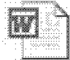
From:	alejandro latorre/ny/frs;nsf;alejandro.latorre@ny.frb.org;smtp
Sent:	Sun Sep 14 2008 14:10:44 EDT
To:	adam ashcraft/ny/frs@frs;alejandro latorre/ny/frs@frs;brian peters/ny/frs@frs;christine cumming/ny/frs@frs;christopher calabia/ny/frs@frs;elise liebers/ny/frs@frs;hayley boesky/ny/frs@frs;jim mahoney/ny/frs@frs;patricia mosser/ny/frs@frs;paul whynott/ny/frs@frs;richard charlton/ny/frs@frs;tobias adrian/ny/frs@frs;william walsh/ny/frs@frs;catherine voigts/ny/frs@frs;spence hilton/ny/frs@frs;
CC:	bettyann griffith/ny/frs@frs;daniel boulos/ny/frs@frs;meg mcconnell/ny/frs@frs;millie martinez/ny/frs@frs;sandy krieger/ny/frs@frs;susan mclaughlin/ny/frs@frs;
Subject:	Pros and Cons on AIG Lending

For our meeting at 2:30pm in the board room



Pros and Cons of Lending to AIG.doc

CONFIDENTIAL

FRBNY-STARR(CFC)-00006555

Pros and Cons of Lending to AIG

S&P's current financial strength rating for AIG is AA+ for the leading insurance companies and AA- on the senior debt of the parent company (put on negative outlook due to risk management issues).

Pros:

1. Collapse would be extremely complex to resolve given global nature of the firm; lending could contain market dislocations already happening due to Lehman.

2. AIG as a whole appears solvent and lending could provide "bridge finance" to implement strategic plan (e.g. longer-term asset sales, capital infusions, etc.);

   - Lending could bolster market confidence in strengthen perception of the plan with appropriate safeguards for the Federal Reserve.

   - AIG's fair value on ABS CDO aggressive ($25B); greater than internal ($9B) and rating agency loss estimates (S&P:$8B).

   - Allows time to sell assets from the investment portfolio an orderly fashion (i.e., avoids liquidity spiral, negative feedback loops)

   - Firm could sell the ABS CDO risk, sell subsidiaries, mortgage portfolio, municipal securities, or raise more capital.

3. Collapse could lead to dislocation in CP markets and exacerbate risk aversion generally; lending could alleviate spillover effects on other firms involved in similar activities (e.g., GE Finance).

4. Lending might allow AIG to avoid bankruptcy; allows AIG to perform on balance sheet CDO swaps, which provide reg capital relief to European banks; failure would lead to $18B increase in European bank capital requirements.

   - Swaps allow banks to hold 1.6% in regulatory capital as opposed to 8%.

   - Total notional exposure of $290B; down from $80B as deals wound down.

   - ABN Amro ($3.6B), Den Danske ($2.3B), Calyon, BNP, Deutsche most affected.

5. Lending could contain dislocations in CDS market; AIG is a commonly traded name and "tear ups" could leave dealer books significantly unbalanced.

6. Non-trivial exotic derivatives book would be difficult to unwind in an orderly fashion.

CONFIDENTIAL FRBNY-STARR(CFC)-00006556

Cons:

1. Could diminish incentive to pursue private sector solutions and/or solutions proposed by insurance regulators, which appear to be moving forward.

   - Infusion of capital from private equity, could to happen today ($15B)

   - Asset swap between P+C and Parent where Parent sells equity in Life insurance business in return for municipal securities, for use as collateral ($20B)

   - Immediate sale of assets ($13B; $5B auto loans; $8B annuity)

   - Berkshire Hathaway is investigating the provision of liquidity on Guaranteed Investment Contracts ($5B)

2. Strategic plan may not be well-received if turmoil ensues following Lehman bankruptcy.

3. Lending could precipitate failure and the exit strategy would not be clear.

   - Signals that existing universe of facilities is not enough to assure financial stability.

   - Increases moral hazard as other insurance companies seek protection.

4. Could be perceived as being incoherent to lend to AIG if Lehman is perceived to be more systemic in nature.

5. Assets available from Ins. Co. subs ($60B) may not be sufficient to cover potential liquidity shortfalls as many of the subs do not appear to be sources of strength.

   - Life Ins. Co. subs have significant unrealized losses on investments.

   - P&C could be source of strength; paid $1.4B dividends, but amounts small relative to size of hole.

6. Dealers may have insulated themselves from their largest exposure (i.e. ABS CDO) to AIG through write-downs; or AIG can sell exposures.

7. Forbearance could address increases in European bank capital requirements; makes lending unnecessary.

8. Without punitive terms, lending could reward poor risk management practices cited by rating agencies (e.g. S&P).

CONFIDENTIAL FRBNY-STARR(CFC)-00006557