts could risk not reaching agreement on the ML III transaction by the target date of November 10, 2008. The cost of not being able to announce the transaction as planned, coupled with a resultant credit rating downgrade, would have been greater than the amount of any concessions achievable in the best case, they said. Although FRBNY did not continue to pursue concessions, officials told us that ML III was nevertheless designed to allow repayment of the FRBNY loan under extreme economic stress without them. Therefore, FRBNY officials told us they were comfortable moving ahead without concessions. The former FRBNY President said that officials could not risk lengthy negotiations in the face of a severe economic crisis, AIG's rapidly deteriorating position, and the prospect of a credit rating downgrade.

Counterparties approached for a concession told us that once FRBNY dropped the request for a discount, they agreed to par value, and the transactions moved forward as final details were resolved. Federal Reserve Board officials told us that although the expectation was that concessions would be obtained, securing such discounts was not a requirement at the time ML III was authorized.

According to FRBNY officials and records we reviewed, there were a number of reasons FRBNY decided not to pursue concessions:

- Participation in ML III was voluntary, and coercing concessions was inappropriate, given the Federal Reserve System's role as regulatory supervisor over a number of the counterparties.

- 
- There was no coherent methodology to objectively evaluate appropriate discounts from par.<sup>97</sup>
  - Getting all counterparties to agree to an identical concession would have been a difficult and time-consuming process. Consistency was important, both to maximize participation and to make clear that FRBNY was treating the counterparties equally. Lengthy negotiations would have been a challenge for executing ML III over 4 days by the November 10 target.
  - FRBNY had little or no bargaining power given the circumstances. The attempts at concessions took place less than 2 months after the Federal Reserve System had rescued AIG, and the counterparties expected that the government would not be willing to put the credit it had extended to the company in jeopardy.

FRBNY officials said in congressional testimony that the probability of the counterparties agreeing to concessions was modest. Even if they had agreed, FRBNY did not expect them to offer anything more than a small discount from par.<sup>98</sup> FRBNY officials told us that setting aside any attempts to coerce concessions, the economic basis for concessions was relatively modest because AIG had been providing the counterparties with collateral. Thus, any exposure of the counterparties upon an AIG default would have been low compared to the notional size of the CDS transactions.

Because some of the counterparties were French institutions, French law also entered into concession considerations. FRBNY officials told us that FRBNY had contacted French regulators for assistance, but that the French regulators opposed concessions. Also at issue was whether French law permitted discounts. FRBNY officials said that the French regulator was forceful in saying concessions were not possible under French law, and the former FRBNY President has testified that the

---

<sup>97</sup>As noted earlier, however, FRBNY and its advisor had developed three approaches to calculating concessions. Also, two counterparties we spoke with had a rationale for evaluating concessions, which included considering the removal of hedging costs and details associated with collateral postings by AIG.

<sup>98</sup>Testimonies of Thomas C. Baxter, Jr., Executive Vice President and General Counsel, FRBNY, and Treasury Secretary Timothy F. Geithner, before the House Committee on Government Oversight and Reform, January 27, 2010.

---

French regulator unequivocally told FRBNY officials that under French law, absent an AIG bankruptcy, the French institutions were prohibited from voluntarily agreeing to accept less than par value. FRBNY told us that they did not conduct any legal analysis. Nevertheless, whatever an analysis might have determined, if the French regulator was not willing to support its institutions accepting concessions, then concessions would not be possible, FRBNY officials told us. Given the desire for consistent treatment of the counterparties, the French opposition effectively prevented concessions, the officials said. However, in congressional testimony, the then-FRBNY President said legal issues faced by the French institutions were not the deciding factor.<sup>99</sup>

A French banking official offered a different view to us. The official declined to discuss conversations with Federal Reserve System officials, citing French secrecy law. In general, though, the official provided a more nuanced explanation of French law's treatment of any concessions than that cited by the former FRBNY President. According to the French banking official, there could be legal liability if an institution accepted a discount, with liability depending on individual facts and circumstances and a key consideration being whether any discount involved all creditors.<sup>100</sup> In addition, one French institution told us its research indicated French law would not have been a factor in concessions.

---

<sup>99</sup>See Questions for the Record, submitted in conjunction with testimony of Timothy F. Geithner, before the House Committee on Oversight and Government Reform, January 27, 2010.

<sup>100</sup>According to the French banking official, liability would arise under civil law through claims by shareholders, and generally would not involve an administrative action by regulators themselves. This is because typically, banks would not act if they believed the regulator would take subsequent action, the official said. If there was to be liability, it could be governed by statutory provisions applicable to specific legal forms of organization, such as joint stock company, or cooperative or mutual banks. Liability could also arise generally under the French civil code. Article 1382 of the French civil code, cited by the French official, states: "Any act whatever of man, which causes damage to another, obliges the one by whose fault it occurred, to compensate it."



---

**While FRBNY Sought to Treat Counterparties Alike, the Perceived Value of Maiden Lane III Participation Likely Varied Among Counterparties**

In establishing ML III, FRBNY sought to broadly include the AIGFP counterparty CDOs from the portfolio that was creating liquidity risk for AIG, because the more that were included, the greater the liquidity relief for the company. For various reasons, however, not all such CDOs were acquired for inclusion in ML III. In acquiring CDOs for ML III, FRBNY focused on the counterparties receiving the same total value as a way to ensure equal treatment, without which officials said ML III would not have been successful. Specifically, ML III paid counterparties an amount determined to be the fair market value of their CDOs, while the counterparties also retained collateral AIG had posted with them under terms of the CDS contracts being terminated. The sum of these two amounts was roughly equal to par value of the CDOs. Although FRBNY applied this equal treatment approach consistently, the perceived value of benefits derived from ML III participation likely varied because the circumstances of individual counterparties varied. FRBNY officials agreed there were differences among counterparty positions, but they said the most important consideration was the overall value provided and that taking account of individual circumstances would have been unfeasible and too time-consuming given the time pressure of addressing the financial crisis.

**FRBNY Sought to Include a Broad Range of CDOs in Maiden Lane III**

To select the CDOs to be purchased for inclusion in ML III, FRBNY reviewed a list of CDOs protected by AIGFP CDS contracts. FRBNY's focus was multisector CDOs because these securities were subject to collateral calls and were one of the main sources of AIG's liquidity pressure. FRBNY officials told us their strategy was for ML III to acquire a large volume of CDOs from AIGFP's largest counterparties so as to attract other counterparties to participate. In addition, the concern was that without the largest counterparties' participation, ML III would not have been successful. FRBNY officials said, however, that no formal analysis was conducted to determine a specific CDO acquisition target amount that would produce ML III success. Ultimately, about 83 percent by

---

notional value, or \$62.1 billion of about \$74.5 billion in CDOs, were sold to ML III, according to information from an FRBNY advisor.<sup>101</sup>

CDOs that ML III did not purchase were excluded due to decisions by both FRBNY and counterparties. FRBNY did not include “synthetic” CDOs due to questions of practicality and legal authority.<sup>102</sup> It excluded synthetics because they might not have met the Federal Reserve System’s requirement to lend against assets of value, given that they were not backed by actual assets. According to an FRBNY advisor, excluded synthetics totaled about \$9.7 billion in notional value.<sup>103</sup>

AIG counterparties decided to exclude certain CDO assets for financial and operational reasons. They elected to exclude euro-denominated trades with a total notional value of \$1.9 billion after the trades were converted to dollars. For example, one counterparty told us that it elected not to participate with some of its holdings because movement in foreign exchange rates would have caused a loss, based on FRBNY’s structuring of the transaction.<sup>104</sup> Additionally, another counterparty told us that \$500 million in assets were not included because the counterparty did not have the underlying bonds and could not get them back for delivery to ML III.

---

<sup>101</sup>Once FRBNY and AIG counterparties agreed on the CDOs to be acquired, the ML III transaction closed, with ML III paying the counterparties for the CDOs it acquired. The ML III transaction had three separate closings in two rounds, on November 25, 2008, and on December 18 and 22, 2008. The two rounds settled \$46.1 billion and \$16 billion in CDO notional values, respectively. On the closing dates, the counterparties delivered the CDOs into an escrow account. ML III funded the escrow account with \$29.3 billion. The escrow agent released \$26.9 billion to the counterparties and delivered the CDOs to ML III.

<sup>102</sup>Synthetic CDOs are backed by credit derivatives such as CDS or options contracts, not assets such as bonds or mortgage-backed securities.

<sup>103</sup>Our review showed that ML III acquired CDOs from two counterparties that had no collateral-posting provisions. The notional value of these positions was about \$487.5 million. FRBNY officials told us they acquired these CDOs because posting of collateral (via a credit support annex) was just one way that liquidity pressure, which ML III was designed to relieve, could be created. Also, another ML III objective was to assure a reasonably diverse portfolio for the vehicle, with rights aimed at maximizing return on disposition, officials said. They said CDOs from these two counterparties were included for these reasons.

<sup>104</sup>FRBNY officials also told us that having CDOs in ML III that were denominated in a foreign currency would have introduced foreign exchange risk into management of the ML III portfolio, which they wanted to avoid.

---

FRBNY Aimed for Counterparties to Receive Par Value on CDOs

To obtain the agreement of AIG counterparties to participate in ML III, FRBNY sought to treat the counterparties consistently by providing each, through the ML III structure, with essentially par value on their CDO holdings, FRBNY officials told us. This value—for selling their CDOs and terminating their AIG CDS contracts—was based on the sum of two parts: (1) fair market value of the CDOs as determined shortly before ML III acquired them and (2) collateral that AIG had posted with the counterparties, which the counterparties retained. Under this structure, ML III itself did not pay par value for the CDOs it acquired. Rather, it paid fair market value, which at the time was below the initial, or notional, values of the CDOs. FRBNY officials told us that providing the counterparties with essentially par value based on these two components was important to achieving the objective of broad counterparty participation. They said that if counterparties had thought they were getting different arrangements, they would not have elected to participate in ML III, and FRBNY would not have achieved its goal of liquidity relief for AIG.

The decision to provide the counterparties with essentially par value for selling their CDOs and terminating their CDS protection on them, rather than providing a lower level of compensation, was based on making them whole under terms of their CDS contracts, FRBNY officials told us. Because AIG had guaranteed the notional, or par, value in those CDS contracts, FRBNY officials said it was appropriate to provide essentially par value to the counterparties, which reflected the market value of the covered CDOs plus the value of AIG's CDS protection on those securities.<sup>105</sup> FRBNY officials explained that underlying their approach was the assumption that AIG would have been able to make good on its CDS obligations.

For the counterparties, the risk of AIG failing to fulfill its CDS obligations had two elements: First, that AIG could not pay out on the contracts if CDOs protected by the company were unable to repay all principal and interest due at maturity, and second, that AIG could fail to make required collateral postings as required under the CDS contracts. According to FRBNY officials, of the two, failing to post collateral was the more

---

<sup>105</sup>As noted earlier, counterparties cited similar logic to us in explaining their opposition to concessions for ML III participation—namely, that because the CDS contracts protected par value, they were entitled to par value for selling their CDOs and terminating their CDS protection.

---

important risk because under the CDS contracts, AIG would not have been required to make payouts following default on any principal balances until the maturity of the CDOs, which could be years into the future. On the other hand, a failure by AIG to post collateral when required would have represented a more immediate dishonoring of its CDS contracts.

FRBNY officials told us that the assumption underlying their approach for providing par value—that AIG would make good on its CDS obligations—was appropriate because there was no realistic concern among the counterparties that AIG, with its recent government support, would fail to honor its CDS obligations. However, some counterparties we spoke with said that when ML III was created, they did have concerns that AIG would not be able to fulfill its CDS guarantees. For example, one counterparty told us that it believed there was still a risk of losses based on an AIG default because posting of collateral mitigated risk but did not eliminate it. Another counterparty said that providing par value was attractive because it provided an exit to a position it viewed as risky.

In addition to concerns that counterparties had about AIG's ability to honor its CDS contracts, market indicators at the time showed newly elevated concern about AIG's health. This can be seen in the cost of obtaining CDS protection on AIG itself. On November 7, 2008, the last business day before the announcement of ML III and other assistance on November 10, 2008, premiums on CDS protection on AIG were near the level reached on September 16, 2008, when the company was on the verge of failure. Reflecting market perceptions of AIG's financial health, the premium costs on November 7 were about 43 times higher than the cost at the start of the year.<sup>106</sup>

### Counterparties Might Have Valued Benefits Differently

Although FRBNY used the same approach in acquiring CDOs from all the counterparties, the counterparties' perception of the value of ML III participation likely varied, according to FRBNY officials and analysis that we conducted. FRBNY officials said that counterparties' circumstances

---

<sup>106</sup>On January 1, 2008, the cost of CDS protection on AIG was 79.7 basis points for 3-year coverage and 68.9 basis points for 5-year coverage. On September 16, prior to the initial government intervention, the premium cost had risen to 3,921.8 and 3,500.3 basis points, respectively. On November 7, after having fallen by about 72 percent following establishment of the Revolving Credit Facility, the cost had risen again, to 3,358.9 and 3,016.9 basis points, respectively.

---

differed based on factors such as size of exposure to AIG, methods of managing risk, and views on the likelihood of continued government support for AIG. As a result, counterparties would have perceived different benefits and value from participating in ML III, FRBNY officials said. The ML III combination of the market value of the purchased CDOs and collateral retained had different value to different counterparties, which might have created different desires to participate, they said.

In addition, there are other ways that counterparties might have been differently situated before agreeing to participate in ML III. In particular, we examined (1) the degree to which the counterparties had collected collateral under their CDS contracts following declines in the value of their CDO holdings and (2) the counterparties' credit exposure to AIG based on the quality of the CDO securities they held.

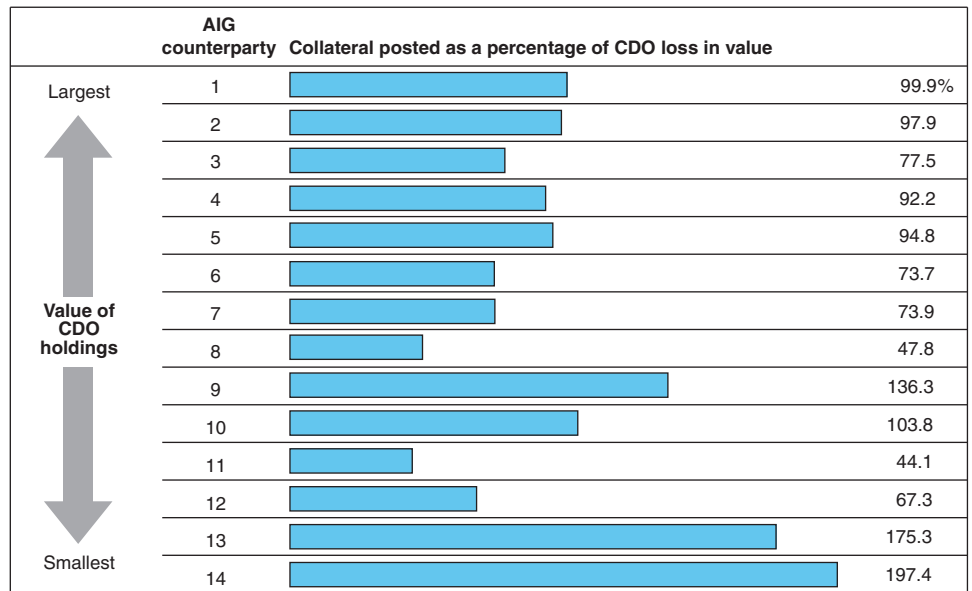
**Differences in collateral collected under CDS contracts.** FRBNY officials told us that the measure of a counterparty's exposure to AIG was the amount of decline in CDO value that had not been offset by AIG's posting of collateral under its CDS contracts. For example, if two counterparties each had \$1 billion in CDOs and each group of CDOs had lost \$400 million in value, each counterparty would expect AIG to post collateral to offset the loss in value. But if one counterparty had collected the entire \$400 million while the other had collected only \$200 million, the first counterparty would have fully collateralized its exposure, while the second counterparty would have had uncollateralized exposure to AIG.

We found that prior to ML III, the counterparties had widely varying uncollateralized exposure to AIG. Figure 4 shows each counterparty's uncollateralized exposure to AIG as of October 24, 2008, shortly before ML III was announced. For each counterparty, it shows the percentage of the loss in CDO value that had been covered by collateral collected from AIG.<sup>107</sup> Collateral posted included payments that AIG had made to its counterparties using proceeds from the Revolving Credit Facility provided by FRBNY in September 2008.

---

<sup>107</sup>To the extent there was uncollateralized exposure, actual losses could vary, such as if the counterparties could sell their CDOs on the open market and obtain enough value to cover any uncollateralized amounts. Also, we examined counterparty exposure as a percentage of CDO value lost, and high or low percentage figures, as shown in figure 4, do not necessarily correlate with size, in dollars, of fair market values of CDO holdings or payments counterparties received from ML III.

**Figure 4: Differences in AIGFP Counterparty Collateralization, as of October 24, 2008**



Source: GAO analysis of FRBNY and SEC data.

Notes: Counterparty collateralization is calculated as collateral posted as a percentage of loss in CDO value. Loss in CDO value is calculated as notional, or par, value, less fair market value. Fair market value is the amount paid by ML III to acquire the CDOs, based on valuations as of October 31, 2008. The October 24 date for collateral posting is the date closest to the October 31 valuation date for which information was available. FRBNY officials noted that during this period, the counterparties did not know about the upcoming ML III vehicle. Only 14 of 16 ML III counterparties shown here, because two counterparties did not have collateral posting agreements. Counterparty names omitted because analysis is based on some nonpublic information.

For example, as shown in the figure, as of October 24, a number of counterparties were at or near full collateralization, as collateral posted was at or near 100 percent of the decline in CDO values. Some of the counterparties had actually collected more collateral than value lost. Others, however, had collected less than half the CDO value lost. In all, the amounts collected varied by more than a factor of four, ranging from a low of about 44 percent to a high of about 197 percent. We found the same pattern of differences among the counterparties when considering total collateral requested by each counterparty, not all of which AIG may have posted.<sup>108</sup> FRBNY officials offered several caveats for our analysis

<sup>108</sup>As of October 24, the total amount of collateral requested ranged from about 44 percent of the loss in value of CDO holdings to more about 235 percent.

---

but agreed with the basic methodology of comparing collateral posted to loss in CDO value.<sup>109</sup> They said that overall, despite what collateral postings might have been at a particular point, the collateral posting process was working as intended, and amounts posted grew in advance of the announcement of ML III.

An issue factoring into the collateral situation was disputes over the amount of collateral AIG should have posted with its counterparties. Collateral postings were based on declines in CDO values, and there were disagreements over what the proper valuations should be. To the extent that lower valuations (more CDO value lost) produced greater collateral postings, counterparties had an interest in seeking lower valuations. Similarly, to the extent that higher valuations (less CDO value lost) meant smaller collateral postings, AIG had an interest in seeking higher valuations. According to information we reviewed, on a CDO portfolio of \$71 billion (a preliminary portfolio somewhat different from the final ML III portfolio), AIG and its counterparties had valuation differences totaling \$4.3 billion. Among a group of 15 counterparties, 9 had valued their assets differently than AIG. FRBNY officials told us they viewed the amount of collateral in dispute as relatively minor, but counterparties told us they viewed disputed amounts as significant.

**Varying AIG exposure due to credit quality of underlying assets.**

















Analysis conducted by an FRBNY advisor indicated that CDOs the counterparties sold to ML III were expected to incur widely varying losses in value during periods of economic stress. These differences arose from the varying quality of assets underlying the CDOs. FRBNY officials stressed to us that such differences in quality were reflected in the fair market value that ML III paid for the CDOs and that counterparties held collateral based on declines in CDO values. From the perspective of individual counterparties, these differences illustrate dissimilar circumstances among the counterparties in the time before ML III was established. Figure 5 shows, in descending order, that the amount of value expected to be lost in each counterparty's CDO portfolio during extreme economic stress ranged

---

<sup>109</sup>In particular, FRBNY officials noted that market valuations at the time were uncertain, as there was little or no trading in the relevant securities. The amount of collateral requested should not be seen as a proxy for the amount entitled, they said. Also, market conditions may have changed in the week between October 24 (the date for which collateral posting data was available) and October 31 (the date fair market values were established).

from a high of 75 percent to a low of 1 percent. Eleven of the 16 counterparty CDO portfolios were expected to lose at least 50 percent of their value during such periods of extreme stress.

**Figure 5: Differences in Expected Losses by Counterparty for Extreme Stress, as of November 5, 2008**

AIG counterparty	Expected CDO loss in value	
1		75%
2		71
3		69
4		68
5		67
6		67
7		65
8		59
9		59
10		54
11		51
12		49
13		42
14		26
15		15
16		1

Source: FRBNY advisor analysis.

Note: Counterparty names omitted because analysis is based on some nonpublic information.

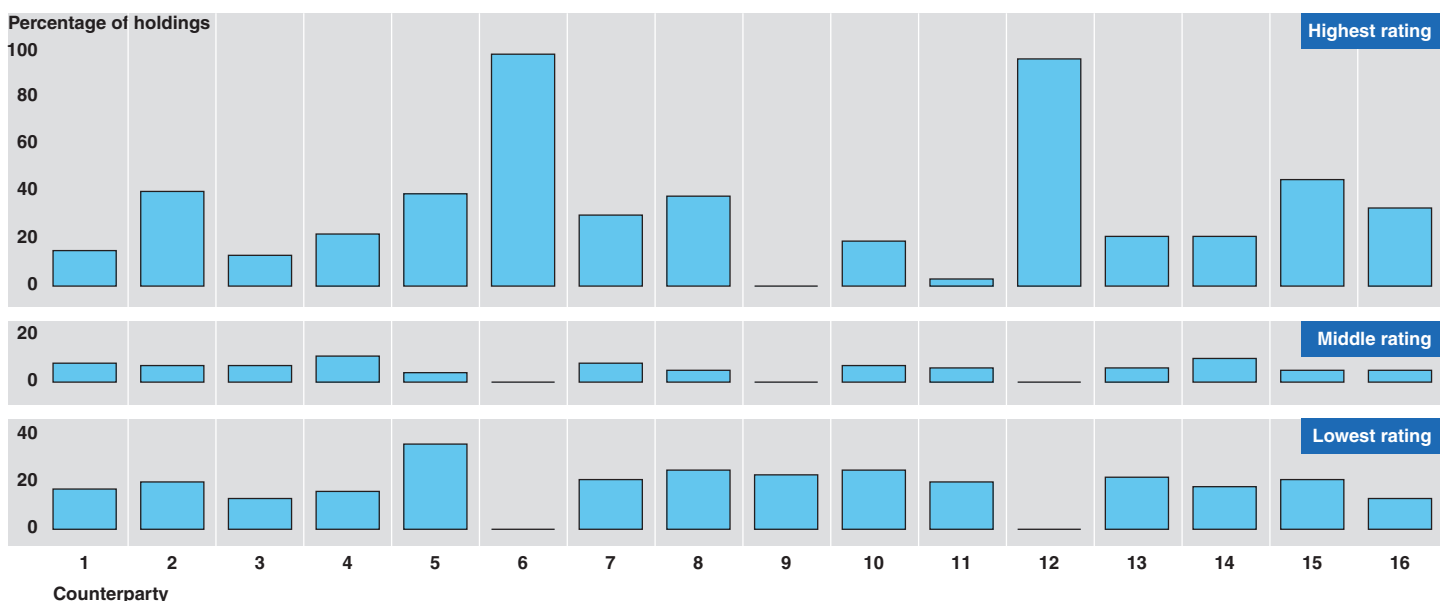
FRBNY’s advisor estimated, for instance, that counterparty 1’s CDO holdings would lose 75 percent of their notional value during extreme stress. By contrast, counterparty 16’s CDO portfolio was projected to lose only 1 percent of its value. The advisor’s analysis also indicated a wide range of expected losses for the base and stress economic cases. For the base case, projected losses ranged from 0 percent to 52 percent of CDO portfolio value. For the stress case, expected losses ranged from 0 percent to 67 percent.

Another indicator of differing asset quality can be seen in widely varying credit ratings among the CDOs that counterparties sold to ML III. An FRBNY advisor examined CDO credit ratings, grouping them into 11 categories. Figure 6 focuses on 3 of those 11 categories, showing the



percentage of each counterparty's holdings that fell into the highest-, middle-, and lowest-rated groupings.

**Figure 6: Differences in CDO Credit Ratings by Counterparty, as of October 29, 2008**



Source: GAO analysis of FRBNY advisor data.

In general, the analysis shows a relatively level amount of assets in the middle-rated category, with variance in the best and lowest ratings. For example, counterparty 5 had about 40 percent of its holdings in the highest-rated category, with about as much in the lowest-rated group. But counterparty 15 had about twice as much in the highest category as the lowest. One counterparty had 98 percent of its CDO portfolio in the top rating category, while another had none. Eleven counterparties' CDO portfolios contained "nonrated" positions, which meant that the credit quality of those assets was unknown and their risk potentially higher. All else being equal, CDOs with lower credit ratings would be expected to produce higher losses compared to more highly rated positions.

In addition, the FRBNY advisor also noted differences among the counterparties' situations shortly before ML III was announced. For example, according to records we reviewed, the advisor noted that in a nonstressed economic environment, one counterparty's portfolio was of higher quality, and that the counterparty expected there would be recoveries in value of the assets. For another counterparty, the advisor

---

noted that its portfolio, overweighted with subprime assets, was forecast to experience higher losses in all economic scenarios, and disproportionately worse performance under extreme stress. In another case, the advisor noted that based on the counterparty's situation, it would likely have been satisfied with its position without ML III participation.

Another difference among AIG counterparties' positions prior to their participation in ML III was that some had obtained hedge protection on AIG generally or had obtained protection specifically on their AIG CDS positions. Therefore, their overall risk posture was different from that of counterparties that had not obtained such hedge protection.

FRBNY officials told us they agreed that the counterparties and their CDO holdings were not similarly situated. The officials said that the counterparties generally started out in similar positions, where each had CDS protection on the notional, or par, values of their CDO holdings. As the financial crisis intensified, the value of the CDOs declined, some more than others, and as a result, the counterparties' relative positions diverged. The crisis was the differentiator, they said. As the value of the underlying assets changed, the value of AIG's CDS protection became different, the officials said. Despite the counterparties' dissimilar situations, FRBNY officials said the goal was to make sure the counterparties agreed to terminate their CDS contracts in order to stem liquidity pressure on AIG, and the approach they took, based on par value, was the best way to accomplish this given constraints at the time. They said that while some underlying CDOs may have been of differing quality, these CDOs also had the benefit of AIG's CDS protection, which promised to protect their value.

The counterparties' differing situations and varying perceptions of the benefit of ML III participation might have offered an opportunity to lower the amount FRBNY lent to ML III if FRBNY had been able to negotiate individually with the counterparties based on their individual circumstances. However, FRBNY officials told us that trying to negotiate tailored agreements by counterparty would have been unworkable and too time consuming given the pressure of the financial crisis. According to the officials, trying to determine the economic implications of each counterparty's position would have been speculative, as different parties would have made different arguments about the costs or benefits of the ML III transaction based on their individual circumstances. Further, they said that taking note of such positions would have led to different deals

---

with different parties on the basis of how each had chosen to manage risk. While negotiations might have been possible, they would have been long and complicated and there was no time for such talks.<sup>110</sup>

In reaching agreement with the AIG counterparties on ML III, FRBNY provided counterparties with varying opportunities to negotiate some terms. FRBNY officials said that after the first set of eight counterparties agreed to participate in ML III on the par value basis, FRBNY provided transaction documents to them and then negotiated some details with them.<sup>111</sup> Over the course of the weekend preceding November 10, 2008, ahead of the release of AIG's quarterly earnings report, FRBNY had separate conversations with the eight counterparties representing the most significant exposure for AIG. FRBNY officials told us that these counterparties had the opportunity to suggest amendments to contract language, and FRBNY incorporated some of their comments into the final contracts. According to FRBNY and counterparties we spoke with, the negotiated items generally involved clarifications and technical items, not material economic terms. While in principle, ML III was an easy transaction to describe, there were important details to be worked out, involving such matters as timing and delivery of the CDOs at issue, FRBNY officials told us.

After agreements were reached with the first group, FRBNY contacted the next group of counterparties, whose holdings FRBNY officials said were not significant compared to those of the first group. FRBNY officials told us that ML III needed to have the same contract with all the counterparties. According to our interviews, counterparties in the second group asked for changes, but FRBNY declined. For example, one counterparty told us it wanted to make procedural changes and clarify certain terms. FRBNY would not do so, saying that other counterparties with larger exposures had already commented on the terms. FRBNY made clear it was up to the counterparty to decide whether it wanted to engage on the terms offered, executives of the counterparty told us. Our review also identified at least one instance where a counterparty in the first group of eight was allowed to amend contract language after signing

---

<sup>110</sup>Any such negotiations would have been like those required for the three-tiered ML III option, the officials said, which, as discussed earlier, they rejected as unworkable.

<sup>111</sup>The documents were a term sheet and two agreements—one to sell their CDOs to ML III and another to terminate AIGFP's CDS contracts on the CDOs.

---

ML III agreements. FRBNY characterized the changes as technical and clarifying.

---

## **The Federal Reserve's Actions Were Generally Consistent With Existing Laws and Policies, but They Raised a Number of Questions**

The actions of the Federal Reserve System in providing several rounds of assistance to AIG involved a range of laws, regulations, and procedures. First, we found that while the Federal Reserve Board exercised its broad emergency lending authority to aid AIG, it did not make explicit its interpretation of that authority and did not fully document how its actions derived from it. Second, after government intervention began, FRBNY played a role in the federal securities filings that AIG was required to make under SEC rules. We found that although FRBNY influenced AIG's filings, it did not direct the company's decisions about what information to file for public disclosure about key details of federal aid. Finally, in providing assistance to AIG, FRBNY implemented vendor conflict-of-interest procedures similar to those found in federal regulations, but granted a number of waivers to conflicts that arose. In addition, we identified a series of complex relationships involving FRBNY, its advisors, AIG counterparties, and service providers to CDOs in which ML III invested that grew out of the government's intervention.

---

## **The Federal Reserve Exercised Its Broad Emergency Lending Authority to Aid AIG but Did Not Fully Document Its Decisions**

When the Federal Reserve Board approved emergency assistance for AIG beginning in September 2008, it acted pursuant to its authority under section 13(3) of the Federal Reserve Act. At the time, section 13(3) authorized the Federal Reserve Board, in "unusual and exigent circumstances," to authorize any Reserve Bank to extend credit to individuals, partnerships, or corporations when the credit is endorsed or otherwise secured to the satisfaction of the Reserve Bank, after the bank obtained evidence that the individual, partnership, or corporation was unable to secure adequate credit accommodations from other banking

---

institutions.<sup>112</sup> The Reserve Bank making the loan was to establish the interest rate in accordance with section 14(d) of the Federal Reserve Act, which deals with setting of the Federal Reserve discount rate.<sup>113</sup>

In authorizing assistance to AIG, the Federal Reserve Board interpreted its broad authority under section 13(3) as giving it significant discretion in satisfying these conditions.<sup>114</sup> The statute does not define “unusual and exigent circumstances,” and, according to our review, the Federal Reserve Board believes it has substantial flexibility in assessing whether such circumstances exist. The statute also does not define an inability “to secure adequate credit accommodations from other banking institutions” or set forth any standards for Reserve Banks to use in making this determination.

As a result, Federal Reserve Board staff have stated that the Federal Reserve Board would be accorded significant deference in defining this

---

<sup>112</sup>Section 13(3) was subsequently amended by the Dodd-Frank Act. As a result of the amendments, as further discussed in this section, the Federal Reserve System can now make section 13(3) loans only through programs or facilities with broad-based eligibility. The language of section 13(3) in effect at the time the Federal Reserve System provided assistance to AIG was:

“In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal Reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank; *Provided*, That before discounting any such note, draft, or bill of exchange for an individual, partnership, or corporation the Federal Reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.”

<sup>113</sup>Section 14(d) of the Federal Reserve Act authorizes each Reserve Bank to set rates as follows:

“(d) To establish from time to time, subject to review and determination of the Board of Governors of the Federal Reserve System, rates of discount to be charged by the Federal reserve bank for each class of paper, which shall be fixed with a view of accommodating commerce and business; but each such bank shall establish such rates every fourteen days, or oftener if deemed necessary by the Board[.]”

<sup>114</sup>We did not conduct any independent legal analysis of section 13(3) lending authority.

---

standard. The Federal Reserve Board notes that its Regulation A—which governs extensions of credit by Reserve Banks, including emergency credit—does not require any specific type of evidence and bases the finding about credit availability on the “judgment of the Reserve Bank.”<sup>115</sup>

As noted, the statute authorizes Reserve Banks engaging in section 13(3) emergency lending to establish interest rates in accordance with section 14(d) of the Federal Reserve Act. Section 14(d), which authorizes Federal Reserve banks to establish rates for discount window lending, is implemented by Regulation A.<sup>116</sup> Federal Reserve Board staff have stated that while Regulation A contains provisions relating to the rate for emergency credit from Reserve Banks, these provisions do not limit its power to authorize lending under section 13(3) in other circumstances and under other limitations and restrictions. The Federal Reserve Board’s rationale is that section 13(3) further allows it to authorize a Reserve Bank to extend credit to an individual, partnership, or corporation “during such periods as the said board may determine” and “subject to such limitations, restrictions, and regulations as the [Board] may prescribe.” As a result, the Federal Reserve Board has stated that it has complete statutory discretion to determine the timing and conditions of lending under section 13(3). Federal Reserve Board officials told us that the interest rate the Reserve Bank recommends to the Federal Reserve Board is based on the facts and circumstances of a particular instance of lending, and that the rate need not be the discount rate itself. Section 14(d) has never been viewed as linking the interest rate on section 13(3) lending to the then-prevailing discount rate, a Federal Reserve Board official told us.

The Federal Reserve Board views the section 14(d) rate-establishing provision as procedural, an official told us, because the Reserve Bank extending the loan proposes the rate and the Federal Reserve Board must approve it. The official said that more analysis on rates takes place at the Reserve Bank level than at the Federal Reserve Board. Factors taken into account when setting rates include risk and moral hazard. For

---

<sup>115</sup>See 12 C.F.R. § 201.4(d).

<sup>116</sup>Discount window lending is when financial institutions borrow money from the Federal Reserve at the “discount rate,” which is the interest rate charged member banks for loans backed by collateral, such as government securities or eligible notes. The discount rate provides a floor on interest rates, as banks set their loan rates above the discount rate.

example, one FRBNY official described the Revolving Credit Facility as being akin to debtor-in-possession financing—that is, it has a high interest rate, aggressive restrictions on AIG’s actions, a short term, and a substantial commitment fee. These features were consistent with section 13(3), the official said, because if a loan is risky, there must be sufficient protection for the Reserve Bank making it.

Section 14(d) also directs that rates be set “with a view of accommodating commerce and business.” Federal Reserve Board officials told us their view is that if the section 13(3) requirements for such factors as unusual and exigent circumstances and inability to obtain adequate financing from other banking institutions are met, then the section 14(d) directive of “with a view of accommodating commerce and business” is automatically satisfied.

Rates on the Federal Reserve Board’s section 13(3) lending to aid AIG have varied, as shown in examples in table 6.

**Table 6: Rates on Selected Federal Reserve AIG-Related Lending**

<b>AIG-related lending</b>	<b>Interest rate</b>	<b>Rationale for rate</b>
Revolving Credit Facility	3-month LIBOR +8.5 percentage points	Impose terms sufficiently high to provide incentive for company to repay assistance, whether it borrowed all available or not
Maiden Lane III	1-month LIBOR +1 percentage point	Hedge interest-rate risk by matching interest rate on loan with rates paid on CDOs held in ML III portfolio
For securitization of certain cash flows (approval granted but lending not implemented)	Not set when loan approved (subject to further analysis)	Set rate at level to assure “reasonable likelihood” of repayment

Source: GAO analysis based on Federal Reserve Board records and interviews with officials.

Notes: Rate on Revolving Credit Facility was later revised twice. In addition to items listed in the table, other AIG-related emergency lending approved was the Securities Borrowing Facility, October 2008, which was terminated with Maiden Lane II; and Maiden Lane II, November 2008.

Internal correspondence we reviewed discussed an FRBNY rationale for setting interest rates, noting that different rates could be expected based on the approach officials were taking. Under this approach, FRBNY set rates for its lending to SPVs that provided assistance to AIG according to risk and matching of the interest rate to characteristics of assets that were related to a particular loan. For example, FRBNY loan facilities held securities with floating rates that paid interest monthly based on the

---

1-month LIBOR rate. Hence, officials concluded that using the 1-month LIBOR rate as a base for the interest rates associated with emergency loans to those facilities was appropriate.<sup>117</sup> In other cases, considerations were different. For the restructuring of the Revolving Credit Facility, the rationale for reducing the interest rate included stabilizing AIG, boosting its future prospects, and satisfying credit rating agency concerns. For the final, unused emergency lending facility, which dealt with securitizing cash flows from certain insurance operations, the rationale advanced was AIG's ability to pay.

The statute also does not impose requirements on the amount or type of security obtained by a Reserve Bank for section 13(3) lending, other than requiring that the loan be secured "to the satisfaction" of the lending bank. The Federal Reserve Board has stated that the absence of objective criteria in the statute leaves the extent and value of the collateral within the discretion of the Reserve Bank making the loan. As one Federal Reserve Board official told us, the security accepted by the Reserve Bank could range from equity stock to anything with value. As with interest rates, the security on emergency lending associated with AIG assistance has varied. For example, the Revolving Credit Facility was secured with assets of AIG and of its primary nonregulated subsidiaries, and ML III used the CDOs purchased from AIG counterparties as security for the SPV. For the facility approved but not implemented, the security would have been cash flows from certain AIG life insurance subsidiaries.

Although the statute has no documentation requirements, we requested documentation of the Federal Reserve Board's interpretation of its section 13(3) authority generally, as well as for each of its five decisions to extend aid to AIG in particular. While the Federal Reserve Board provided some documentation, it did not have a comprehensive analysis of its legal authority generally under section 13(3), and it did not maintain comprehensive documentation of its decisions to act under that authority to assist AIG. In particular, we found the Federal Reserve Board's interpretation of its emergency lending authority to be spread across various memorandums, with limited analysis and varying degrees of detail. For the specific decisions to assist AIG, the documentation provided some support underlying use of the section 13(3) authority, but

---

<sup>117</sup>This explanation is inconsistent with another rationale provided by a Federal Reserve Board official, who said the rates for these vehicles were set according to what a private-sector borrower likely would have obtained.



---

such analysis was absent in some cases and incomplete in others. For example, for the Revolving Credit Facility, Federal Reserve Board minutes and other records we reviewed noted that the discussion of terms included collateralizing the loan with all the assets of AIG and of its primary nonregulated subsidiaries but did not include documentation of FRBNY's determination that the loan was secured to its satisfaction. For ML II and ML III, there was no documentation of how the interest rates on the loans to each vehicle were established.<sup>118</sup> For the proposed facility to securitize life insurance subsidiary cash flows, information we reviewed stated that it was well established that AIG was unable to secure adequate credit accommodations from other sources and that, with a projected fourth quarter 2008 loss exceeding \$60 billion, it was unlikely to find adequate credit accommodations from any other lender. However, there was no documentation that AIG was, in fact, unable to secure adequate credit from other banking institutions.

Federal Reserve Board officials underscored that section 13(3) loans by nature are done on a fast, emergency basis. They told us the Board does not assemble and maintain documentary support for its section 13(3) lending authorizations. According to the officials, such information, while not specifically identified, can generally be found among the overall records the agency keeps and could be produced if necessary, much as documents might be produced in response to a lawsuit. Further, the officials told us, any necessary evidence or supporting information was well understood by the Federal Reserve Board and FRBNY during the time-pressured atmosphere when section 13(3) assistance was approved for AIG, beginning in September 2008 and continuing into 2009. As a result, it was not necessary to compile a formal assembly of evidence, the officials told us.

As noted previously, recent legislation has amended section 13(3) since the Federal Reserve Board approved emergency lending for AIG. In the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Congress limits future use of section 13(3) lending to participants in programs or facilities with broad-based eligibility and restricts assistance to individual companies under specified

---

<sup>118</sup>Records we reviewed discussing the interest rates on these facilities were prepared by FRBNY officials after Federal Reserve Board approval of the lending.

---

circumstances.<sup>119</sup> The act also mandates greater disclosure about section 13(3) lending, requiring the Federal Reserve Board to establish, by regulation and in consultation with Treasury, the policies and procedures governing such emergency lending. In addition, the establishment of emergency lending programs or facilities would require prior approval of the Secretary of the Treasury. The Federal Reserve Board is also required to report to Congress on any loan or financial assistance authorized under section 13(3), including the justification for the exercise of authority; the identity of the recipient; the date, amount and form of the assistance; and the material terms of the assistance.

As part of our recent review of the Federal Reserve System's implementation of its emergency lending programs during the recent financial crisis, we identified instances where the Federal Reserve Board could better document certain decisions and processes.<sup>120</sup> As a result, we recommended that the Federal Reserve Board set forth its process for documenting its rationale for emergency authorizations and document its guidance to Reserve Banks on program decisions that require consultation with the Federal Reserve Board.<sup>121</sup> These actions will help address the new reporting process required by the Dodd-Frank Act and better ensure an appropriate level of transparency and accountability for decisions to extend or restrict access to emergency assistance.

---

<sup>119</sup>Section 1101(a)(6) of the Dodd-Frank Act amends section 13(3) of the Federal Reserve Act to provide, among other things, that “[a] program or facility that is structured to remove assets from the balance sheet of a single and specific company, or that is established for the purpose of assisting a single and specific company avoid bankruptcy, resolution under title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, or any other Federal or State insolvency proceeding, shall not be considered a program or facility with broad-based eligibility.”

<sup>120</sup>See [GAO-11-696](#).

<sup>121</sup>Federal Reserve Board officials have said the agency should be more open about its actions to promote financial stability. In exchange for the ability to make independent monetary policy, the Federal Reserve System must be transparent, the Federal Reserve Board Chairman has said. Transparency about actions to promote financial stability assures Congress and the public that the Federal Reserve System is using its resources and authority well, its General Counsel has said. According to the Chairman, the Federal Reserve System will look for opportunities to broaden the scope of information and analysis it provides on its efforts to ensure financial system soundness.

---

The Federal Reserve Influenced AIG's Securities Filings About Federal Aid but Did Not Direct the Company on What Information to File

During the financial crisis, questions arose about FRBNY's involvement in AIG's exclusion of some ML III-related information from its federal securities filings—counterparty transaction details and the description of a key ML III design feature.

In December 2008, after ML III was created, AIG filed two Form 8-K statements with SEC related to ML III, following consultations with FRBNY.<sup>122</sup> The filings included the Shortfall Agreement but not the agreement's Schedule A attachment, which contained ML III counterparty and CDO deal information. As noted earlier, under the Shortfall Agreement, ML III transferred about \$2.5 billion to AIGFP for collateral adjustment purposes. This amount was based on what FRBNY officials described as excess collateral that AIGFP had posted to the counterparties, based on fair market values determined for the CDOs in the ML III portfolio.

SEC noted the Schedule A omission and told AIG that under agency rules, it must include the schedule for public disclosure or request

---

<sup>122</sup>SEC Form 8-K is a report companies must file with SEC to announce major events that shareholders should know about. AIG filed two 8-K statements because the company amended an original filing, SEC officials told us. AIG's first 8-K statement was filed on December 2, 2008, and is available at (last accessed, Sept. 21, 2011) [www.sec.gov/Archives/edgar/data/5272/000095012308016800/y72879e8vk.htm](http://www.sec.gov/Archives/edgar/data/5272/000095012308016800/y72879e8vk.htm). It reported the company's November 25, 2008, agreement with FRBNY on ML III. The second 8-K statement, available at (last accessed, Sept. 21, 2011) [www.sec.gov/Archives/edgar/data/5272/000095012308018339/y73482e8vk.htm](http://www.sec.gov/Archives/edgar/data/5272/000095012308018339/y73482e8vk.htm), was filed December 24, 2008, and reported purchases of additional CDOs for ML III on December 18 and 22, 2008.

---

confidential treatment of the information in it.<sup>123</sup> Subsequently, AIG filed a confidential treatment request (CTR) for the information.<sup>124</sup>

FRBNY became involved in AIG's ML III filings after the company had failed to consult FRBNY or its advisors on an earlier company filing on the Revolving Credit Facility, which contained inaccurate information about details of the facility. FRBNY objected to the information, and AIG corrected its filing and agreed to consult on future filings in advance. The ML III agreement contained a confidentiality clause in which AIG generally agreed to keep confidential nonpublic information and to provide notice of any proposed disclosure. AIG executives told us that they expected FRBNY, given its role in assisting the company, to review securities filings and other information involving the Federal Reserve System. FRBNY officials told us they concurred that if counterparty information was to be released, it would be reasonable for FRBNY, as a co-venturer, to have the ability to express an opinion.

We found that FRBNY, through its counsel, in November 2008 told AIG it did not believe the Shortfall Agreement needed to be filed at the time.<sup>125</sup> When that effort was unsuccessful, and AIG moved to file the agreement nonetheless, FRBNY then urged that the Schedule A counterparty information be omitted from the company's filings. FRBNY was also influential in shaping AIG's arguments to SEC in support of the

---

<sup>123</sup>SEC officials told us this discussion prompted AIG to consider seeking confidential treatment of the information. According to the officials, AIG responded that given the two choices, the company would likely seek confidential treatment.

<sup>124</sup>AIG filed two distinct CTRs—because there initially were two 8-K filings—but the material under consideration was the same, SEC officials told us. In this report, we use the singular “CTR” to refer to both. According to information from SEC, CTRs are not unusual. From 2001 to 2009, the agency received from 1,200 to 1,700 CTRs annually. Most requests involve competitively sensitive information. According to SEC officials, when evaluating a CTR, SEC's goal is to balance investors' need for information with the impact of disclosure on a company. A key determining factor is whether the information is material to investors for making an investment decision. If so, confidential treatment will not be granted. According to SEC, a matter is “material” if there is a substantial likelihood that a reasonable person would consider it important in making an investment decision. Procedures for requesting confidential treatment of information that otherwise must be disclosed in reports to SEC are contained in Rule 406 under the Securities Act of 1933 and Rule 24b-2 under the Securities Exchange Act of 1934, as well as in SEC Staff Legal Bulletin No. 1, dated February 28, 1997, as amended.

<sup>125</sup>FRBNY officials never considered that ML III deal information would be made public and had told the AIG counterparties their identities would not be disclosed.

---

company's request to keep the counterparty information confidential. In particular, FRBNY and its advisers made what they described as significant comments and edits to AIG filings regarding the information claimed as confidential, according to FRBNY officials and correspondence we reviewed. After AIG filed its CTR and SEC officials had reviewed and commented on it, FRBNY remained active in pursuing the CTR matter. Officials discussed making direct contact with SEC on the information they did not want the company to disclose. When SEC requested a telephone conference with the company to discuss the issues, FRBNY officials and its counsel began considering what information FRBNY should present to SEC, after first checking with AIG about the matter.

FRBNY's public arguments for confidentiality were twofold: that the counterparty information was commercially sensitive for the parties involved but did not provide material information to investors, and that disclosure could hurt the ability to sell ML III assets at the highest price, potentially to the detriment of taxpayers and AIG. In addition to these publicly stated reasons, FRBNY staff in internal correspondence also discussed other rationales for withholding Schedule A information. One was unspecified policy reasons, which officials later told us may have referred to the general practice of keeping the identities of discount window borrowers confidential. Another was that disclosure could attract litigation or Freedom of Information Act requests. A third such rationale was that seeking confidential treatment for all of Schedule A, and not just portions, could be a useful negotiating strategy because seeking protection for the entire document could make SEC more likely to grant such a request. FRBNY officials told us these other rationales were opinions voiced during internal discussions before FRBNY took a formal position. According to FRBNY officials, there was also concern that release of the information for ML III could lead to demands for release of similar information for other Federal Reserve System emergency lending facilities—ML II, which was created to deal with problems in AIG's securities lending program, and Maiden Lane, a vehicle created in March 2008 to facilitate JPMorgan Chase & Co.'s merger with Bear Stearns.<sup>126</sup>

---

<sup>126</sup>The goal of Maiden Lane goal was to prevent contagion effects on the economy from a disorderly collapse of Bear Stearns, according to FRBNY. Maiden Lane borrowed \$28.8 billion from FRBNY. This loan, together with \$1.15 billion in funding from JPMorgan Chase, was used to purchase a portfolio of mortgage-related securities, residential and commercial mortgage loans, and associated derivatives from Bear Stearns.

---

As part of its involvement, FRBNY participated in three teleconference calls with SEC officials about AIG's CTR filing, according to SEC records and officials. On January 13, 2009, the day before AIG filed its request with SEC, FRBNY officials at their request spoke with SEC to explain the ML III transaction. Another call came on March 13, 2009, when representatives of AIG and FRBNY contacted SEC to say that AIG intended to file an amended CTR in response to SEC comments on the original request. The third call, on April 22, 2009, took place at SEC's request to discuss AIG's competitive harm arguments. SEC, AIG, and, at AIG's request, FRBNY participated in that call. According to SEC, discussions with FRBNY were at the staff level.

While SEC was reviewing AIG's CTR, the company considered dropping its request, thus making all the contested information public. However, FRBNY officials convinced the company not to do so. By that point, FRBNY was willing to have some information released, such as counterparty names and amounts paid, but did not want to release other material, such as information related to individual securities, according to correspondence we reviewed. The specific concern was that release of security-specific information could allow market participants to identify ML III holdings. FRBNY officials told us they made their opinion known to AIG, and that such communication was appropriate given that FRBNY was a major creditor to ML III. AIG concurred with FRBNY's concerns, according to an FRBNY communication.<sup>127</sup>

According to interviews and information we reviewed, underlying FRBNY's desire that AIG not file sensitive ML III information with SEC was concern that such information could then be requested by Congress and ultimately be made public. This was because SEC rules require that applicants for CTRs consent to furnishing the information claimed as confidential to Congress, among others. SEC officials told us that although there are no records of Congress requesting such information,

---

<sup>127</sup>AIG executives said the company's disclosure counsel circulated for comment the idea of withdrawing the CTR but that, upon reflection, the company realized a complete withdrawal was inappropriate, and the idea was dropped.

---

their best recollection is that Congress has never sought information filed in a CTR with the agency.<sup>128</sup>

SEC's handling of AIG's confidentiality request was routine, SEC officials told us, albeit under unusual circumstances. SEC officials told us they viewed FRBNY's involvement with the agency as that of a counterparty to an agreement with a company required to make filings. In such a situation, it is not common for a counterparty to contact SEC, officials told us. In addition, FRBNY's participation was more active than would be expected of a counterparty, they said. Officials said the agency processed AIG's CTR using its normal CTR review process, and that SEC's review of the request was prompt. But circumstances were unusual for several other reasons, SEC officials told us. First, the AIG filings had been targeted for heightened scrutiny as part of special review efforts arising out of the financial crisis and government aid to private companies. These efforts involved continuous review of selected companies' filings. Second, FRBNY—which FRBNY officials characterized as a federal instrumentality—was an involved party. Third, in response to FRBNY concerns, SEC allowed a special drop-off procedure for the CTR aimed at protecting the information from disclosure.<sup>129</sup> This action came after SEC had declined FRBNY requests for special ways to provide the information for SEC review, such as by SEC officials going to FRBNY offices to review relevant material or FRBNY officials showing SEC the information at SEC headquarters but outside the normal filing system. Finally, the case reached SEC's associate director level and eventually the SEC Chairman. Officials told us that due to AIG's high public profile, the Chairman was advised immediately before the CTR determination on the Schedule A information. SEC officials told us this was not typical. It is rare for SEC staff to brief the Chairman on a CTR determination, they said, but that was done in this case due to anticipated publicity for the matter.

---

<sup>128</sup>Although companies grant the consent, release of information is not automatic, SEC officials told us. In general, no SEC staff may release confidential information to an agency or Congress without formal Commission approval. In the specific case of releasing CTR information to Congress, officials said the Commission would consider such approval on a case-by-case basis.

<sup>129</sup>SEC rules require CTR filings to be made in paper format only. The drop-off procedure involved hand delivery of the CTR to an agency official, bypassing normal routing procedures within SEC that involve delivery of the CTR by mail or courier. SEC officials said that if requested, they would consider this procedure in other instances as well.

---

AIG's original CTR sought confidential treatment for all of the Schedule A information. On May 22, 2009, SEC granted the company's request, but only in part.<sup>130</sup> SEC officials said AIG's initial CTR was too broad, and the agency, through its review process, narrowed the scope of the request. As part of its review, SEC officials provided AIG with detailed comments and questions after reviewing its request and also monitored information that was already publicly available to determine if AIG's CTR should be amended to reflect that availability.

SEC officials said that notwithstanding FRBNY's unusual involvement, they examined the case from the usual standpoint of investor protection, in which the key issue was harm to AIG. Any harm to the Federal Reserve System was not an SEC issue, officials told us. The agency determined that the following elements of the Schedule A information should not be treated confidentially, and thus should be disclosed:

- counterparty names;
- amount of cash collateral posted;
- CDO pricing information that reflected the securities' loss in market value;
- complete Schedule A information for 10 CDOs, including CUSIP identifier, tranche name, and notional value, as related information had previously been made public;<sup>131</sup>
- totals for notional value, collateral posted, and revised values based on market declines for all CDOs; and
- all Schedule A titles and headings.

---

<sup>130</sup>In March 2009, AIG began disclosing Schedule A information, following SEC review. On January 27, 2010, the ranking member of the House Committee on Oversight and Government Reform released the full Schedule A after a committee hearing on AIG. On January 29, 2010, AIG amended its 8-K filings to fully disclose Schedule A.

<sup>131</sup>CUSIP, a commonly used acronym for Committee on Uniform Securities Identification Procedures, provides a unique identifying number for most securities. The CUSIP system facilitates clearing and settlement of securities trades. In the case of information previously made public, AIG had made a disclosure on 4 of the 10 CDOs, and FRBNY had released information on the remaining 6. "Tranche" refers to a particular class within a multi-class security.



---

Except for the 10 CDOs cited, SEC permitted confidential treatment of the following information for each of the other CDOs listed in Schedule A: CUSIP number, tranche name, and notional value. However, the SEC action eventually became moot, as on January 29, 2010, AIG amended its 8-K filings to fully disclose Schedule A.<sup>132</sup>

We also found that the desire to keep Schedule A-type information confidential was not a new position for AIG. Before ML III and any government assistance, AIG had sought protection for similar information on the basis that it was confidential business information. Specifically, in response to an unrelated request for information from SEC, AIG in August 2008 requested that CDO-related information be kept confidential.<sup>133</sup>

In addition to Schedule A, another disclosure issue arose later, after the CTR matter, out of FRBNY's involvement in AIG's securities filings regarding the description of a key ML III design feature. An early draft of

---

<sup>132</sup>FRBNY officials told us it is difficult to gauge any effect of the disclosure yet, for two reasons. First, there has not been a CDO liquidation since the CUSIPs were made public, partly because the market has performed better. Second, any impact will not be felt until wholesale disposition of portfolio assets begins, when FRBNY will negotiate with investors. But even then, it will be difficult to draw cause-and-effect relationships, they said. In the meantime, there has been considerable interest in the information, officials told us. After the CUSIPs were released, for example, FRBNY got a number of calls from market participants who were pleased to learn the positions held by ML III, officials told us, because the market typically is opaque and a private investor would not release such information.

<sup>133</sup>See AIG correspondence to SEC, August 12, 2008, available at (last accessed, Sept. 21, 2011) [www.sec.gov/Archives/edgar/data/5272/000095012308009400/filename1.htm](http://www.sec.gov/Archives/edgar/data/5272/000095012308009400/filename1.htm). SEC officials told us the correspondence was in response to agency comments in connection with review of an AIG quarterly Form 10-Q filing. According to the officials, a table in the AIG response letter included names of the company's largest CDO counterparties, including a summary of aggregate notional values. AIG, in its correspondence, said the material was confidential business and financial information relating to a "breakdown of the super senior multi-sector CDO credit default swap portfolio." SEC officials noted differences between this matter and the company's later CTR. The earlier request was not a CTR, and it did not involve information required to be disclosed under SEC disclosure requirements. The information was provided pursuant to SEC Rule 83, which provides a different standard of review than a CTR and does not require SEC to make a determination on the request until it receives a request for the information under the Freedom of Information Act. AIG provided the information in response to SEC staff comments, to assist the staff in understanding information AIG had disclosed in the 10-Q report. Although a different matter than the CTR AIG later filed, we note nonetheless that it was an effort, in advance of government aid, to protect CDO information similar in nature to Schedule A data. Other than to note the earlier filing and the nature of the content, review of this matter was beyond the scope of this report.

---

an AIG securities filing for December 2008 explaining the ML III transaction contained this sentence:

“As a result of this transaction, the AIGFP counterparties received 100 percent of the par value of the Multi-Sector CDOs sold and the related CDS have been terminated.”

At the request of FRBNY’s outside counsel, AIG omitted this language from its filing, company executives told us.<sup>134</sup> This omission led to criticism that FRBNY was seeking to conceal information about payments to AIG’s counterparties.<sup>135</sup> AIG executives told us the company omitted this language because of concerns that it misrepresented the transaction, as ML III itself was not paying par value. Instead, as noted, ML III paid an amount that, when combined with collateral already posted by AIG to the counterparties, would equal par value (or near par value). In internal correspondence, FRBNY also said “par” was inaccurate, as counterparties paid financing charges and had to forgo some interest earnings. Thus, the amount received was less than par when all costs were considered; in some cases, the difference was in the tens of millions of dollars.

We found that two units of SEC—the Division of Corporation Finance and the New York Regional Office—examined the deletion of the par value statement and concluded there was no basis for an enforcement action for inadequate disclosure. SEC staff considered whether AIG’s filing provided enough information for investors to see that the sum of the collateral counterparties kept and the payments from ML III amounted to 100 percent of value. SEC has not brought any enforcement action concerning this issue.

In February 2010, FRBNY issued a memorandum formalizing its process for reviewing AIG’s securities filings. The memorandum emphasizes that AIG is solely responsible for the content of its filings, and that any FRBNY

---

<sup>134</sup>As noted earlier, AIG filed two 8-K statements initially. The first, as originally prepared, did not contain the language directly stating that the counterparties would receive par value, AIG executives told us. It was in the initial draft of the second 8-K filing that this language appeared, they said.

<sup>135</sup>See, for example, *Public Disclosure As a Last Resort: How the Federal Reserve Fought to Cover Up the Details of the AIG Counterparties Bailout From the American People*, House Committee on Oversight and Government Reform, report by the ranking member, January 25, 2010.

---

review is to promote accuracy or protect taxpayer interests. It also specifies material to be subject to review.

Ultimately, according to both AIG and FRBNY, the company retained responsibility for its own filings. Based on our review, we found that while FRBNY's involvement was influential, it was not controlling. AIG did not comply with all FRBNY requests about information in its filings. Also, later in the process, after Schedule A information was released publicly, an AIG executive reported to an SEC official that FRBNY had told the company to make its own decision on whether to disclose full Schedule A information in filings with SEC. According to AIG executives, there was no occasion when AIG strongly disagreed with a course advocated by FRBNY but adopted FRBNY's position nonetheless. SEC enforcement staff found that AIG exercised independent judgment. The staff examined correspondence related to AIG filings, and their review showed that although FRBNY had a viewpoint it was not reluctant to express, AIG nevertheless remained actively involved in the process and exercised its own independent judgment on what its filings should say. More broadly, although FRBNY was aware of criticism that ML III funds were provided to unnamed counterparties or foreign institutions, we found no evidence that FRBNY urged AIG to withhold information in order to conceal identities or nationalities of the counterparties.

According to FRBNY officials, FRBNY's involvement with AIG illustrated the dual role of a central bank as a public institution that sometimes must also carry out private transactions as a private market participant. In our review, we considered whether FRBNY's involvement in AIG's securities filings was consistent with what might be expected in the private-sector under similar circumstances. We found that in broad terms, FRBNY's activities appear to be consistent with actions of a significant business partner.

The government assumed multiple roles in assisting AIG. Through its arrangement for initial aid, a government vehicle became the company's majority equity investor.<sup>136</sup> Its emergency lending also made it a significant creditor to AIG. In addition, FRBNY was a joint venturer with AIG in ML III.

---

<sup>136</sup>Neither the Federal Reserve Board nor FRBNY owned AIG stock. Instead, as a condition of extending the Revolving Credit Facility to AIG, FRBNY required that AIG agree to transfer a 79.9 percent controlling interest in the company to a trust for the benefit of the U.S. Treasury, which officials noted is distinct from the Department of the Treasury.

---

In the private-sector, any of these roles could provide a basis for involvement in a company's affairs. Majority shareholders can have significant influence—for example, by naming the board, which exercises control over significant aspects of a company's business. A company might consult with a majority owner on business decisions and might share draft securities filings. Creditor involvement in company affairs can be extensive, particularly in times of stress. Credit agreements can include detailed affirmative and negative covenants—requirements to take, or refrain from, certain actions—through which creditors can shape and constrain financing, management, and strategic decisions. Agreements often require corporations to provide extensive financial information to the creditor. In the case of joint venturer, the academic research we reviewed does not discuss the influence that private-sector counterparties may have over each others' SEC filings. However, individuals with whom we spoke indicated sharing draft filings in a merger and acquisition context is common. Parties to a joint venture may share draft filings as well.

The circumstances of Federal Reserve System aid to AIG preclude a direct private-sector comparison for several reasons. Majority ownership of large public companies is unusual. The trust agreement for the government's AIG holdings placed limitations on the trust's role as shareholder. In addition to any assistance relationship with AIG, the government, via OTS, has also had a regulatory relationship with the company. The government also had goals in the AIG intervention beyond those of typical private-sector actors: attempting to stabilize financial markets and the broader economy. Nevertheless, through its various actions, the government provided significant resources to AIG and took on significant risk in doing so. A private party in similar circumstances could be expected to become involved in company affairs.<sup>137</sup>

---

<sup>137</sup>Overall, the federal government's involvement in the corporate governance of companies receiving exceptional amounts of assistance—including AIG—has varied according to the nature of the assistance. In the case of Bank of America, Citigroup, and GMAC, for example, the government's role was as an investor, but its activities were initially limited because the government received preferred shares with limited voting rights. In the case of General Motors and Chrysler, the government was an investor and creditor, and it has been more involved in some aspects of the companies' operations than it has been with other companies. This has included monitoring financial strength through regular reports and meetings with senior management, plus requiring certain actions, such as maintaining the level of domestic production. See GAO, *Financial Assistance: Ongoing Challenges and Guiding Principles Related to Government Assistance for Private Sector Companies*, [GAO-10-719](#) (Washington, D.C.: Aug. 3, 2010).

---

While FRBNY Implemented Updated Vendor Conflict-of-Interest Procedures in Providing AIG Assistance, Aid Gave Rise to Complex Relationships that Posed Challenges

To provide emergency assistance that the Federal Reserve Board approved for AIG, FRBNY contracted for financial advisors to perform a range of activities for the Revolving Credit Facility and ML III.<sup>138</sup> FRBNY retained its principal financial advisors for the Revolving Credit Facility and ML III in September and October 2008. According to FRBNY officials, they awarded contracts for at least two of the advisors without competitive bidding, due to exigent circumstances.<sup>139</sup> They said there was insufficient time to bid the services competitively as advisors were needed to quickly begin setting up the program.

For the Revolving Credit Facility, the principal financial advisors were Ernst & Young and Morgan Stanley, which were engaged for these main duties:

- structuring the loan documentation between FRBNY and AIG after the company accepted FRBNY's initial loan terms on September 16, 2008;
- providing advisory services for AIG asset sales;
- performing valuation work on AIG securities posted as collateral to secure the Revolving Credit Facility;
- calculating AIG cash flow projections to monitor the company's use of cash, plus actual and predicted draws on the Revolving Credit Facility;
- advising FRBNY on how to address rating agency and investor concerns; and
- monitoring Revolving Credit Facility requirements on information AIG must provide to FRBNY to identify any instances where AIG did not comply.

---

<sup>138</sup>FRBNY contracted with a number of vendors for AIG assistance, including those for the Revolving Credit Facility and ML III. For details, see [GAO-11-696](#), appendix III.

<sup>139</sup>FRBNY's Operating Bulletin 10 sets forth FRBNY's acquisition policy. Exigency is defined as occurring when "[t]he Bank's need for the property or services is of such unusual and compelling urgency that it would be demonstrably and significantly injured unless it can limit the number of suppliers from which it solicits responses or take other steps to shorten the time needed to acquire the property or services." See [GAO-11-696](#) for a more detailed discussion on FRBNY's use of noncompetitive bidding to award contracts to vendors for Federal Reserve System emergency lending programs.

---

For ML III, FRBNY's three primary financial advisors have been Morgan Stanley, Ernst & Young, and BlackRock, Inc., which were engaged for these main duties:

- developing alternate designs for ML III;
- identifying CDO assets for inclusion in ML III;
- valuing CDO securities under economic stress scenarios;
- advising FRBNY on how to structure the transaction to address rating agency and investor concerns; and
- managing the ML III portfolio for FRBNY.<sup>140</sup>

FRBNY has also contracted for two other vendors to provide key services for ML III: Bank of New York Mellon performs accounting and administration for the ML III portfolio, and another vendor, Five Bridges Advisors, conducts valuation assessments.

One of the factors FRBNY considered when selecting vendors was potential conflicts of interest. In general, potential and actual conflicts of interest can arise at either the personal or organizational levels. A personal conflict could arise, for example, through the activities of an individual employee, whereas an organizational conflict could arise through the activities of a company or unit of a firm. Our work focused on potential organizational conflicts of interest that involved the Revolving Credit Facility and ML III. When FRBNY engaged its Revolving Credit Facility and ML III advisors, FRBNY had its Operating Bulletin 10 as guidance, which applies to vendor selection but did not include provisions

---

<sup>140</sup>In the case of ML III portfolio management, the advisor directs the investment and manages the assets of ML III, according to the direction and authority granted to it by FRBNY.

---

on vendor conflicts.<sup>141</sup> By contrast, Treasury, which has also engaged a number of vendors in implementing TARP, in January 2009 issued new interim guidelines for its management of TARP vendor conflicts of interest. The Treasury regulations provide that a “retained entity”—generally, an individual or entity seeking or having a contract with Treasury—shall not permit an organizational conflict of interest unless the conflict has been disclosed to Treasury and mitigated under an approved plan, or unless Treasury has waived the conflict.<sup>142</sup>

However, even though FRBNY guidance did not have provisions on vendor conflicts, FRBNY officials told us that they held internal discussions to identify potential advisor conflicts that could arise. FRBNY also identified some activities, such as providing advisory services, as presenting a greater risk of conflict than other activities, such as administrative services where there is no discretionary or advisory role. As a result, FRBNY subjected the advisors to greater conflict of interest scrutiny. Based on its internal discussions, FRBNY identified a number of potential conflicts, including two main types of conflicts for advisors other than its investment advisor:

---

<sup>141</sup>Operating Bulletin 10 is labeled as an “acquisition policy” and describes, for example, a FRBNY contract representative’s responsibility to avoid “conduct which gives rise to an actual or apparent conflict of interest, or which might result in a question being raised regarding the independence of the Contract Representative’s judgment or the Contract Representative’s ability to perform the duties of his or her position satisfactorily.” Overall, an evaluation of FRBNY’s implementation of conflict procedures was beyond the scope of this report. See [GAO-11-696](#) for a review of Federal Reserve System emergency lending facilities created during the financial crisis, which includes a review of FRBNY’s conflict policies and procedures. FRBNY also has an employee Code of Conduct, which generally addresses conflict issues for employees, such as avoiding preferential treatment, conduct that places private gain above duties to the bank, or situations that might result in questions about employee independence. The code also incorporates the provisions of a federal criminal conflict of interest statute and its regulations. See (last accessed, Sept. 21, 2011) [www.newyorkfed.org/aboutthefed/ob43.pdf](http://www.newyorkfed.org/aboutthefed/ob43.pdf).

<sup>142</sup>The Treasury regulations, at 31 C.F.R. Part 31, define an organizational conflict of interest as a situation in which the retained entity has an interest or relationship that could cause a reasonable person with knowledge of the relevant facts to question the retained entity’s objectivity or judgment to perform under the contract, or its ability to represent Treasury. The regulations provide that, as early as possible before entering into a contract to perform services for Treasury, a retained entity shall provide Treasury with sufficient information to evaluate any organizational conflict of interest. Steps necessary to mitigate a conflict may depend on a variety of factors, including the type of conflict, the scope of work, and the organizational structure of the retained entity. Some conflicts may be so substantial and pervasive that they cannot be mitigated. 31 C.F.R. § 31.211.

- 
- instances in which AIG or its subsidiaries seek entities serving as FRBNY advisors to assist them, for matters in the past, present, or future; and
  - instances in which potential buyers of AIG assets seek entities serving as FRBNY advisors to assist them, for matters in the past, present, or future.

Without specific conflict policies for its advisors in its established guidance, FRBNY relied upon contract protections and what officials said was day-to-day vendor management to address certain conflict situations. For example, one advisor's agreement with FRBNY provided that when a potential buyer of AIG assets, also known as a "buy-side" firm, sought transaction advisory services from the advisor, the advisor was to determine if it could perform all services for each party objectively and without compromising confidential information. Upon determining it could be objective, the advisor was to notify FRBNY and AIG of the names of each potential buyer and provide an opportunity for FRBNY and AIG to discuss the scope of services the advisor would provide to the would-be buyer. Another advisor's agreement similarly provided for seeking FRBNY's consent before entering into transactions that would create a conflict. Contractual conflict mitigation procedures included separation of employees conducting work for FRBNY from those doing buy-side advisory work, as well as information barriers to prevent sharing of confidential information between FRBNY engagements and the advisor's other work. One advisor's engagement agreement also had a provision giving FRBNY the right to audit the advisor's performance and determine whether it was in compliance with requirements. According to FRBNY, it performed conflict of interest reviews of four advisors providing AIG-related services.<sup>143</sup>

Similarly, the ML III investment management agreement of November 25, 2008, by and among FRBNY, ML III, and BlackRock, noted potential conflicts and provided mitigation procedures involving employee separation of duties and information barriers. Among other things, BlackRock employees engaged for ML III are not permitted to perform managerial or advisory services related to ML III assets for third parties or to provide valuation services for third parties for those assets without

---

<sup>143</sup>The reviews were of Morgan Stanley, Ernst & Young, BlackRock, and Bank of New York Mellon.



---

FRBNY's consent. BlackRock is also barred from recommending or selecting itself as a replacement collateral manager for any ML III CDO.<sup>144</sup> Further, it cannot knowingly purchase for ML III any asset from a portfolio for which it serves as an investment advisor or knowingly sell any ML III assets to portfolios for which it serves as an investment advisor. However, BlackRock may aggregate trading orders for ML III-related transactions with similar orders being made simultaneously for other accounts the advisor manages, if aggregating the orders would benefit FRBNY.<sup>145</sup>

In addition to the contract provisions, in December 2008 FRBNY asked its Revolving Credit Facility advisors to disclose potential and actual conflicts arising from their duties and to provide a comprehensive plan to mitigate such conflicts. The mitigation plan was to include implementation steps, conflict issues that were reasonably foreseeable, and identification of how the advisor would notify FRBNY of conflicts identified in the course of their duties. FRBNY requested this information to assist it in developing an approach to managing conflicts related to AIG assistance and other Federal Reserve System emergency facilities created to address the financial crisis.<sup>146</sup> In response, the advisors provided general information on their conflict-of-interest policies and procedures, according to FRBNY officials. Officials told us that FRBNY did not make the same request of one of its ML III advisors because FRBNY had been working with the advisor on a frequent basis for some time and the officials felt they understood the advisor's conflict issues and policies.

Over the course of FRBNY assistance to AIG, FRBNY's advisors have disclosed a number of conflict situations, both when first engaged and subsequently while performing their duties. These have involved several kinds of conflicts, which FRBNY has waived or permitted to be mitigated.<sup>147</sup> When signing their agreements with FRBNY, one advisor

---

<sup>144</sup>Collateral managers perform duties including managing portfolio risks, such as credit and interest rates; purchasing and managing collateral assets; executing trades and hedges; and working closely with trustees.

<sup>145</sup>"Aggregating" orders is when a firm combines different orders together, involving its own account, customer account(s), or both.

<sup>146</sup>See [GAO-11-696](#) for a description of such facilities.

<sup>147</sup>According to FRBNY officials, advisors generally prescreened their conflict waiver requests internally, so that they only presented those likely to be approved.

---

disclosed two buy-side advisory engagements that were underway. FRBNY permitted the arrangements, provided that employee separation and information barriers be created and that the advisor not provide FRBNY with advisory services related to certain potential AIG divestitures. However, FRBNY's consent still allowed some potential sharing of information between separate employee teams at the advisor. Two advisors had teams providing advisory services to AIGFP when FRBNY engaged them. Both FRBNY and AIG agreed to waive the potential conflicts. One advisor was working on a broad range of advisory and tax services for AIG. Another was involved in analysis of certain AIG CDOs and the RMBS portfolio associated with AIG's securities lending program. One ML III advisor reported that it was a collateral manager for certain CDOs in which ML III was an investor, and it was allowed to continue subject to conditions.<sup>148</sup>

FRBNY officials told us their general approach to conflict issues such as these was to rely on information barriers, which are intended to prevent sensitive information from being shared among people or teams, and to avoid having the same people work in potentially conflicting roles, such as both buy-side and sell-side engagements. We note, however, that such precautions involve a trade-off: all else equal, these measures may protect against conflicts, but they can also preclude application of skills or resources that would otherwise be available.

FRBNY and its advisors also set up regular communications for addressing conflicts. For example, one advisor would provide FRBNY with a weekly list of projects requested by AIG subsidiaries or potential acquirers of AIG assets. After considering whether it could accept the project, the advisor would seek waivers from FRBNY when necessary. FRBNY officials told us that they discussed the projects, addressed concerns, and raised questions as needed. The advisor would also get approval of the project proposals from AIG. Another advisor likewise presented potential project requests to FRBNY as they arose. This process was written into a new engagement letter in November 2010. Conflict provisions for another advisor included advisor identification of conflict situations to FRBNY and use of appropriate trading limitations.

---

<sup>148</sup>According to FRBNY officials, the decision in this matter took into account that certain trigger events had already occurred, which resulted in a restriction on any trading by the CDO collateral manager. In addition, FRBNY staff took on sole responsibility for monitoring the assets.

---

---

FRBNY Has Granted a Number of Waivers to Its Conflict Prohibitions

As part of its conflict management process, FRBNY commissioned compliance reviews for several Revolving Credit Facility and ML III advisors in order to assess the advisors' policies and identify potential conflicts. One review found several instances in which the advisors allowed employees to work on an engagement for an AIG subsidiary, but these situations were disclosed to FRBNY and the staff in question were reassigned. Another review that covered several Federal Reserve System lending facilities noted that the ML III investment management agreement did not require conflict policies and procedures tailored specifically for ML III. Due to the complexity of ML III assets and the presence of third parties that could influence the portfolio, the report said that FRBNY should consider requiring an advisor to revise its policies and procedures to address unique issues raised by ML III, including potential conflicts and mitigating controls. As discussed later, in May 2010, FRBNY implemented a new vendor management policy to serve as a framework to minimize reputational, operational, credit, and market risks associated with its use of vendors.

Our review of advisor records showed that FRBNY's Revolving Credit Facility advisors have requested at least 142 waivers for AIG-related projects and buy-side work. FRBNY has granted most of these waiver requests. According to FRBNY officials, overall figures on conflict waiver requests and outcomes are not available because FRBNY did not begin tracking the requests until about January 2010, about 16 months after government assistance began.

According to the records, one advisor made at least 132 conflict waiver requests to FRBNY for the period of 2008 to 2011.<sup>149</sup> The work requested covered an array of advisory projects involving AIG business units. The records did not indicate how many requests FRBNY granted consent for, but according to FRBNY officials, FRBNY granted a large majority of them on the condition of employee separation and information barriers.

Another advisor initially made 10 conflict waiver requests but later dropped one. The remaining nine requests covered at least the 2009–2011 period, with five related to work requested by AIG and four related to work on behalf of potential buyers of AIG assets. The AIG projects

---

<sup>149</sup>Although FRBNY did not begin tracking waiver requests until January 2010, we obtained records for such requests from FRBNY advisors.

---

---

Overlapping Interests of  
FRBNY and AIGFP Have at  
Times Created Competing  
Interests

were for such matters as assisting with asset sales and raising funds for subsidiaries. The buy-side projects related to acquisition and financing of AIG assets. FRBNY granted four waiver consents for AIG-related work and two for buy-side transactions. For example, according to FRBNY, it denied one of the conflict waivers in an instance where the advisor provided FRBNY with sell-side advice and deal structuring for a potential AIG asset sale. The advisor requested a waiver to participate in financing to assist the buy-side client to the transaction. According to FRBNY, officials decided that the advisor had been too involved in providing FRBNY with advice and thus turned down the waiver request. In another case, the advisor was in a situation where it had multiple roles involving an AIG subsidiary. One unit of the advisor recommended AIG sell the subsidiary, while another recommended AIG conduct an initial public offering of stock. The advisor was providing FRBNY with advice at the same time it was advising a potential purchaser. The conflict issue became moot when the sale idea was abandoned, but before that, FRBNY had decided not to allow a conflict waiver, officials told us.

In cases such as these, FRBNY officials said they considered separation of duties to be a significant mitigating factor, because individuals with access to AIG-related information would not be staffed to other potentially conflicting engagements.

FRBNY's interests as an ML III creditor and its interest in the health of AIG have created competing interests because the interests of ML III and AIGFP overlap: (1) AIGFP owns tranches in the same CDOs in which ML III owns tranches<sup>150</sup> and (2) AIGFP has been an interest rate swap counterparty to certain CDOs in which ML III is an investor.<sup>151</sup> These interests have resulted in circumstances where ML III and AIGFP have either worked together or instead have had conflicts due to divergent interests. FRBNY has identified instances in which decisions made that reflect the overlapping interests could have led to a total of as much as \$727 million in losses or foregone gains for ML III. However, ML III gains could have come at the expense of AIGFP, the health of which is also of interest to the Federal Reserve System.

---

<sup>150</sup>Voting rights allow the holder to direct, or consent to, certain significant actions, such as replacing managers or amending contracts.

<sup>151</sup>Hedge counterparties, through derivative contracts with CDOs, hedge various CDO risks, including interest rate, foreign exchange, and cash flow timing.

---

In December 2009, FRBNY's Investment Support Office documented 10 such instances in 2008 and 2009, including the following:

- In three instances, the ML III portfolio lost a total of \$72.5 million, with AIGFP gaining at least \$59.3 million. For example, in one instance, ML III and AIGFP together held voting rights to control a CDO. A default occurred, and FRBNY's ML III advisor sought AIGFP's consent to "accelerate" the CDO, a process that would have directed cash flows to the benefit of both ML III and AIGFP. However, AIGFP declined to cooperate because it was in a dispute with the CDO manager on another transaction. FRBNY believed AIGFP did not want to antagonize the manager by voting to accelerate the CDO, which would have reduced the manager's fee income.
- In three instances, ML III saw total gains of \$5.6 million. For example, in one instance, AIGFP agreed to vote with ML III to direct a CDO trustee to terminate a CDO manager and replace it with a new manager at reduced cost.
- In two instances, FRBNY refrained from taking action, in its role as managing member of ML III, for the benefit of AIGFP. This resulted in foregone ML III gains of up to \$660 million. At issue was potential termination of interest rate swap protection AIGFP provided on certain CDOs in which ML III was an investor.<sup>152</sup> FRBNY's Risk Advisory Committee considered the issue in February 2009, deciding that ML III should refrain from exploring termination of the interest rate swaps, because there was a potential loss at AIGFP that would not be offset by the gain to ML III, and because there was concern that terminating the swap protection could have encouraged other market participants to do the same, to AIGFP's detriment, the committee indicated. The \$660 million was a maximum potential gain for ML III, assuming the swap termination would have been successful, FRBNY officials told

---

<sup>152</sup>Interest rate swaps are financial products that provide swap buyers with hedging protection against the risk that interest rates will increase in the future. Because AIG's credit rating had been downgraded below a specified level, the collateral managers of these CDOs had the right to direct the termination of AIGFP as an interest rate swap counterparty. At issue were timing of a potential CDO liquidation and the effect that would have had on AIGFP's ability to receive a swap termination payment. In deciding whether to direct liquidation, FRBNY did not discuss these matters with AIGFP. As of February 5, 2009, AIGFP was an interest rate swap counterparty to 72 CDOs in which ML III was an investor, with a net exposure of about \$12 billion.

---

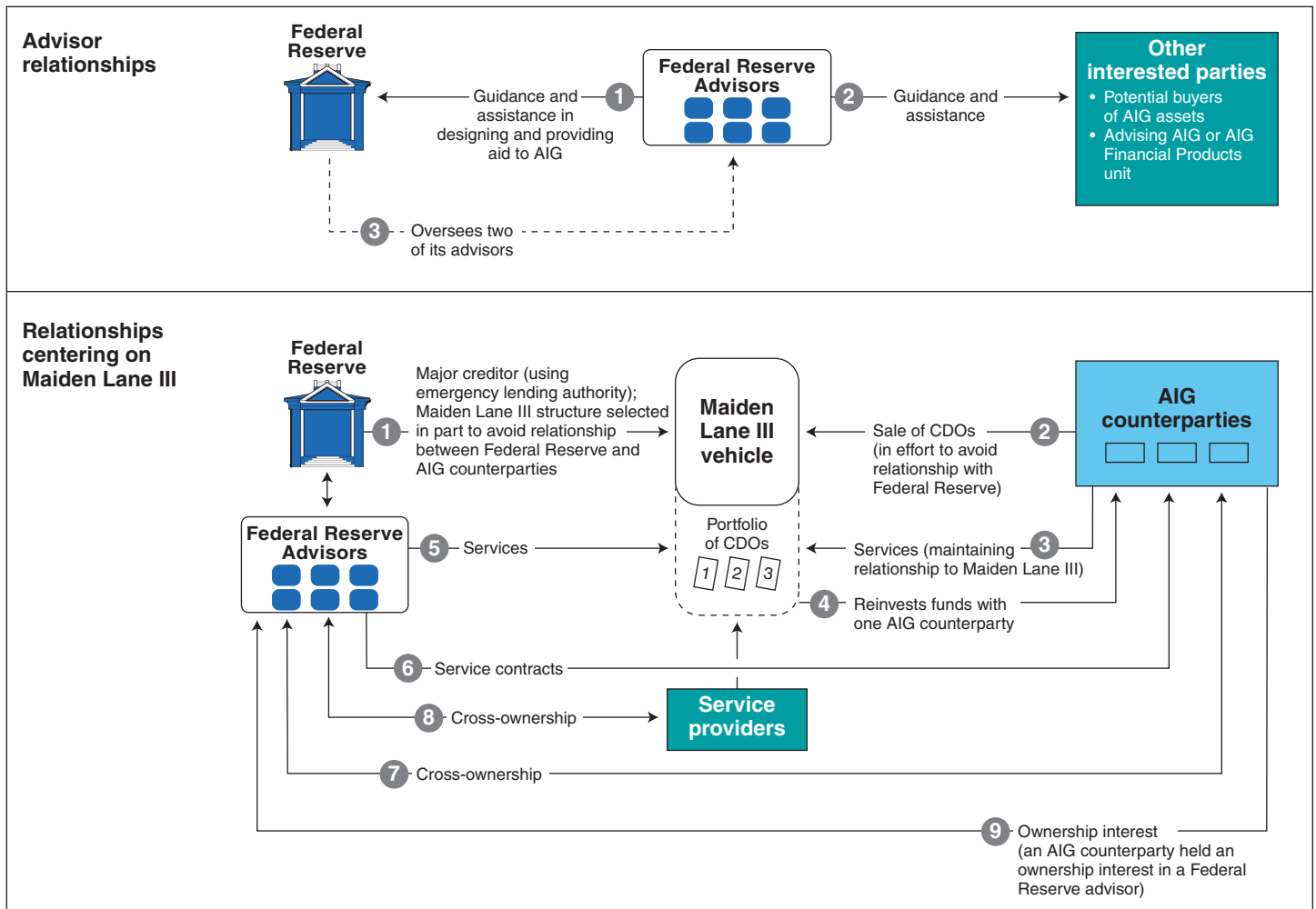
us, although they expected AIG to vigorously oppose any attempts to terminate.

Overall, FRBNY officials told us that if different choices had been made in these instances, then AIGFP rather than ML III would have suffered losses, which would have had direct and indirect implications for the Federal Reserve System and the larger public interest.

Assistance Gave Rise to  
Complex Relationships among  
the Parties

We also reviewed a number of other relationships that resulted from FRBNY's assistance to AIG. These involve (1) the continuing involvement of AIG's CDS counterparties with CDOs in which ML III is an investor; (2) other relationships among parties involved in AIG assistance, such as FRBNY vendors and advisors; (3) regulatory relationships; and (4) cross-ownership interests. Figure 7 depicts a number of these situations, which are discussed in further detail in the sections following.

**Figure 7: Roles and Relationships among the Federal Reserve, Its Advisors, and Other Parties**



Source: GAO summary, based on interviews with participants, and review of records from the Federal Reserve Board, FRBNY, an FRBNY advisor, SNL Financial, and SEC.

**Links to AIG counterparties.** Our review identified continuing indirect relationships between FRBNY and the AIG counterparties that sold CDOs to FRBNY’s ML III vehicle. The AIG counterparties have acted as trustees and collateral managers to CDOs in which ML III is an investor. They have also been interest rate swap counterparties to these ML III CDOs and had other continuing relationships. For example, our review of public data and information obtained from an FRBNY advisor showed that five AIG counterparties have provided either CDO trustee or collateral manager services to CDOs in which ML III is an investor. The AIG

counterparties thus continued to have involvement with ML III and FRBNY via FRBNY's management of the assets in ML III.

For trustee services, our analysis identified four AIG counterparties that sold assets to ML III that were trustees for CDOs in which ML III is an investor. These counterparties accounted for 66 percent of the trustees for CDOs in which ML III invests.<sup>153</sup> For example, Bank of America, which sold CDOs with a notional value of \$772 million to ML III, was trustee for 71, or 40 percent, of the CDOs in which ML III invests. Trustee duties involve interaction with the ML III investment manager, BlackRock; the ML III administrator, Bank of New York Mellon; and by extension, FRBNY. FRBNY officials said the fact that counterparties act as trustees shows that the trustee business is highly concentrated, meaning that such relationships are difficult to avoid. They also said they see little conflict because the job of a trustee is largely ministerial. Table 7 provides a breakdown of the trustees of CDOs in which ML III is an investor, showing AIG counterparties among them.

**Table 7: ML III CDO Trustees that Were Also AIG Counterparties**

<b>AIG counterparty</b>	<b>Percentage of ML III CDOs for which counterparty is trustee</b>
Bank of America	40%
Wachovia	16
Deutsche Bank	9
HSBC	1
Other	34

Source: GAO analysis of CDO service provider data.

Notes: "Other" category reflects noncounterparty trustees. Figure for Wachovia includes Wells Fargo & Co., which acquired Wachovia.

Our analysis also identified an additional AIG CDS counterparty—Societe Generale, which sold CDOs with a notional value of \$16.4 billion to ML III—as accounting for 31, or 17 percent, of all collateral managers in the ML III portfolio.<sup>154</sup> As described previously, in the case of AIGFP's dispute

<sup>153</sup>Trustee duties generally include distributing payments to CDO investors according to their payment seniority, performing compliance tests on the composition and quality of CDO assets, and producing and distributing investor reports.

<sup>154</sup>The collateral manager is Trust Company of the West, which is a Societe Generale subsidiary.



---

with a collateral manager, issues can arise with collateral managers. FRBNY officials told us that collateral managers work for a CDO and its trustee, not the CDO investors, and that investors have no right to direct the collateral manager. However, some CDOs permit investors with sufficient voting rights to direct a trustee to replace a collateral manager if certain conditions have been met, officials said.

Another area of continuing relations involves interest rate swap counterparties. As described earlier, interest rate swaps help manage interest rate risk. Through December 31, 2008, three AIG counterparties had a total of five swap arrangements with CDOs in which ML III was an investor. To the extent that these swap counterparties' interests diverge from ML III's interests, similar to the AIGFP swap case discussed previously, issues can arise.

According to FRBNY and an advisor, AIG counterparties that sold CDOs to ML III have also been involved with AIG's asset sales, the proceeds of which have paid down federal assistance, such as the Revolving Credit Facility. For example, one counterparty was involved in the divestiture of AIG's ALICO, Star, and Edison life insurance subsidiaries. Additionally, four other counterparties provided advisory services to AIG, according to the advisor. FRBNY officials told us they did not view such assistance in asset sales as raising an issue.

Another continuing relationship arose temporarily through placement of ML III cash in an investment account offered by an AIG counterparty. For example, according to a December 2008 advisor memorandum, in November and December 2008, ML III's portfolio holdings generated cash flows of approximately \$408 million, which were placed in the AIG counterparty's investment fund. Later, according to FRBNY, it moved most cash into U.S. Treasury bills, using the counterparty's fund as a short-term holding account. FRBNY officials said the relationship was not a concern, and that they chose the fund because it had flexibility for withdrawals and offered the best return.

**Advisor or vendor relationships.** FRBNY advisors or vendors have also acted as service providers to CDOs in which ML III is an investor. For example, as noted previously, one ML III advisor reported to FRBNY that it was collateral manager for CDOs in which ML III was an investor. Specifically, the advisor managed other investor accounts that held 11

---

CDOs managed by other parties and in which ML III held a senior interest.<sup>155</sup> According to FRBNY, the notional value of the assets was approximately \$539 million. The advisor also managed one ML III CDO for which ML III held the super senior tranche, which had a notional value of about \$800 million. The advisor sought a conflict waiver, and FRBNY consented, stipulating that the advisor would not make management decisions or take a position contrary to the interests of ML III and that the advisor would immediately seek to sell the CDO positions in question where permissible.

Our review also identified instances in which this advisor has managed other ML III-related CDO assets that it said presented a potential for conflicts and where the advisor did not seek waivers from FRBNY. At the time ML III was established, the advisor was investment manager for clients owning approximately eight junior tranches in CDOs for which ML III held the senior tranches. FRBNY officials said that under the structure of the assets, neither the advisor nor ML III is able to influence the CDO holdings.

We also found that the ML III administrator, Bank of New York Mellon, has also been a trustee for individual CDOs in which ML III is an investor. This means Bank of New York Mellon has had interests that could diverge. Bank of New York Mellon has been the trustee for 50 CDOs in which ML III is an investor, or 28 percent of all trustees, according to our analysis. As an individual CDO trustee, Bank of New York Mellon is involved in such tasks as performing compliance tests on the composition and quality of CDO assets; identifying CDO events of default; and liquidating CDOs upon events of default at the direction of CDO holders, subject to certain conditions.<sup>156</sup> As the administrator for the overall ML III portfolio, Bank of New York Mellon's income would depend on the CDO assets held in the ML III portfolio. But as noted previously, as trustee to individual CDOs, it could be called upon to determine if CDOs are in

---

<sup>155</sup>Tranches can vary in risk profile and yield. Junior tranches will bear the initial risk of loss, followed by more senior tranches. The CDOs in the ML III portfolio are largely senior tranches. Because senior tranches are shielded from defaults by the subordinated tranches, they typically have lower yields and higher credit ratings—often investment grade.

<sup>156</sup>ML III had unilateral liquidation rights upon events of defaults in 26 of 89 CDO deals (39 percent by principal balance). Prior to liquidation, discussions take place between the investor and the trustee on liquidation matters.

---

default, which can lead to liquidation if requisite conditions are met.<sup>157</sup> Such liquidations could reduce overall portfolio assets, and hence, the administrator's income.<sup>158</sup> FRBNY officials said that this divergence of incentives is inherent in the CDO trustee business, and they emphasized that as the ML III administrator, Bank of New York Mellon had no authority to make ML III decisions.

According to FRBNY, Bank of New York Mellon performed custodial and administrative services and had no discretion, and thus was considered to present a low conflict risk. In the case of an ML III advisor managing individual CDOs, or related assets, FRBNY officials told us they examined individual situations as necessary.

Finally, our review also identified other relationships. For example, an ML III advisor has had service contracts with the AIG counterparties that sold CDOs to ML III. FRBNY officials told us they did not consider these relationships to be of concern because the advisor was not involved in direct negotiations with counterparties with respect to ML III purchases of CDOs. Also, there are one or two instances where interests in Maiden Lane—the vehicle for another Federal Reserve System emergency program—hold tranches of CDOs in ML III, FRBNY officials told us. In some cases, the interests of Maiden Lane LLC and ML III could diverge, similar to the situations described earlier relating to AIGFP and ML III. According to FRBNY, it manages from the standpoint of its overall loans for assistance. FRBNY officials also said that it would be rare that a loss to Maiden Lane LLC would be greater than the gain to ML III.

According to FRBNY officials, they would have avoided any involvement with the various parties if practicable. They said that the relationships we identified, the majority of which stemmed from arrangements that existed before ML III was established, reflected areas that did not raise concern. From FRBNY's perspective, after AIG's counterparties no longer owned the CDO positions sold to ML III, those counterparties had no ongoing

---

<sup>157</sup>Liquidation involves selling a CDO's underlying securities through an auction process. If a CDO experiences an event of default, specified voting classes may have the right to either accelerate or liquidate the CDO to recover any remaining value. Acceleration alters the CDO cash flow payment priority to divert cash flows to the senior tranches, which are generally the tranches ML III holds.

<sup>158</sup>Bank of New York Mellon's fee letter with FRBNY states that fees are based on the average notional balance of ML III assets.

---

interest in ML III's structure or interactions with FRBNY related to ML III. FRBNY officials said that positions that ML III held in the CDOs came with the rights and obligations the CDO structure itself stipulated, as well as the trustees and collateral managers then involved—all of which predated FRBNY's involvement. They acknowledged that FRBNY's ML III investment manager presented the potential for conflict but said that adequate measures were taken to avoid actual conflicts.

**Regulatory relationships.** The Federal Reserve System oversees two of FRBNY's advisors, which means that while FRBNY has been receiving advice from the advisors, it also has been responsible for oversight of them.<sup>159</sup> According to FRBNY, it has maintained its AIG monitoring team separately from staff who perform supervisory duties. The AIG monitoring staff has no contact with those involved in supervision, officials told us. In addition, officials told us that FRBNY policy requires bank supervisory information to be kept separate from other operations, including separate computer systems.<sup>160</sup>

As an example of attention to separation of supervisory duties, FRBNY officials cited the case of MetLife, which in 2010 acquired AIG's ALICO unit. MetLife is a bank holding company regulated by the Federal Reserve System. At the time of the acquisition, there were inquiries from an FRBNY MetLife team to the AIG team. When that happened, officials said they immediately put in place an information barrier to make clear that supervisory decisions would not be affected by information the AIG team had. Officials saw the matter as a serious potential conflict because FRBNY had an interest in seeing the acquisition being completed, as that would aid repayment of federal lending, while at the same time, it had a supervisory responsibility for MetLife.

**Cross-ownership.** Cross-ownership occurs when parties have ownership interests in each other—for example, if a company owns stock in another firm and that firm owns stock in the first company. According to academic

---

<sup>159</sup>According to officials, the Federal Reserve Board makes supervisory rules and is responsible for supervision. To carry out that responsibility, the Federal Reserve Board has delegated functions to the Reserve Banks, including FRBNY.

<sup>160</sup>In addition to the advisor relationships described here, the Federal Reserve System was also the regulator of some entities involved in efforts to obtain private financing for AIG prior to extension of the Revolving Credit Facility and of some AIG CDS counterparties that were part of negotiations leading to ML III.

---

literature we reviewed, such reciprocal ownership can create mutual interests among the parties or interests that might not have been present absent the ownership, which can diminish independence between the parties. Our review found that a number of AIG CDS counterparties, FRBNY advisors, and service providers to CDOs in which ML III is an investor have held cross-ownership interests in each other, both at the time ML III was established and more recently.

For example, we found that as of December 31, 2008—the end of the quarter during which ML III was planned and formed—FRBNY ML III advisor Morgan Stanley had stock holdings in nine AIG CDS counterparties totaling at least \$1.4 billion.<sup>161</sup> Among those nine counterparties, four have been service providers to CDOs in which ML III is an investor (such as trustees or collateral managers, as discussed previously). Morgan Stanley's largest counterparty holding was Bank of America, valued at \$925 million. At the same time Morgan Stanley held its equity ownership in these nine counterparties, the nine counterparties had equity ownership in Morgan Stanley valued at about \$1.1 billion, our review found. The counterparties' ownership ranged from a low of \$6.7 million for counterparty HSBC to a high of \$384.2 million for Goldman Sachs.<sup>162</sup>

Similarly, and more recently, we identified cross-ownership between AIG CDS counterparties and FRBNY ML III advisor BlackRock. In particular, we found that 12 counterparties owned BlackRock stock worth at least \$998 million, based on information available as of April 2011—3.8 percent of BlackRock's outstanding shares. Among these 12 firms, 5 have been service providers to CDOs in which ML III is an investor. The largest AIG

---

<sup>161</sup>Our review was based on information from data provider SNL Financial and SEC Form 13F filings, the latter of which report holdings of institutional investment managers. According to SEC, in general, an institutional investment manager is (1) an entity that invests in, or buys and sells, securities for its own account or (2) a person or entity that exercises investment discretion over accounts of others. Institutional investment managers can include investment advisers, banks, insurance companies, broker-dealers, pension funds, and corporations. There is a \$100 million threshold for Form 13F reporting. If cross-holding of the type we identified existed at a level below the threshold, it would not be reportable.

<sup>162</sup>Our analysis focused on cross-ownership. Hence, we do not discuss one-way ownership here—that is, where an advisor had holdings in a counterparty but the counterparty did not have holdings in the advisor, or vice-versa. Our analysis also excluded counterparties not publicly traded.

---

CDS counterparty owner of BlackRock stock was Barclays, with holdings valued at \$603 million. At the same time these 12 counterparties owned BlackRock stock, BlackRock had equity ownership interests in them worth \$44.3 billion. BlackRock's ownership ranged from a low of \$248 million for Calyon (later renamed Credit Agricole) to a high of \$8.4 billion for HSBC.

BlackRock and Merrill Lynch, an AIG CDS counterparty, have had business interests in addition to investment interests. In September 2006, BlackRock merged with the investment management unit of Merrill Lynch. Later, Merrill Lynch became one of the largest recipients of ML III payments. At year-end 2008, Merrill Lynch owned about 44 percent of BlackRock's common stock. In September 2008, Bank of America announced its acquisition of Merrill Lynch. Bank of America was also an AIG CDS counterparty that received payments from ML III. According to BlackRock's 2008 year-end SEC filing, Merrill Lynch would vote its BlackRock shares according to the recommendation of BlackRock's board of directors.<sup>163</sup>

Similarly, we found that cross-ownership extends to FRBNY advisors and service providers (that is, CDO trustees and collateral managers) for CDOs in which ML III is an investor. For example, we found that 15 of 52 CDO service providers owned BlackRock stock valued at \$624 million, based on information available as of April 2011, with holdings equal to 2.4 percent of BlackRock's outstanding shares. Among these providers, for example, was State Street Global Advisors, which had the largest BlackRock stake, worth \$300 million, or 1.2 percent of BlackRock's outstanding shares. At the same time, BlackRock held State Street stock worth \$293 million, or 1.1 percent of shares outstanding.

FRBNY officials told us that they had not considered the cross-ownership issue, either before or after executing ML III, but that by itself, it was not of concern. First, they distinguished BlackRock from other entities, saying BlackRock is an investment management company that owns securities on behalf of clients, which accounts for most of the holdings we identified. However, we note that BlackRock would still have an interest in the performance of client holdings from the standpoint of management fees and client satisfaction with investment performance. Second, the officials

---

<sup>163</sup>Bank of America later reduced its BlackRock holdings. According to a BlackRock securities filing, as of December 31, 2010, Bank of America did not hold any BlackRock voting common stock but still held approximately 7.1 percent of BlackRock's capital stock.

---

said that entities have subdivisions, such as affiliates or subsidiaries; therefore, relationships among parties are not necessarily as linked as they might appear. For example, they distinguished between BlackRock Solutions, the portion of BlackRock that has been FRBNY's advisor, and other operations of BlackRock, Inc., the BlackRock corporate entity. However, according to BlackRock federal securities filings, BlackRock Solutions is not a distinct subsidiary of the parent, and instead operates as a "brand name" for certain services the company provides. While different units could nonetheless be affiliated within an overall corporate structure, the relevance or impact of any such affiliations is not clear, FRBNY officials said. Overall, FRBNY officials compared the cross-ownership issue to the former large investment banks, which could provide both advisory services and sales and trading functions. The officials noted that while there were considerable interconnections of interests, the point at which they become unacceptable is not clear.

Overall, while our review indicated FRBNY devoted attention to conflict of interest matters involving assistance to AIG, FRBNY's decision to rely on private firms for key assistance in designing and executing aid to the company introduced other challenges. For example, FRBNY established conflict of interest standards that permitted waivers, and it has granted a number of waiver requests. But because a system for tracking conflict waiver requests was not implemented until about 16 months after assistance began, FRBNY officials cannot provide a comprehensive account of such requests and their dispositions. Also, the relationships we identified among FRBNY, its advisors, and the AIG CDS counterparties raise questions in light of officials' statements that one goal was to avoid continuing relationships with firms involved in AIG assistance. Given the time pressure of the financial crisis and FRBNY's decision to rely upon private firms, FRBNY had to develop policies and procedures on an ad hoc basis. While FRBNY was attuned to conflict of interest issues, its procurement policy did not address vendor or other nonemployee conflicts of interest.<sup>164</sup> As FRBNY officials told us, it is not necessarily clear at what point interrelations between parties becomes a matter for concern.

---

<sup>164</sup>For example, FRBNY's employee Code of Conduct, in addressing conflicts of interest, summarizes its general standard as "[a]n *employee* should avoid any situation that might give rise to an actual conflict of interest or even the appearance of a conflict of interest" (emphasis added). As an illustration, it cites an employee working on a contract award who has a sibling or close friend working for one of the bidders.

---

In our recent report on the Federal Reserve System’s emergency lending programs, which included assistance to AIG, we found that the emergency programs brought FRBNY into new relationships with institutions that fell outside of its traditional lending activities, and that these changes created the possibility for conflicts of interest for vendors, plus FRBNY employees as well. FRBNY used vendors on an unprecedented scale, both in the number of vendors and the types of services provided. FRBNY created a new vendor-management policy in May 2010, but we found that this policy is not sufficiently detailed or comprehensive in its guidance on steps FRBNY staff should take to help ensure vendor conflicts are mitigated. FRBNY staff have said that they plan to develop a documented policy that codifies practices FRBNY put in place during the crisis. The lack of a comprehensive policy for managing vendor conflicts, including relationships that cause competing interests, could expose FRBNY to greater risk that it would not fully identify and appropriately manage vendor conflicts of interest in the event of future crises. In that report, we recommended that FRBNY finalize this new policy to reduce the risks associated with vendor conflicts.<sup>165</sup> FRBNY officials said they plan to document a more comprehensive policy for managing vendor conflict issues.

---

## Initial Federal Reserve Lending Terms Were Designed to Be More Onerous than Private Sector Financing

FRBNY officials have said that when they provided the first assistance to AIG—the \$85 billion Revolving Credit Facility—they adopted key terms of an unsuccessful private-sector lending package. Our review, however, found that the initial federal lending was considerably more onerous than the contemplated private deal. After accepting the terms of government lending—which included restrictions on some company activities—AIG reduced some investment activities but did not fail to meet any legal obligations, the company said.

---

## The Revolving Credit Facility Was More Expensive than the Failed Private Loan Plan and Was Intended to Be Onerous

FRBNY officials told us that after an agreement could not be reached on private financing for AIG, they adopted key economic terms of the private-sector loan syndication plan for the Federal Reserve System’s initial assistance—the Revolving Credit Facility. Our review, however, showed that the terms of the FRBNY loan were more expensive in key respects and that the government intended them to be onerous. The initial cost of

---

<sup>165</sup>See [GAO-11-696](#).



---

the Revolving Credit Facility created financial challenges for AIG and its ability to repay FRBNY. In response, the Federal Reserve System twice restructured its loan before the company fully repaid it in January 2011. According to both FRBNY officials and AIG executives, it was apparent at the time the Revolving Credit Facility was offered that restructuring would be necessary, although Federal Reserve Board officials told us that they believed the \$85 billion credit facility had solved the company's problems until economic conditions deteriorated further.

FRBNY officials told us that some of the Revolving Credit Facility's initial loan terms were different from those of the failed private-sector plan but that key economic terms, such as the interest rate and fees were the same. FRBNY also stated publicly on its website that the interest rate was the same as the private-sector plan, and an FRBNY advisor also said that the credit facility's terms were those that had been outlined in the private-sector plan. FRBNY officials told us that the Federal Reserve System used the private-sector terms because it did not have sufficient time to do otherwise prior to extending government aid, and that in the process, they took a signal from the private sector on what was appropriate in light of the risk. Given the situation, according to an FRBNY internal fact sheet, officials attempted to assess AIG's situation and take into account the terms of the private-sector lending plan, before finalizing the FRBNY loan offer to the company.<sup>166</sup>

Our review, however, showed that key economic terms of the Revolving Credit Facility were more expensive than those of the private plan, until loan terms were subsequently modified. For example, as shown in table 8, the rate on drawn amounts was two percentage points higher, and the FRBNY loan included a fee on undrawn amounts, which the private-sector plan did not. Apart from the financial terms, the Revolving Credit Facility also provided a longer term than the private plan.

---

<sup>166</sup>AIG signed a term sheet outlining the terms of the Revolving Credit Facility on September 16, 2008. To meet AIG's funding needs until a final agreement could be drafted, FRBNY made four loans to AIG from September 16–19. In the following week, FRBNY and its advisors drafted final documentation, which the parties signed on September 22. FRBNY officials told us they did not communicate to AIG the terms of the facility prior to the company's Board of Directors meeting on September 16.

**Table 8: Comparison of the Terms of the Private Lending Plan and Federal Reserve Revolving Credit Facility**

Loan term	Private plan	Original Revolving Credit Facility	November 2008 restructuring	March 2009 restructuring
Amount	\$75 billion	\$85 billion	\$60 billion	Announcement of future reduction; later set at \$35 billion in December 2009
Maturity	18 months	24 months	5 years	5 years
Rate on drawn amounts <sup>a</sup>	LIBOR +6.5%, with 3.5% LIBOR floor	LIBOR +8.5%, with 3.5% LIBOR floor	LIBOR +3.0%, with 3.5% LIBOR floor	LIBOR +3.0% (elimination of floor amount)
Rate on undrawn amounts	–	8.5%	0.75%	0.75%
Commitment fee	5.0%	2.0% <sup>b</sup>	n/a	n/a
Other fee	1% at 6 months, 1% at 12 months	–	–	–
Default rate	–	Normal rate +2.0%	Normal rate +2.0%	Normal rate +2.0%

Sources: FRBNY, GAO review of Federal Reserve System records.

<sup>a</sup>Rate on private plan stated generally as LIBOR; FRBNY loan specified 3-month LIBOR.

<sup>b</sup>AIG received \$500,000 credit on FRBNY commitment fee, related to payment for preferred shares.

Note: N/a = not applicable

In an e-mail sent to the then-FRBNY President about a month after the Revolving Credit Facility was authorized, an FRBNY official cited the interest rate as being high and expressed concern about the Federal Reserve Board imposing such a rate in approving the lending.<sup>167</sup> In our review, FRBNY officials could explain only the increase in the base rate, from LIBOR plus 6.5 percentage points to LIBOR plus 8.5 percentage points. The officials said an advisor made that increase, on the theory that the loan had become more risky since the failed private-sector attempt. The rationale was that market turmoil had increased in the day before Federal Reserve Board approval of the loan, following the Lehman bankruptcy, and that it would be FRBNY alone, rather than a syndicate of lenders, that would extend the credit. Otherwise, the officials were unable to provide us with an explanation of how other original terms for the Revolving Credit Facility became more expensive, such as the undrawn

<sup>167</sup>The official told us that FRBNY discount window staff found the interest rate exceedingly high. Ordinarily, rates would be set low enough that they would not be an additional burden in a crisis, but high enough that they would not be attractive once conditions improve and the market returns to normal. The rate imposed appeared to be extremely high and a burden to AIG and thus seemed contrary to the idea of trying to sustain the firm, the official told us.

---

amount fee. FRBNY officials also told us there were some reservations internally about the initial interest rate on the Revolving Credit Facility. As FRBNY officials described to us, the rate would be high whether AIG used the facility or not, reflecting the 8.5 percent rate on undrawn amounts. Despite internal concerns, there were no efforts to seek changes at the time the loan was approved, FRBNY officials said.

Although FRBNY officials could not fully explain the rate discrepancy we identified, they told us nonetheless that in general, they intended the original Revolving Credit Facility terms to be onerous, as a way to motivate AIG to quickly repay FRBNY and to give AIG an incentive to replace the government lending with private financing. Without reconciling the changing terms of the lending, the former FRBNY President told us that FRBNY provided for appropriately tough conditions on AIG. An FRBNY advisor also described the terms as onerous and said the market recognized them as such. Similarly, as noted, AIG initially objected to the terms, in particular, the interest rate and the 79.9 percent equity stake the company gave up.<sup>168</sup> Many of the terms of the Revolving Credit Facility resembled those of bankruptcy financing, FRBNY officials said, and their objective was to devise terms that reflected the company's condition, the nature of its business, and the large exposure the government faced. According to the officials, they had to balance that AIG would need to maintain its daily business operations against the exposure FRBNY faced with its loan and the contemplated source of repayment, namely asset sales. The officials said they also constructed the economic terms based on what private-sector lenders would have considered appropriate for the risk involved. An AIG advisor characterized the loan as aggressive and unprecedented, but said AIG was in a price-taking position, and that notwithstanding the high cost, the loan nevertheless allowed AIG to survive.

In addition to the economic terms highlighted in table 8, the credit agreement for the Revolving Credit Facility also imposed a number of affirmative and negative covenants, or obligations. Under the terms of an accompanying security agreement, AIG granted a lien against a substantial portion of its assets, including its equity interests in its

---

<sup>168</sup>Objections notwithstanding, AIG executives told us they expected the terms of any financing, whether from the private-sector or government, to be punitive and expensive and that would-be private lenders were initially enthusiastic about a potentially lucrative opportunity when exploring the possibility of a private loan.

---

regulated U.S. and foreign subsidiaries.<sup>169</sup> AIG's insurance subsidiaries did not pledge any assets in support of the facility, as noted in a Federal Reserve System internal fact sheet, and the subsidiaries themselves did not act as guarantors of the loan.<sup>170</sup> This arrangement was established because officials wanted to better ensure that AIG's insurance subsidiaries would be well capitalized and solvent, according to the fact sheet. The agreements did not require AIG's foreign subsidiaries to become guarantors, according to FRBNY. The credit agreement also stipulated repayment of FRBNY's loan with proceeds from asset sales or the issuance of new debt or equity.<sup>171</sup> In addition, officials told us there were other restrictions barring AIG from making large capital expenditures or providing seller financing on asset sales without FRBNY's consent.<sup>172</sup> Finally, the agreement also included a negative covenant that provided protection for the government on how AIG could use the government's TARP equity investment.<sup>173</sup>

FRBNY officials told us the loan structure proved durable and achieved its purpose of providing AIG with needed liquidity while protecting FRBNY's position as a creditor. In a secured lending facility such as the Revolving

---

<sup>169</sup>A lien is a creditor's claim against property.

<sup>170</sup>After authorization of the Revolving Credit Facility, FRBNY drew on two advisors to assist in valuing the assets that secured its loan to AIG, according to FRBNY officials. The officials said there was a considerable effort to calculate collateral value, with much of the collateral in the form of equity in insurance subsidiaries that AIG held. Officials said that because this type of collateral valuation was new to FRBNY, they needed the assistance of the advisors. The valuation of the collateral securing the loan was based on AIG as a going concern, the officials told us.

<sup>171</sup>According to an internal FRBNY memorandum on August 26, 2009, FRBNY viewed it as undesirable for AIG to have excess cash, out of the concern the company might not use it effectively.

<sup>172</sup>Seller financing is when a seller receives a secured note from a buyer in exchange for financing the purchase of the asset.

<sup>173</sup>Specifically, FRBNY officials cited section 6.04 of the credit agreement, which states that AIG and its subsidiaries will not "purchase, hold or acquire any Equity Interests, evidences of indebtedness or other securities of, make or permit to exist any loans or advances to, or make or permit to exist any investment or any other interest in, any other Person," except in specified cases. Also, notwithstanding specific instances listed in the agreement, "the Borrower and its Subsidiaries shall not be permitted to make any material investment in illiquid, complex structured products for which no external market price, liquid market quotes or price based on common agreed modeling is available except (i) pursuant to Investment Commitments in effect on the Closing Date and entered into in the ordinary course of business or (ii) with the prior written consent of the Lender."

---

Credit Facility, it is not unusual to negotiate a range of restrictions to protect the lender, the officials said. Nonetheless, the structure created challenges for AIG shortly after its creation. Concerns remained, for example, about the level of AIG's debt, the rate on the Revolving Credit Facility, and the company's ability to sell off assets to repay the lending. FRBNY officials told us that the amount AIG initially withdrew from the Revolving Credit Facility (\$62.5 billion) and how quickly it did so (slightly more than 2 weeks) demonstrated the depth of the company's problems. Thus, rating agency concerns were not unexpected, although officials said they were surprised by how quickly those concerns arose. In addition, Federal Reserve Board staff comments cited an issue with the loan, namely, that it required AIG to use proceeds of the Revolving Credit Facility to meet preexisting liquidity needs and not for investment in assets that would generate returns. Thus, as officials told us, rather than repaying FRBNY from productive activities funded by the loan, AIG had to repay the Revolving Credit Facility by selling assets. This requirement ultimately proved difficult to fulfill given the challenges AIG faced in carrying out its asset-sales plan.

FRBNY and AIG both told us they understood at the time the Revolving Credit Facility was established that it was only an interim solution and that additional assistance, or restructuring of the assistance, would be required. According to FRBNY officials, the Revolving Credit Facility was a necessary step to forestall AIG's immediate problems, and the loan gave them time to consider more targeted solutions. FRBNY officials also highlighted the uncertainties that remained after the initial loan, including the condition of the broader economy, as well as the reactions of AIG's counterparties to Federal Reserve System assistance. In particular, AIG's securities lending counterparties were terminating their contracts, resulting in increased draws on the Revolving Credit Facility early on.<sup>174</sup> According to AIG executives, while the Revolving Credit Facility addressed the company's immediate liquidity problems, it also created an unsustainable situation, given the company's high debt levels, downward pressure on credit ratings, and illiquid markets in which to sell assets.

While FRBNY and AIG considered the need for additional government assistance immediately after the Revolving Credit Facility, Federal

---

<sup>174</sup>The officials noted that these terminations ultimately led to the establishment of the Securities Borrowing Facility authorized by the Federal Reserve Board.

---

Reserve Board officials told us that a number of factors accounted for why the Federal Reserve Board determined restructuring became necessary only after economic conditions worsened following authorization of the initial lending. According to Federal Reserve Board officials, markets continued to deteriorate in October and November 2008, resulting in increased cash demands from AIG and heightened prospects for a downgrade. Market conditions worsened more than they expected, officials noted, making it necessary to revisit the terms of the Revolving Credit Facility. In particular, it was important at that point to make the interest rate less burdensome.

As noted, the Federal Reserve System twice restructured the terms of the Revolving Credit Facility in order to, among other things, improve AIG's capital structure and enhance the company's ability to conduct its asset sales plan. As shown in table 8, the November 2008 restructuring included reductions in the interest rate and the undrawn amount fee, as well as an extension of the loan's maturity. According to an FRBNY internal fact sheet from November, the lower interest rate and commitment fee on undrawn amounts reflected AIG's stabilized condition and outlook following Treasury's \$40 billion TARP investment in preferred stock. In addition, according to the fact sheet, the Federal Reserve Board extended the loan's maturity in order to provide AIG with additional time to sell assets and to repay FRBNY with the proceeds.<sup>175</sup> The restructuring also reduced AIG's degree of indebtedness and improved its ability to cover interest payments, the fact sheet said, which were key measures for the marketplace and rating agencies in assessing AIG's future risk. FRBNY's commitment to lend to AIG under the Revolving Credit Facility was reduced to \$60 billion.

The March 2009 restructuring included, as noted, a further reduction of the amount available under the Revolving Credit Facility. As part of this restructuring, FRBNY received preferred interests in two SPVs created to hold all of the outstanding common stock of two life insurance holding company subsidiaries of AIG.<sup>176</sup> In addition, officials eliminated the LIBOR

---

<sup>175</sup>The fact sheet also noted that the restructured loan would be more durable in addressing AIG's problems because ML II and ML III removed capital and liquidity drains stemming from AIG's exposure to domestic mortgage markets.

<sup>176</sup>AIG retained control of the two limited liability companies, AIA Aurora LLC and ALICO Holdings LLC, and FRBNY held rights with respect to preferred interests it held in each vehicle.

---

floor on the interest rate for the Revolving Credit Facility, potentially reducing the cost of the loan. Following these changes, the amount available to AIG under the Revolving Credit Facility was further reduced. On January 14, 2011, FRBNY announced full repayment of the Revolving Credit Facility and exchange of the 79.9 percent controlling equity interest in AIG for common stock. FRBNY officials told us repayment of the loan was, as expected, the product of AIG asset sales.

---

### After Accepting the Federal Reserve's Loan Terms, AIG Says It Restricted Some Investment Activities but Otherwise Stayed Current on Obligations

After the Federal Reserve Board approved assistance for AIG, questions arose about the company's treatment of financial counterparties and its ability to meet its obligations. We examined this issue from the standpoint of whether, after receiving federal aid, AIG failed to perform on legally required obligations. FRBNY officials said that while they monitored company activities as part of oversight following the rescue, they did not direct AIG on how to treat its counterparties, and company executives told us they did not fail to honor existing obligations. However, AIG executives told us that the company did reduce its investments in certain projects.<sup>177</sup>

As noted previously, AIG's loan agreements imposed a number of restrictions (negative covenants) on the company's activities. For example, the credit agreement for the Revolving Credit Facility generally barred the company from creating or incurring new indebtedness. It also placed restrictions on payment of dividends and on capital expenditures greater than \$10 million. In addition, FRBNY officials told us other restrictions arose from the credit agreement, as amended, although they were not explicitly contained in the agreement. For instance, the AIG parent company ordinarily could inject capital into subsidiaries that were not guarantors of FRBNY's loan without FRBNY's consent. However, FRBNY officials said they had concerns about funds going to AIGFP. Thus, according to the officials, in a separate letter agreement with the company, they required that any loan, advance, or capital contribution to AIGFP would require consent.

Apart from the loan agreements and related items, the Federal Reserve System and Treasury did not place any additional limitations on AIG's activities or its use of cash, such as the ability to make loan payments or

---

<sup>177</sup>We did not seek to independently verify the company's representations about fulfillment of its obligations.

---

to fulfill previously committed obligations, company executives told us.<sup>178</sup> Similarly, short of actual restrictions, the Federal Reserve System and Treasury did not impose any limitations that caused AIG to forego activities it otherwise would have undertaken, the executives said. AIG executives also told us that AIG did not act, or fail to act, due to restrictions arising from federal aid. More specifically, the executives said AIG has not failed to perform any legally required obligations to parties such as creditors, joint venture partners, and other counterparties. In particular, AIG's credit agreement with FRBNY stipulates that AIG is not to be in default of contractual obligations, the executives said.<sup>179</sup>

However, the AIG executives distinguished between the obligations described in the previous paragraphs and investment-based decisions not to make additional contributions of capital to certain projects, or to discontinue payments on certain projects and allow lenders to foreclose on them, so that the lenders took over the projects under terms of lending agreements. AIG has made such business decisions, involving a number of projects, when it judged them to be in the best interest of the company, its stakeholders, and FRBNY as AIG's lender, the executives told us. They said that in such instances, AIG has not had any obligation to continue funding under any contract and had the ability to make payments if it chose to do so. Citing one real estate development project as an example, the executives characterized the situation as a bad real estate decision by the banks involved.

FRBNY became involved in ongoing AIG business activities by attending meetings of steering committees AIG set up in certain business units, as one way to obtain information officials felt was necessary to inform judgments FRBNY needed to make under the credit agreements, FRBNY officials told us. For instance, FRBNY would ask for information to understand the company's risk position or utilization of proceeds from government lending. However, FRBNY did not substitute its judgment for company executives' judgment, officials told us, and did not direct AIG's activities. Instead, FRBNY officials told us they focused on issues of

---

<sup>178</sup>This discussion excludes employee compensation matters. Under TARP, through which Treasury provided assistance to AIG, compensation was limited for executives of companies receiving assistance.

<sup>179</sup>Notwithstanding the company's position, Federal Reserve officials said the fact of government involvement, and need to repay government lending, probably caused the company to behave differently than it would have otherwise.



---

interest as a creditor to the company and, as such, would probe company assumptions or analyses. Officials told us that although they did not exercise control, in some instances, AIG reconsidered ideas after discussions with FRBNY. FRBNY never indicated whether AIG should not pay a particular lender or counterparty, officials told us. Instead, FRBNY's interest was broader and involved evaluating whether a proposed use of capital made sense from a broad context and in light of competing demands for capital, they said. FRBNY encouraged AIG to make decisions based on economics, which sometimes was at odds with narrower interests of managers in particular business units, FRBNY officials said. AIG executives characterized this FRBNY review of its corporate initiatives as constructive, typical of a creditor-borrower relationship, and said they could not recall an instance when AIG wanted to pursue a course that they believed made good business sense but FRBNY did not agree.

---

## The AIG Crisis Offers Lessons That Could Improve Ongoing Regulation and Responses to Future Crises

As with past crises, the Federal Reserve System's experience with assisting AIG offers insights that could help guide future government action, should it be warranted, and improve ongoing oversight of systemically important financial institutions. Already, the Dodd-Frank Act seeks to broadly apply lessons learned from the financial crisis in a number of regulatory and oversight areas. For example, the act contains oversight provisions in the areas of financial stability, depository institutions, securities, brokers and dealers, and financial regulation. In addition, our review of Federal Reserve System assistance to AIG has identified other areas where lessons learned could be applied:

- identifying ways to ease time pressure in situations that require immediate response,
- analyzing collateral disputes to help identify firms that are coming under stress, and
- conducting scenario stress testing to anticipate different impacts on the financial system.

---

## Actions Could Be Taken Earlier to Reduce Time Pressure

As discussed earlier, time pressure was an important factor in Federal Reserve System decision making about aid to AIG. For example, the Federal Reserve Board made its initial decision on the Revolving Credit Facility against the urgency of expected credit rating agency downgrades in mid-September 2008, which would have imposed significant new

---

liquidity demands on the company. Similarly, FRBNY chose among ML III design alternatives based largely on what could be done quickly.

Time pressure also played a key role in decisions whether federal aid was appropriate. As noted, the Federal Reserve Board's emergency lending authority under section 13(3) of the Federal Reserve Act was conditioned on the inability of borrowers to secure adequate credit from other banking institutions. In AIG's case, the company and the Federal Reserve System sought to identify private financing over several days in September 2008 leading up to the first offer of government aid to the company. But entities contemplating providing financing to AIG said the process forced them to compress what ordinarily would be weeks' worth of due diligence work into only days. As the scope of the financial crisis and AIG's situation evolved, potentially large investments were being considered in an environment of uncertain risk. When FRBNY stepped in to try to arrange bank financing—at which point AIG's identified financial need had grown substantially—there was even less time to act, and the Federal Reserve Board quickly moved to extend its offer of assistance.<sup>180</sup>

While unforeseeable events can occur in a crisis, easing time pressure could aid future government decision making and the process of seeking private financing. In AIG's case, the Federal Reserve System could have eased time pressure two ways. First, it could have begun the process of seeking or facilitating private financing sooner than it did—the day before the Federal Reserve Board approved the Revolving Credit Facility—as warning signs became evident in the months before government intervention. Second, given the warning signs, it could have compiled information in advance to assist would-be investors or lenders. Potential private-sector financiers told us the process would have benefited from both more time and information.

An example of the kind of information that would be useful in a crisis can be seen in recent rulemaking by the Federal Reserve Board and the

---

<sup>180</sup> Against the backdrop of time pressure, another factor at work, according to one Reserve Bank official, was the unofficial practice of “constructive ambiguity,” in which regulators encourage financial firms and their creditors to behave as if government support will not be available while at the same time standing ready to act in a crisis. Thus market participants must draw their own inferences about future policy. The ambiguity, however, tends to force officials' decisions in a crisis because deciding against providing aid would mean greater turmoil, the official said. In effect, policymakers are forced to be more generous than desired, the official said.

---

Federal Deposit Insurance Corporation. As part of Dodd-Frank Act implementation, the two agencies proposed that large, systemically significant bank holding companies and nonbank financial companies submit annual resolution plans and quarterly credit exposure reports. A resolution plan would describe the company's strategy for rapid and orderly resolution in bankruptcy during times of financial distress. A company would also be required to provide a detailed listing and description of all significant interconnections and interdependencies among major business lines and operations that, if disrupted, would materially affect the funding or workings of the company or its major operations. The credit exposure report would describe the nature and extent of the company's credit exposure to other large financial companies, as well as the nature and extent of the credit risk posed to others by the company.<sup>181</sup> Such information was of interest to those contemplating providing financing to AIG ahead of federal intervention, as well as to government officials themselves.

This information could also benefit ongoing regulation of financial entities, whether by the Federal Reserve System or other financial regulators, but it could be of particular benefit to the Federal Reserve System, given its broad role in maintaining the stability of the financial system. Such efforts could also improve the quality of information that the Financial Stability Oversight Council is now charged with collecting from, among others, financial regulatory agencies, pursuant to the Dodd-Frank Act. Under terms of the legislation, the Federal Reserve Board Chairman is a member of the Financial Stability Oversight Council, whose purpose is to identify risks to financial stability that could arise from distress, failure, or ongoing activities of large, interconnected bank holding companies or nonbank financial companies; promote market discipline; and respond to emerging threats to the stability of the U.S. financial system. The law created an Office of Financial Research within Treasury to support the Council and its member agencies.

---

<sup>181</sup>Resolution Plans and Credit Exposure Reports Required, 76 Fed. Reg. 22,648 (Apr. 22, 2011).

---

## Analyzing Collateral and Liquidity Issues Could Help Identify Warning Signs

Requirements to post collateral figured prominently in the difficulties in AIGFP's CDS business that spurred the creation of ML III. Leading up to government intervention, AIG was in dispute with some of its counterparties on the amount of collateral the company was required to post with them under terms of AIG's CDS contracts. A number of the counterparties told us that they were in disagreement with AIG over billions of dollars of collateral they claimed the company owed them. For example, one counterparty told us it had contentious discussions with AIG over collateral, and another said it made multiple unsuccessful demands for payment. Records we reviewed also indicated that market mechanisms for valuing assets had seized up, which AIG told us contributed to the disagreements over the amount of collateral to be posted.

This experience suggests that identifying, monitoring, and analyzing collateral issues may offer opportunities for enhancing regulators' market surveillance or developing warning signs that firms are coming under stress. A large AIG CDS counterparty told us that it was not clear that regulators appreciated the significance of collateral disputes involving the company. Collateral disputes can be a warning sign and usually involve valuation conflicts. While regulators generally are expected to look for such things as fraud and problems in economic modeling, whether they are attuned to looking closely at collateral disputes and the warnings they might yield is not clear, the counterparty said. In AIG's case, the duration of the dispute and sharply differing views of values were unusual, the counterparty said.

The idea of tracking collateral issues is gaining some attention among financial regulators. For example, the Financial Industry Regulatory Authority has recently issued guidance for broker-dealers that lists "notable increases in collateral disputes with counterparties" among factors that could be warning flags for funding and liquidity problems.<sup>182</sup>

More sophisticated monitoring of financial firms' liquidity positions could likewise be valuable, a former Treasury official who was involved in AIG assistance told us. Proper assessment of liquidity requires not just knowing how much cash is available, the former official said, but also the amount of cash a firm would have available in the event that all parties

---

<sup>182</sup>See *Regulatory Notice 10-57*, November 2010.

---

with the potential to make calls on the firm were to do so. In AIG's case, neither the company nor regulators understood the situation in this way, but this kind of assessment should be an essential part of future regulatory oversight, the former official said.

---

## Scenario Stress-Testing Could Increase Analytical Insights

In general, risk analysis that involves thoughtful stress testing can allow for better-informed and more timely decision making. For example, in evaluating elements of federal assistance to AIG, FRBNY and an advisor analyzed expected performance and outcomes under varying conditions of economic stress. Similarly, we reported on the Supervisory Capital Assessment Program that was established through TARP, which assessed whether the 19 largest U.S. bank holding companies had enough capital to withstand a severe economic downturn.<sup>183</sup> Led by the Federal Reserve Board, federal bank regulators conducted stress tests to determine if these banks needed to raise additional capital. These experiences underscore the value of stress testing generally, and the particular circumstances of AIG's difficulties suggest an opportunity to expand and refine such testing in order to better anticipate stress in the financial system. In AIG's case, FRBNY officials cited the company's financial interconnections and the multifaceted nature of the financial crisis as contributing to the need for federal assistance. Similarly, the Federal Reserve Board Chairman has highlighted the risks presented by large, complex, and highly interconnected financial institutions.<sup>184</sup> More sophisticated stress testing that incorporates comprehensive measures of financial interconnectedness and different crisis scenarios could offer the opportunity to study expected outcomes of financial duress, not only for a single institution but for a range of institutions as well. Such testing could allow regulators to better understand the potential systemic impacts of

---

<sup>183</sup>See GAO, *Troubled Asset Relief Program: Bank Stress Test Offers Lessons as Regulators Take Further Actions to Strengthen Supervisory Oversight*, [GAO-10-861](#) (Washington, D.C.: Sept. 29, 2010).

<sup>184</sup>In congressional testimony, the former Treasury Secretary summed up AIG's interconnections: "AIG was incredibly large and interconnected. It had a \$1 trillion dollar (sic) balance sheet; a massive derivatives business that connected it to hundreds of financial institutions, businesses, and governments; tens of millions of life insurance customers; and tens of billions of dollars of contracts guaranteeing the retirement savings of individuals. If AIG collapsed, it would have buckled our financial system and wrought economic havoc on the lives of millions of our citizens." See testimony of Henry M. Paulson before the House Committee on Oversight and Government Reform, January 27, 2010.

---

crises or actions, which, among other things, could help them in their new role to monitor systemic risk under the Dodd-Frank Act. The Dodd-Frank Act requires annual or semiannual stress testing by the Federal Reserve Board or financial companies themselves, according to type of institution and amount of assets. The AIG experience underscores the importance of interconnectedness in such analysis.

---

## Agency and Third Party Comments and Our Evaluation

We provided a draft of this report to the Federal Reserve Board for its review and comment, and we received written comments that are reprinted in appendix II. In these comments, the Federal Reserve Board generally agreed with our approach and results in examining the Federal Reserve System's involvement with AIG within the context of the overall financial crisis at the time, and it endorsed the lessons learned that we identified in our work. Regarding regulators taking earlier action to reduce time pressure during a crisis, the Federal Reserve Board stated that it has established a new division to focus on market pressures and developments that may create economic instability, and is otherwise working to identify threats to financial stability. Regarding the opportunity that collateral disputes may offer for enhancing regulators' market surveillance or for developing warning signs that firms are coming under stress, the Federal Reserve Board stated that it is working with other financial regulators to implement changes in supervision and regulation of derivatives markets, including requirements governing collateral posting. Regarding the notion that risk analysis that involves thoughtful stress testing—especially focusing on interconnections among institutions—can allow for better-informed and more timely decision making, the Federal Reserve Board stated that it has begun development of an annual stress testing program for large financial firms within its supervisory purview. In response to our findings that Federal Reserve System assistance to AIG gave rise to overlapping interests and complex relationships among the various parties involved, the Federal Reserve Board said it is exploring opportunities to improve its approach to potential or actual conflicts of interest that can arise from such interests and relationships. The Federal Reserve Board and FRBNY also provided technical comments, which we have incorporated as appropriate.

In addition, we provided a draft of this report to Treasury for review and comment, and we also provided relevant portions of the draft to AIG, SEC, and selected others for their review and comment. We have incorporated comments from these third parties as appropriate.

---

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its date. At that time, we will send copies to the Chairman of the Federal Reserve Board, interested congressional committees, and others. In addition, this report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions regarding this report, please contact me at (202)-512-8678 or [williamso@gao.gov](mailto:williamso@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix III.



Orice Williams Brown  
Managing Director,  
Financial Markets and  
Community Investment

---

*List of Congressional Requesters*

Spencer Bachus  
Chairman  
Committee on Financial Services  
House of Representatives

Elijah E. Cummings  
Ranking Member  
Committee on Oversight  
and Government Reform  
House of Representatives

Edolphus Towns  
House of Representatives



---

# Appendix I: Objectives, Scope, and Methodology

---

To examine the sequence of events and key participants as critical decisions were made to provide federal assistance to American International Group, Inc. (AIG), we reviewed a wide range of AIG-related documents. We obtained these documents primarily from the Board of Governors of the Federal Reserve System (Federal Reserve Board) and the Federal Reserve Bank of New York (FRBNY), including records they have provided to Congress.<sup>1</sup> These documents included e-mails, information relating to options and plans for aiding AIG, research, memorandums, financial statements, and other items. We also obtained information from congressional testimonies of the former FRBNY President and officials of the Federal Reserve Board, FRBNY, the former Secretary of the Department of the Treasury (Treasury), and former AIG executives. In addition, we reviewed Federal Reserve Board and FRBNY announcements, presentations, and background materials. We also reviewed our past work and the work of others who have examined the government's response to the financial crisis, including the Congressional Oversight Panel, the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), and the Financial Crisis Inquiry Commission. We conducted interviews with many of those involved in federal assistance to AIG, to obtain information on their participation in the events leading up to federal assistance for AIG, as well as their perspectives on the condition of AIG and the financial markets at the time. From the regulatory sector, we interviewed Federal Reserve Board and FRBNY officials, a former Federal Reserve Board Governor, a Reserve Bank President, current and former officials from state insurance regulatory agencies, SIGTARP staff, current and former Treasury officials, and an official of the Federal Home Loan Bank system. From the private sector, we interviewed current and former AIG executives, representatives from FRBNY advisors, an AIG advisor, AIG business counterparties, credit

---

<sup>1</sup>The Federal Reserve Board is a federal agency. A network of 12 Reserve Banks and their branches carries out a variety of functions, including operating a nationwide payments system, distributing the nation's currency and coin, and, under delegated authority from the Federal Reserve Board, supervising and regulating member banks and bank holding companies. The Federal Reserve Board oversees the operations and activities of the Reserve Banks and their branches. The Reserve Banks, which combine features of public and private institutions, are federally chartered corporations with boards of directors. As part of the Federal Reserve System, the Reserve Banks are subject to oversight by Congress. In this report, we distinguish among the Federal Reserve Board, meaning the Board of Governors of the Federal Reserve System; the Federal Reserve System, meaning the Federal Reserve Board and at least one of its regional Reserve Banks; and the Federal Reserve Bank of New York, which is the regional Reserve Bank for the Second Federal Reserve District.

rating agencies, potential private-sector financiers, and academic and finance experts. In addition, we obtained written responses to questions from the former Office of Thrift Supervision, the former FRBNY President, and a former senior Treasury official.

To examine decisions involving the selection and structure of the Maiden Lane III vehicle (ML III), we obtained and reviewed relevant documents from the Federal Reserve Board, FRBNY, and others, as noted earlier. In addition, we reviewed filings submitted by AIG to the Securities and Exchange Commission (SEC). We also conducted interviews with parties identified earlier. In addition, we obtained written responses to questions from the Autorite de Controle Prudentiel, a French banking regulator. We analyzed the information obtained from documents and interviews to identify the options for assistance considered by Federal Reserve System officials. We followed up with Federal Reserve System officials to understand their rationale for selecting the as-adopted ML III vehicle. To determine the extent to which FRBNY pursued concessions from the counterparties, we interviewed Federal Reserve Board and FRBNY officials and 14 of the 16 counterparties that participated in ML III. Bank of America and Merrill Lynch were unable to provide information on the concession issue.

To examine the extent to which key actions taken were consistent with relevant law or policy, we reviewed AIG-related documents indicated earlier to identify key actions taken. More specifically, to understand the Federal Reserve Board's authority to provide emergency assistance to nondepository institutions and related documentation issues, we reviewed legislation including the Federal Reserve Act of 1913, as amended, and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. We interviewed Federal Reserve Board officials to obtain their interpretation of the Federal Reserve Board's authority. Further, to determine FRBNY's involvement in AIG's securities disclosures on the federal assistance, we reviewed relevant SEC records and interviewed SEC officials. Relevant documents we reviewed included e-mails, memorandums, disclosure filings, regulations and procedures, and material connected with AIG's request for confidential treatment of ML III-related information. Finally, to evaluate the effectiveness of FRBNY policies and practices for managing conflicts of interest involving the firms that provided services to FRBNY, we reviewed FRBNY vendor agreements and FRBNY's Operating Bulletin 10, which address procurement issues, as well as FRBNY's employee Code of Conduct. We also reviewed documentation of on-site reviews of advisor and vendor firms and obtained documentation related to waivers granted to the firms.

To determine relations among companies involved with ML III, we obtained and analyzed equity stock holdings data for the firms. We conducted interviews with a number of the parties indicated earlier—in particular, with Federal Reserve Board officials, FRBNY officials and advisors, SEC officials, a representative of the SEC Inspector General's office, AIG executives, AIG counterparties, and academic experts.

To examine criteria used to determine the terms for key assistance provided to AIG, we reviewed AIG-related documents indicated earlier, to understand the nature of the assistance and the terms. We compared the terms of a contemplated private-sector loan syndication deal with the original terms for FRBNY's Revolving Credit Facility, and we also discussed differences between the two sets of terms with FRBNY officials. To review AIG's treatment of various creditors and other significant parties after receiving federal assistance, we reviewed the FRBNY credit agreement, as amended, to understand the restrictions that were applied to AIG. To obtain information on FRBNY's involvement in AIG's decisions on meeting obligations and making investments, we conducted interviews with FRBNY officials, AIG executives, and those involved in AIG-supported real estate development projects.

To identify lessons learned from AIG assistance, we relied generally on our analysis of information obtained from all the sources cited earlier and comments obtained from a number of interview subjects. We inquired generally about what the process of providing assistance to AIG might suggest for any future government interventions, as well as specifically about such matters as reducing time pressure in critical decision making and improving analytical insights into conditions at individual financial institutions and in financial markets at large.

We conducted this performance audit from March 2010 to September 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

# Appendix II: Comments from the Board of Governors of the Federal Reserve System



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ  
GENERAL COUNSEL

September 27, 2011

Ms. Orice Williams Brown  
Managing Director  
Financial Markets and Community Investment  
Government Accountability Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Ms. Brown:

On behalf of the Board of Governors of the Federal Reserve System ("Board") and the Federal Reserve Bank of New York ("FRBNY"), thank you for providing us with the opportunity to comment on your draft report titled "Review of Federal Reserve System Financial Assistance to American International Group, Inc." ("AIG"). As you know, the Board and the FRBNY have worked very closely and cooperatively with GAO throughout this audit and we appreciate the thorough review the GAO has undertaken.

We believe the report as a whole reflects the GAO's commitment to accurately and fully telling not just the story of the Federal Reserve's involvement with AIG, but also the context of the severe financial crisis that the U.S. economy faced and the Federal Reserve was trying to address at each stage of that involvement. From the Federal Reserve's September 16, 2008, extension of an \$85 billion credit line to AIG, through the credit restructurings and Maiden Lane II and III transactions in 2008-2010 designed to stabilize AIG and minimize taxpayer risk, to the termination of Federal Reserve aid after AIG's full repayment of Federal Reserve loans in January 2011, we believe the GAO's report shows how the Federal Reserve was successful in safeguarding the taxpayer's investment while it worked with Treasury and the company to stabilize AIG and minimize disruption to the economy as a whole.

As the report notes, the Federal Reserve did not have the authority to supervise AIG. Using publicly available information, the Federal Reserve tracked AIG's financial condition, in the same way it tracks the financial condition of many institutions that it does not supervise. In the fall of 2007, many of the institutions the Federal Reserve tracked but did not supervise were facing dire situations, including but not limited to AIG, Lehman Brothers, Merrill Lynch, and

Ms. Orice Williams Brown  
Page Two

several other investment banks. As the GAO reports, given the failure of Lehman Brothers and the worsening economic conditions, AIG's failure, at that moment in time, would likely have sparked a very dangerous economic chain reaction because of AIG's size, interconnectedness and activities. When it became clear that no private sector solution to AIG's growing liquidity problems was forthcoming, the Federal Reserve decided to extend credit to AIG in order to avoid a material injury to the U.S. and global financial systems.

The GAO draws three lessons from its review of the AIG experience that could improve responses to future crises. These lessons are consistent with statutory revisions established in the Dodd-Frank Wall Street Reform and Consumer Protection Act. The first lesson, that actions can be taken earlier to anticipate problems and reduce time pressures in developing solutions, is one the Federal Reserve has been acting diligently to implement. For example, the Board has established a new division to focus on market pressures and developments that may create economic instability. We are also working with the Financial Stability Oversight Board and the other federal financial regulators to identify threats to financial stability.

The second lesson relates to monitoring and analyzing private sector disputes about the value and amount of collateral that should be posted on derivatives contracts. The Board is working with the Commodity Futures Trading Commission and the Securities and Exchange Commission to implement a number of changes to the supervision and regulation of the derivatives market, including requirements governing collateral posting. We will carefully consider the lessons identified by the GAO in developing our supervisory programs in this area.

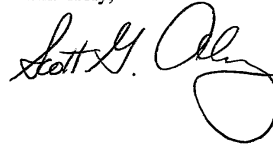
Third, GAO's report underscores the value of stress testing and, in particular, the value of incorporating financial interconnectedness into stress tests. In 2009, the Federal Reserve led the successful simultaneous stress testing of the 19 largest banking organizations in the U.S. That analysis, commonly referred to as SCAP, helped spur the largest capital raising program by major banking organizations in the U.S. The Federal Reserve has since begun development of a program of annual stress testing of large financial firms within our supervisory purview, as well as development of early remediation efforts that require large banking firms to take increasingly stronger steps to improve their financial conditions when they experience financial difficulties.

While not identified as a lesson to be learned, GAO notes in its report that overlapping interests and complex relationships existed among firms that played advisory or administrative roles with the Federal Reserve related to AIG. Given the concentrated and interconnected nature of the financial services market, such interconnectedness was unavoidable and, as the GAO noted, the FRBNY took a number of steps to manage those situations that could give rise to actual or potential conflicts. The Federal Reserve is exploring opportunities to improve its approach to these matters.

Ms. Orice Williams Brown  
Page Three

We believe these and the other steps the Federal Reserve and other federal financial regulators are taking in response to the lessons learned in the recent financial crisis will help prepare us to address future crises.

Sincerely,

A handwritten signature in black ink, appearing to read "Scott L. Allen". The signature is written in a cursive style with a large, prominent loop at the end.

---

# Appendix III: GAO Contact and Staff Acknowledgments

---

## GAO Contact

Orice Williams Brown, (202) 512-8678, or [williamso@gao.gov](mailto:williamso@gao.gov)

---

## Staff Acknowledgments

In addition to the individual named above, Karen Tremba, Assistant Director; Tania Calhoun; Daniel Kaneshiro; Marc Molino; Brian Phillips; Christopher H. Schmitt; Jennifer Schwartz; Wade Strickland; and Gavin Ugale made major contributions to this report.

---

## GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

---

## Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site ([www.gao.gov](http://www.gao.gov)). Each weekday afternoon, GAO posts on its Web site newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to [www.gao.gov](http://www.gao.gov) and select "E-mail Updates."

---

## Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's Web site, <http://www.gao.gov/ordering.htm>.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

---

## To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: [www.gao.gov/fraudnet/fraudnet.htm](http://www.gao.gov/fraudnet/fraudnet.htm)

E-mail: [fraudnet@gao.gov](mailto:fraudnet@gao.gov)

Automated answering system: (800) 424-5454 or (202) 512-7470

---

## Congressional Relations

Ralph Dawn, Managing Director, [dawnr@gao.gov](mailto:dawnr@gao.gov), (202) 512-4400  
U.S. Government Accountability Office, 441 G Street NW, Room 7125  
Washington, DC 20548

---

## Public Affairs

Chuck Young, Managing Director, [youngc1@gao.gov](mailto:youngc1@gao.gov), (202) 512-4800  
U.S. Government Accountability Office, 441 G Street NW, Room 7149  
Washington, DC 20548

