From: julie dolan/ny/frs;nsf;julie.dolan@ny.frb.org;smtp
Sent: Tue Sep 16 2008 15:14:40 EDT
To: dianne dobbeck/ny/frs@frs;
CC: alejandro latorre/ny/frs@frs;
Subject: Fw: <Documents Requested>

FYI>...

Julie Dolan
Executive Assistant
Bank Supervision
Federal Reserve Bank of New York
(212) 720-5857
----- Forwarded by Julie Dolan/NY/FRS on 09/16/2008 03:14 PM -----

Kristin Mayer/NY/FRS
09/16/2008 03:02 PM

To
Julie Dolan/NY/FRS@FRS
cc

Subject
Re: <Documents Requested>

I think it is. Thank you!

____
Kristy Mayer
Chief of Staff's Office
Federal Reserve Bank of New York
Work: 212-720-8090
Personal Info
kristin.mayer@ny.frb.org

Julie Dolan/NY/FRS

09/16/2008 02:55 PM

To
Alejandro LaTorre/NY/FRS@FRS, Kristin Mayer/NY/FRS@FRS
cc

Subject
<Documents Requested>

RESTRICTED Controlled FR

Alex: Thank you very much.

Kristin:
Hope this is what you are looking for....

Julie Dolan
Executive Assistant
Bank Supervision
Federal Reserve Bank of New York
(212) 720-5857

Alejandro LaTorre/NY/FRS
09/16/2008 02:47 PM

To
"Julie Dolan" <Julie.Dolan@ny.frb.org>
cc

Subject
Fw: Raw Materials for our early morning meeting with Tim.

In response to your question on lehman vs. Aig - Yes - see the systemic impact of AIG bankruptcy document below

Sent from my BlackBerry Handheld

----- Original Message -----
From: Alejandro LaTorre
Sent: 09/16/2008 01:08 PM EDT
To: Michael Silva; Meg McConnell
Cc: Adam Ashcraft; Alejandro LaTorre; Alexa Philo; Alexander Psomas; Bard Stermasi; Catherine Voigts; Christopher Calabia; Danielle Vicente; Denise Goodstein; Dianne Dobbeck; Elise Liebers; Erika Gottfried; Jim Mahoney; Kevin Coffey; Mark Scapp; Min Kim; Paul Whynott; Tobias Adrian; Hayley Boesky; Richard Charlton; Azish Filabi; James Hennessy
Subject: Raw Materials for our early morning meeting with Tim.
To be ensure we all have the same docs; am sending around what I've received as input into Tim's summary document from yesterday.

If I've left something out please distribute to the group. I'll defer to banksup as to whether they want to circulate exposure figures as this is confidential.

Proposal to Reinsure Stable Value Fund Business for AIG.doc Systemic Issues in AIG failure.doc Systemic Impact of AIG Bankruptcy.DOC
Pros and Cons of Lending to AIG.doc Retail nature.doc LEGALDOCS-#283317-v3-One_Pager_re__AIG_Bankruptcy_Considerations.DOC

- AIG Summary 16 September 2008.doc

AIG Summary 16 September 2008

Context
- Larger surprise factor than Lehman
    - CDS priced in 35% probability of default on Friday vs 67% today
- Occurs on the back of Lehman bankruptcy
    - Market currently unsure of their positions and functioning is being tested
- AIG derivatives book significantly more complex than Lehman
    - Lehman: plain vanilla products, AIG is heavy on ABS CDO

Derivatives unwind:
- Reg Capital CDOs net notional is $360 bn
- Arbitrage derivatives $130 bn
    - ABS CDO: written at $80 bn, marked at $55 bn, today's mark $25 bn
        - Unwind results in immediate $60 bn hole for financial system
        - Repricing of the market, especially in subprime

Negative Feedback Loop:
- Bankruptcy of AIG CP conduits will freeze CP market
    - AIG CP is $20 bn with significant contagion potential (GE CP is $90 bn)
    - When CP can't be rolled over, issuers draw down on bank lines
        - Credit extension dries up, banks capitalization further deteriorates, rating downgrades spiral
- Repo market
    - Op Co has $68 Billion sec lending book
    - To raise capital, would likely have to liquidate the securities
    - Contagion to other repo lenders
- Stable value wraps: money market fund insures risky assets through AIG
    - AIG default drives asset sales and breaking-of-the-buck for money funds
- Annuities
    - $160 bn Annuities get redeemed at par or cancelled
        - Annuities are not capitalized and will be sold into market

Immediate impact:
- Direct impact on dealer CDS would be deemed 40 - 50% underpriced
- Potential failure of AIG and spillover effects will reverberate through retail community

AIG Bankruptcy Considerations

1. Impact on unregulated subsidiaries if parent Holding Co. files for bankruptcy
    - The bankruptcy process for unregulated companies will be under the federal bankruptcy code; no state regulators
    - If holding co. is guaranteeing the products of the unregulated financial products company, the filing by the holding co. will likely automatically put the subsidiary into bankruptcy
    - The main subsidiaries of concern are a financial products company (derivatives trading business) and an investment management company (securities lending)

2. Impact on regulated insurance subsidiaries if parent Holding Co files for bankruptcy
    - If the insurance subsidiaries are financially healthy:
        - Filing at holding co. level should not, in theory, impact the insurance subsidiaries' operation as a going concern
        - Filing at holding co. level may, however, cause liquidity stresses at the insurance subsidiary level because of exposures to affiliates, and/or runs because of name aversion (risk of run mainly at the life insurance subsidiaries)
        - Under normal conditions, all inter-affiliate transactions must be approved by the insurance regulator; if the parent company has filed for bankruptcy, such approvals will be more scrutinized
    - If the insurance subsidiaries are NOT financially healthy:
        - Once the holding co. files, the state insurance commissioner will likely step-in and initiate either liquidation or rehabilitation proceedings
            - Rehabilitation proceedings are the predominant approach. Insurance commissioner will take control over the insurance subsidiaries to preserve their value, sell certain blocks of business, or otherwise reconstitute the entities so that it will continue as a going concern. Rehabilitation is somewhat equivalent to ring-fencing; impact on consumer confidence is unclear
            - If the going concern value cannot be preserved, then commissioner may liquidate in an orderly manner.

Issue

AIG Financial Products (AIGFP) has approximately $38 billion of stable value wrap contracts written to trustees and investment managers of defined contribution assets. The wrap allows the plans to manage the asset-liability mismatch that arises when funds are withdrawn from participants.[1] Should AIGFP fail, these funds would have to rebalance by selling assets, potentially generating realized losses for these plans. In the extreme, it could lead to several defined contribution plans to "break the buck". The losses, if large and/or unexpected in magnitude, could lead to a crisis of confidence in the eyes of the public more generally about the security of their retirement benefits.

Dilemma

The dilemma is how to allow AIGFP fail in a manner that contains some of the negative and unpredictable spillover effects that could arise if the failure causes the public to lose confidence in benefit plans more generally.

Proposal

The proposal is to have the federal government reinsure AIGFP's stable value wraps so that AIGFP can be unwound in a manner that contains the negative economic and psychological impact on plan participants. The reinsurance could be temporary until such time a buyer can be found for this segment of AIG. This would require an act of Congress.

Pros

1. Removes a significant argument in favor of preserving AIGFP; allows AIGFP to fail so as not to reward the company's poor risk management practices.

2. Relatively inexpensive to implement; funds would be dispensed over time as plan participants draw down over the life of the plan.

3. Would prevent certain money defined contribution plans from "breaking the buck" and impairing confidence in them (i.e., prevents a "run").

4. Would attract political support from Congress as it would protect individuals from the effects of financial market dislocations.

Cons

[1] The third party must be able and willing to make payment on the difference between where the market value of the underlying assets and the book value of these assets (essentially the amounts reported to the Plan participants).

1. Sets a precedent involving tax payer funds.

2. May not be necessary.

3. Congress may not be able to act quickly enough.

Next Steps

The Federal Reserve should approach Treasury on providing reinsurance. If Treasury is convinced, it could liaise with the administration and Congress.

Background

AIG-FP has approximately $38 billion of stable value wrap contracts written to trustees and investment managers of defined contribution assets. These are written directly to individual corporate 401(k) and public 457 plans, as well as to institutional trust company collective trusts (collectively "Plans"). There are over 200 counterparties, including pension plans for AT&T, Bank of America, Boeing, Chrysler, Citibank, DuPont, JPM Chase and Wal-Mart. See tables below for additional information on the top investment managers and Plans in respect of these agreements.

FASB provides accounting guidance (FSP AAG INV-1 and SOP 94-4-1) to these Plans that allow them to account for the value of a portfolio of underlying bond investments at a stable value (without daily mark to markets) if these Plans enter into stable value wrap contracts from a third party. The third party must be able and willing to make payment on the difference between where the market value of the underlying assets and the book value of these assets (essentially the amounts reported to the Plan participants).

The bankruptcy of AIGFP will constitute an event of default under all stable wrap contracts entered into with these Plans. Because participants are allowed to trade on a daily basis, if a bankruptcy were to affect AIG-FP, the investment managers and trustees (Fidelity, Vanguard, BlackRock and JPM Investment Management among others) would be required to replace AIG-FP with another stable value wrap provider on the same day as AIG's (and AIG-FP's) filing or risk having their fund assets "break the buck" on the $38 billion exposure. This is because AIG-FP would no longer be viewed as a strong, financially viable counterparty for these contracts. Replacement may be difficult due to the limited number of possible wrap providers, nearly all of which have capacity constraints for additional business in the current environment.

The stable value industry is approximately $400 billion in size among the $2 trillion Defined Contribution market. Set forth below are the Investment Managers and Individual Plans, ranked by notional amount under the relevant stable value wrap contract.

Top Investment Managers	AIG-FP Notional Exposure
Fidelity	$9.9 bln
Dwight Asset Mgmt	6.3 bln
Galliard (Wells Fargo)	3.4 bln
JPMorgan Inv Mgmt	2.7 bln
Vanguard	2.7 bln
BlackRock	2.6 bln
Morley Asset Mgmt	2.3 bln
Standish (BoNY)	1.7 bln
Deutsche Asset Mgmt	1.7 bln
DuPont Asset Mgmt	.9 bln

Top Individual Plans	AIG-FP Notional Exposure
*Fidelity Managed Income Portfolio II	$3.4 bln
*BlackRock Retirement Preservation Trust	2.1 bln
*Vanguard Retirement Savings Trust	1.8 bln
*Fidelity Managed Income Portfolio	1.7 bln
Boeing Company	1.6 bln
*Wells Fargo Stable Return Fund	1.4 bln
AT&T	1.0 bln
*ICMA Vantage Plus Fund	.9 bln
DuPont	.8 bln
* SEI Trust	.7 bln
JPM Chase Bank	.7 bln
3M	.7 bln
LA County	.5 bln
Raytheon	.5 bln
Lucent	.4 bln
Chrysler	.3 bln
International Paper	.3 bln

* represents institutional collective trusts offered for trust companies, intended for use by thousands of smaller 401(k) and 457 plans.

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. 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 sec lending/repo markets, 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, Den Danske, 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.

Cons:

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

   - Infusion of capital from private equity, which could 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-related; $8B annuity)

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

2. Market must be highly confident that strategic plan will succeed; may not be well-received if turmoil ensues following Lehman bankruptcy.

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

   - Increases moral hazard as other insurance companies seek protection.

4. Lending to AIG could be perceived as inconsistent with treatment of Lehman.

5. Assets available from Ins. Co. subs 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. Forbearance could address increases in European bank capital requirements; makes lending unnecessary.

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

Crisis of confidence: The unique blend of a global distribution network, focusing on retail customers, with strong name recognition, hinders the public's ability to discern financial health and delineate among operating companies. Under these circumstances, no bankruptcy strategy can prevent the wholesale strains from generating a crisis of confidence and attendant retail disruptions.

- *Strong name recognition:* AIG's focus on a single name strategy has made it one of the most recognized corporate names worldwide. It has an iconic franchise with over 300 distinct subsidiaries, most of which use the flagship name. In benign periods, this represents significant strength of franchise, while in disrupted periods it introduces significant name risk and potential contagion.

- *Global distribution:* AIG serves 74 million customers in more than 130 countries and derives nearly half of its revenues overseas.

- *Retail focus:* AIG has over 700,000 agents, brokers, and sales representatives worldwide. Moody's defines its Life Insurance & Retirement Services segment as the "largest global life insurance network of any insurer…"

<u>Systemic Impact of AIG Bankruptcy</u>

I. Key Differences between Impact of AIG and Lehman Failure

1. In important ways, AIG's failure (hold co. and subs) is more systemic in nature due to size, franchise, and, the wholesale and retail dimensions of its business.

   - AIG's focus on a single name strategy has made it one of the most recognized corporate names worldwide. In benign periods, this represents significant strength of franchise, while in disrupted periods it introduces significant name risk and potential contagion.

   - AIG has over 700,000 agents, brokers, and sales representatives worldwide; serves 74 million customers in more than 130 countries and derives nearly half of its revenues overseas.

   - In contrast to Lehman, failure would be more global and have a retail impact; significant retail presence through insurance, notably in stable value funds, variable rate annuities.

   - The unique blend of a global distribution network, focusing on retail customers, with strong name recognition, hinders the public's ability to discern financial health and delineate among operating companies.

2. Similar to Lehman, unwinding of trading books contains rebalancing and feedback loops perhaps of smaller scale b/c trading are smaller size but could pose difficulty in unwinding due to complexity of book (ABS CDO and exotic derivatives).

II. How the Bankruptcy Process Might Unfold

Impact on <u>unregulated</u> subsidiaries if parent Holding Co. files for bankruptcy

1. The bankruptcy process for unregulated companies will be under the federal bankruptcy code; no state regulators.

2. If holding co. is guaranteeing the products of the unregulated financial products company, the filing by the holding co. will likely automatically put the subsidiary into bankruptcy.

3. The main subsidiaries of concern are a financial products company (derivatives trading business) and an investment management company (securities lending).

Impact on <u>regulated</u> <u>insurance</u> subsidiaries if parent Holding Co files for bankruptcy

1. If the insurance subsidiaries are financially healthy:

- Filing at holding co. level should not, in theory, impact the insurance subsidiaries' operation as a going concern.

- Filing at holding co. level may, however, cause liquidity stresses at the insurance subsidiary level because of exposures to affiliates, and/or runs because of name aversion (risk of run mainly at the life insurance subsidiaries).

- Under normal conditions, all inter-affiliate transactions must be approved by the insurance regulator; if the parent company has filed for bankruptcy, such approvals will be more scrutinized.

2. If the insurance subsidiaries are <u>NOT</u> financially healthy:

   - Once the holding co. files, the state insurance commissioner will likely step-in and initiate either liquidation or rehabilitation proceedings.

   - Rehabilitation proceedings are the predominant approach: insurance commissioner takes control over subsidiaries to preserve value, sell certain business, or reconstitute so as to continue as going concern; equivalent to ring-fencing; impact on consumer confidence is unclear.

   - If the going concern value cannot be preserved, then commissioner may liquidate in an orderly manner.

III. Impact on Financial Counterparties (see details from Bank Supervision)

1. AIG to fails to perform on balance sheet CDO swaps, which provide reg capital relief to European banks; failure would lead to 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.

2. ABS CDO exposures unlikely to be re-balanced as other counterparties not willing to provide protection; exposes dealers to market risk.

IV. Impact on Market Liquidity and Related Spillover Effects

1. Larger surprise factor than Lehman; AIG CDS priced in 35% probability of default on Friday vs. 67% today.

2. Occurs on the back of Lehman bankruptcy; market currently unsure of their positions and functioning is being tested.

3. AIG derivatives book more complex than Lehman.

4. Bankruptcy of AIG CP ($20 bn) has significant contagion potential (GE CP is $90 bn). If CP can't be rolled over, issuers draw down on bank lines; credit extension dries up, banks capitalization further deteriorates, rating downgrades ensue.

5. Investors could lose confidence in subsidiaries, withdraw cash from securities lending, leaving liquidity shortfall; induces forced liquidations and leads to losses.

6. AIG would fail to perform on annuities and stable value wraps; latter drives asset sales and breaking-of-the-buck for money funds.

Tim: You asked to explore the set of ways a failure would impact the financial system; we do so providing some context throughout using Lehman as a benchmark.

I. Key differences between impact of AIG and Lehman failure

1. In important ways AIG's failure (hold co. and subs) is more systemic in nature due to its size, franchise and the wholesale and retail dimensions of its business.

2. In contrast to Lehman, failure would be more global and have a retail impact (psychologically and economically).
Psychological: AIG is a global brand; seen by the public all over the world
Economic: Significant retail presence through insurance, notably in stable value funds, variable rate annuity to fortune 500.

3. Similar to Lehman, unwinding of trading books contains rebalancing and feedback loops perhaps of smaller scale b/c trading are smaller size but could pose difficulty in unwinding due to complexity of book (ABS CDO and exotic derivatives).

4. Likely that default of hold co. would impinge psychologically on subs; given the environment and the retail dimension of business not sure these two can be differentiated (unlike a Lehman).

II. How a bankruptcy might unfold

III. Impact on Counterparties

1. European Banks
2. ABS CDO

IV. Impact on Market Liquidity and Spillover Effects

1. Unwinding AIGs liquid derivatives books
2. Impact on financing markets
3. Potential for negative feedback loops

V. Impact on market infrastructure

1. CDS settlement

Issues qualitatively different than Lehman in Corporate CDS.

- In contrast to Lehman, AIG itself is not a large CDS counterparty
- Also in contrast, AIG is an underlying to the CDX.

Dislocations related to CDS more similar to FNM/FRE in terms of scale, and perhaps same degree of uncertainty around deliverables (number of trades consistent with AIG, MER, LEH)

ABS CDO could pose operational issues as these are CDS on cash CDOs and would require physical delivery; cash protocol would be difficult to implement due to valuation challenges. Risk similar to monolines.

In comparison to our previous analyses of CDS data for Lehman ($97B) and Merrill ($87B), the **dealers are generally purchasers** of protection on AIG ($44B).

2. FX Infrastructure Issues for AIG (Settle $15B per day, high volume comparable to dealer platform: $30B -$40B, but was $75B - $80B, 80% settle bilaterally.

- If banks refuse to settle currencies before receiving offsetting payments in other currencies, our NOSTRO banks (Citi and BofA) will be forced to decide if we are credit worthy enough to have significant overdrafts. If they decide not, we will start missing payments.
- This could be driven by a desire not to be caught by a midday bankruptcy where counterparts have sent us payments, but we file later in the day before we have sent ours.
- If that happens, it is likely other counterparts will withhold payments hence exacerbating the problem.
- Ultimately, if this happens all payments to AIG will cease, which would force us to similarly stop settling out.
- This would put all our counterparts in the position of having to replace funding on a same day basis.