

The Rescue of American International Group Module Z: Overview

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Abstract

In September 2008, the Federal Reserve Bank of New York (FRBNY) extended an \$85 billion collateralized credit line to American International Group (AIG), a \$1 trillion insurance and financial company that was experiencing liquidity strains ([Credit Agreement - pp. 1](#)). In connection with the loan, the government received preferred shares and a warrant representing 79.9% interest in AIG ([Credit Agreement - Exhibit D](#)). This was only the second time that the Federal Reserve Board of Governors had accessed Section 13(3) of the Federal Reserve Act to assist a specific company ([Sastry 2018 - pp. 3](#)). AIG's problems stemmed in part from its portfolio investments related to a securities lending program and collateral calls by counterparties to credit default swaps that it had written on multisector collateralized debt obligations. ([FRB PR, 09/16/2008](#)). However, it was also experiencing a very depressed stock price, asset devaluations, and the risk of ratings downgrades leading to questions about its solvency ([SIGTARP November 2009 - pp. 8 - 12](#)). Ultimately, the government had to commit additional assistance to AIG, including equity investments under the Troubled Asset Purchase Program and asset purchases, to stabilize it and provide time for it to restructure ([Webel 2013 - pp. 9 - 17](#)). The total commitment would be \$182.3 billion, the most expensive of any rescue for a single company ([UST Financial Report \(FY 2013\) - pp. 14](#)) (UST PR, 12/14/2012). AIG would survive as a smaller entity and repay all amounts owed to the government, which along with the sale of its AIG equity stake, would result in a combined profit of \$22.7 billion for the government and taxpayers ([UST Financial Report \(FY 2013\) - pp. 14](#)).

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Introductory note: In analyzing the programs that are the focus of this survey, a color coded system is used to highlight particularly noteworthy design features. This system is as follows:

Color	Meaning
BLUE	A design feature that is interesting and may be particularly effective or ineffective, but for which there is insufficient evidence for an evaluation.
YELLOW	A design feature that was amended or changed in such a way that suggests caution should be exhibited when evaluating these.

Introduction

The Yale Program on Financial Stability (YPFS) has written seven case studies that examine in detail the various elements of the government's assistance to AIG.⁴ In this overview case we review the government's actions on a combined basis and analyze how the rescue was conceived and executed in order to better understand how nonbank financial institutions in distress may be addressed. Although the rescue of AIG embodied unique characteristics that must be considered, we believe that the lessons learned through this analysis may also apply to other types of nonbanks as well. While this overview case may be read on its own, it is best read in connection with the other YPFS AIG cases, which provide additional detail with respect to each intervention utilized.

In the first part we review the background of the market factors and particular circumstances that led up to AIG's weakened position. We next consider the interventions taken by the government to support the firms beginning in September 2008. Next, we discuss in detail the key decisions made by the government and highlight unique issues presented by AIG. Lastly, we discuss conclusions that may be that may be of assistance in the future efforts.

Background

The fall of 2008 marked a period of severe economic distress for major banks and financial institutions around the world as the ten-year U.S. housing bubble burst and its effects began to reverberate throughout the financial system. These effects included a widespread decline in housing prices, an increase in delinquencies and foreclosures, and a considerable decrease in the value of residential mortgage-backed securities (RMBS), collateralized debt obligations (CDOs), and other related instruments. Beginning in fall 2007, credit markets began to be disrupted and, within the year, many practically froze as both governments and banks attempted to protect themselves from an unprecedented downturn.

As one of the largest insurance companies in the world with over \$1 trillion in total assets, the American Insurance Group, Inc. (AIG) faced significant exposure to this global market volatility ([Form 10-Q, June 2008 - pp. 50](#)). In addition to traditional insurance products, the

⁴ The other YPFS cases are:

Buchholtz, Alec and Rosalind Z. Wiggins. 2019. "The Rescue of American International Group, Module A: The Revolving Credit Facility."

Engbith, Lily and Alec Buchholtz. 2019. "The Rescue of American International Group, Module B: The Securities Borrowing Facility."

Buchholtz, Alec. 2019. "The Rescue of American International Group, Module C: AIG Investment Program."

Engbith, Lily. 2019. "The Rescue of American International Group, Module D: Maiden Lane II."

Engbith, Lily. 2019. "The Rescue of American International Group, Module E: Maiden Lane III."

Buchholtz, Alec. 2019. "The Rescue of American International Group, Module F: The AIG Credit Facility Trust."

company also had sold complex derivatives, invested in securities such as mortgage backed securities in some of its portfolios, and borrowed from the commercial paper and repo wholesale funding markets ([Form 10-Q, June 2008 - pp. 86](#)). Some of these exposures had begun to worry investors and market participants.

In September 2008, a little more than a week after the two giant government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac were taken over by the government, AIG found itself in the throes of a liquidity crisis ([History of GSE Conservatorships, GAO 11-616 - pp. 6](#)). On September 15, 2008, the corporation's stock price fell 61% and the three major credit rating agencies downgraded its rating by two to three levels ([GAO 11-616 - pp. 6, FCIC 2010 - p. 349](#)). The negative effects of the downgrades, including costly collateral calls from AIG counterparties and heightened fears of eventual insolvency, were further exacerbated by news of Lehman Brothers' collapse on that same day ([GAO 11-616 - pp. 6 - 7](#)). The Federal Reserve Bank of New York (FRBNY) lent \$85 billion to AIG on September 16, 2008 in hopes of avoiding further destabilization of the financial system ([Credit Agreement - pp. 1](#)). The loan was also intended to provide AIG time to sell assets and restructure ([FR Section 129, 11/10/2008 - pp. 6](#)). Over the next six months, the FRBNY and Treasury Department would invest additional funds in AIG for a total of \$182.3 billion, the largest rescue of a single entity during the crisis besides the GSEs ([UST Financial Report \(FY 2013\) - pp. 14](#)).

There were two main sources of AIG's liquidity drain. First, beginning in 1997, AIG had started an in-house securities lending program (SecLending Program) through its insurance subsidiaries ([Peirce 2014 - pp. 18](#)). At the time, the practice was seen as a relatively risk-free way to increase returns on corporate bonds and other stable securities that it held ([Peirce 2014 - pp. 18](#)). AIG's subsidiary, AIG Securities Lending Corp., would lend high-quality securities to counterparties in exchange for cash collateral ([Peirce 2014 - pp. 18](#)). That cash collateral would then be separately reinvested by another subsidiary, AIG Global Investment Corp. (AIG GIC), to generate income ([Peirce 2014 - pp. 18](#)). The SecLending Program was profitable and grew from \$10 billion in 2001 to over \$80 billion by the end of 2007. ([Peirce 2014 - pp. 18](#)).

AIG originally invested the proceeds from the SecLending Program in safe assets such as corporate and sovereign bonds ([Peirce 2014 - pp. 18](#)). Prior to 2008, it began engaging in more aggressive investments, particularly residential mortgage-backed securities (RMBS) and other illiquid assets. ([US COP 2010 - pp. 33 - 34](#)).

As markets became dangerously volatile during the summer of 2008, in the run-up to the height of the financial crisis in September 2008, borrowers who had engaged in securities lending with AIG increasingly returned their securities and, rather than roll over their positions, they requested their cash collateral back ([US COP 2010- pp. 33 - 34](#)). However, the value of the RMBS that AIG had invested the cash collateral in began to collapse rapidly and unexpectedly, making it difficult for AIG to liquidate the securities to repay the collateral. The disruption in the credit markets generally also exacerbated AIG's ability to raise the needed funds ([US COP 2010- pp. 34 - 36](#)).

The second main source of liquidity demand being experienced by AIG was with respect to credit default swaps (CDS), mostly on real estate-related multi-sector collateralized debt obligations (CDOs) ([US COP 2010- pp. 18](#)). CDS are a type of insurance that would pay out in the event of a negative credit event such as a default of the assured security ([US COP 2010- pp. 213](#)). CDS may also provide, as many of the ones written by AIG did, that if the risk of the underlying security increases or if the security is impaired, even prior to a default, counterparties may be entitled to request additional cash collateral.

By September 2008, AIG had written 140 CDS contracts on 112 mortgage-related CDOs with \$71.5 billion (notional value) in credit default swaps (CDS) for 20 counterparties (GAO-11-616 2011 – pp. 56). In the months leading up to September 2008, as the market value of the CDOs underlying the CDS agreements declined and AIG’s own credit rating dropped due to losses on these and other mortgage-related exposures, AIG faced increasing collateral calls from counterparties looking to protect their CDS contracts. (Baxter and Dahlgren 2010 – pp. 4). Collateral calls increased rapidly during the summer; AIG received collateral call requests (even though no CDO had defaulted) totaling \$16.1 billion at the end of July and an additional \$16.5 billion by August 6 ([US COP 2010 – pp. 73](#)). When S&P downgraded its rating on AIG to A- with a negative outlook on September 15, AIGFP estimated it needed \$20 billion in order to satisfy collateral calls and transaction termination payments ([US COP 2010 – pp. 73](#)). By September 30, collateral demands had soared to approximately \$32 billion ([US COP 2010 – pp. 73](#)). The company’s inability to meet cash collateral demands by securities borrowers and the collateral calls by CDS counterparties and other counterparties compelled the company to seek assistance from the Federal Reserve.

Program Description

Encouraging a Private- Sector Solution

AIG CEO Bob Willumstad first approached Tim Geithner, President of the FRBNY, to request access to the discount window on July 29, but Geithner thought that to do so would create a run on AIG. ([COP 2010 –pp. 58](#)). Geithner encouraged Willumstad to seek help from private sources. Geithner maintained this position when Willumstad returned in August. ([COP 2010 –pp. 58](#)).

Shortly thereafter, during the weekend of September 12-14, 2008, Geithner and Treasury Secretary Hank Paulson were ensconced in the offices of the FRBNY with the heads of the major Wall Street banks trying to hammer out a solution to save the investment bank Lehman Brothers ([COP 2010 – pp. 62 – 65](#)). On Saturday, Paulson was told that AIG was in dire straits and in serious need of immediate liquidity and he and Geithner arranged to meet with Willumstad. (Paulson 2010, 200). Willumstad reported that the company was trying to raise \$40 billion by selling assets and informed Paulson and Geithner that without

a major infusion of cash, the company would likely run out of money during the upcoming week. (Paulson 2010, 204). AIG had been having trouble rolling over its financial commercial paper and ABCP, which totaled approximately \$20 billion, and some banks were refusing it repo funding. ([FRBNY Emails, 9-12-2008](#), [FRBNY Meeting Notes, 9-12-2008](#)). It was also concerned about a rating agency meeting that was scheduled to occur on September 15th ([GAO 11-616 – pp. 6](#)). A ratings downgrade would trigger off-balance sheet commitments—including collateral calls, contract terminations, and liquidity puts—as high as \$33 billion. ([FCIC 2010, 346-347](#)).

As it became evident that Lehman would file for bankruptcy, Paulson assigned two of his deputies, Dan Jester and Jeremiah Norton, to work with Geithner on a plan to save AIG. (Paulson 2010, 220-221). Geithner considered a private solution to be the most favorable and utilized the Fed’s convening authority to initiate efforts towards a private solution for AIG.⁵ Efforts were made, led by JP Morgan and Goldman Sachs, to assemble a syndicate of banks willing and able to lend AIG up to \$75 billion. ([FCIC 2010, 349](#)).

The private consortium deliberated throughout the weekend and got as far as to develop a term sheet for a loan of \$75 billion, but ultimately, in the wake of Lehman Brothers’ filing for bankruptcy on September 15th, the effort failed⁶ ([GAO 11-616 – pp. 34 – 35](#)). Some of the reasons given for this were (i) the inability to determine with any certainty how much liquidity AIG needed, (ii) questions about whether AIG had sufficient collateral to secure a loan of the size needed, and (iii) the reaction by many financial institutions to preserve cash and pull back from risk given the escalating turmoil in the markets. ([COP 2010 - pp. 67 - 68](#), [Baxter and Dahlgren 2010](#), [SIGTARP 2009](#), 8).

Also, on September 15th, S & P downgraded AIG by three notches, to A-, and Moody’s and Fitch downgraded it by two notches to A2 and A respectively. ([FCIC 2010, 349](#)). (Paulson 2010, 220-221).

⁵ Geithner has said that seeking a private solution is always the first option, one modelled after the government’s actions in 1998 to save the giant hedge fund Long Term Capital Management from collapse when experiencing a liquidity crisis. ([Geithner 2019](#), 11). Then the Federal Reserve used its convening authority to gather LTCM’s 15 biggest creditors, who eventually agreed to provide a \$3.65 billion lifeline to the fund in exchange for a 90 percent ownership, avoiding a disorderly liquidation. ([Geithner 2019](#), 11) ([The Balance](#)). There was no time to repeat this strategy with respect to Bear Stearns in March 2008, but the Fed and Treasury did employ this strategy with respect to Lehman, although it ultimately failed. ([Geithner 2019](#), 21).

⁶ Former FRBNY General Counsel Tom Baxter told the FCIC:- “Once Lehman filed [for bankruptcy] on the morning of the 15th, everyone decided that, ‘we’ve got to protect our own balance sheet,’ and the banks that were going to provide the \$75 billion decided that they were not going to.” ([FCIC 2010, 349](#)). Sarah Dahlgren, a senior FRBNY official who would lead the AIG team, agreed, “Lehman’s bankruptcy ‘was the end of the private-sector solution,’” she told the Commission. ([FCIC 2010, 349](#)). The government became the company’s last hope. ([Alvarez and Dudley 2018, 19](#)).

Figure 1: AIG's Credit Ratings Downgrade by Agency

	Standard & Poor's	Moody's	Fitch
September 14, 2008	AA-	AA3	AA-
September 15, 2008	A-	AA2	A-
Levels Changed	-3	-4	-3

Sources: Standard & Poor's Ratings Services, Moody's Investors Services, Fitch Ratings; September 16, 2008.

Up until the last minute Geithner continued to hold to the view that a private solution was the best, stating that it “seemed inconceivable that the Federal Reserve could or should play any role in preventing AIG’s collapse.” ([COP 2010, 65](#)). Despite this view, FRBNY, Treasury, and New York State Insurance Department (NYIns) staff were present at the meetings of the private consortium. ([Dinallo 2010 – pp. 19](#)). Additional FRBNY staff also “worked to determine how a failure of AIG would affect the financial system and the broader economy and examined their options for containing the damage from an AIG failure.” ([COP 2010, 65](#)). They did this with the limited information they could gather about AIG. Because the FRBNY was not the company’s regulator, it had no long history of knowledge about the firm’s operations, structure, or reach ([Baxter and Dahlgren 2010](#)).

Direct Government Assistance

In December 2007, the Fed had implemented the Term Auction Facility (TAF)⁷ to provide over-night lending to banks and primary dealers, respectively, should they need it. Following Bear Stearns’s near demise in March 2008 due to liquidity concerns, the Fed had implemented the Primary Dealer Credit Facility (PDCF)⁸ to provide over-night lending to primary dealers. During the summer of 2008, as wholesale credit markets tightened, the Fed considered whether other systemically important entities⁹ might also be at risk of disturbances in their liquidity provisioning. ([FCIC 2010, 345](#)). In August, the Fed had begun to look at AIG, which had \$20 billion in commercial paper outstanding, held by numerous money market funds and pension funds, and met with its regulator, the Office of Thrift Supervision (OTS). ([FCIC 2010, 345](#)) (Paulson 235). While the OTS was comfortable

⁷ The TAF in essence made funding similar to discount window funding available to banks via an auction, which was thought to be necessary because of the stigma attached to Discount Window borrowing was keeping banks from utilizing the facility. ([FRB: Term Auction Facility](#))

⁸ The PDCF was available to primary dealers, which included the other investment banks, such as Goldman, Merrill Lynch, Morgan Stanley and Lehman Brothers, which shared a high-leverage business strategy similar to Bear Stearns, also relying on significant overnight funding ([FRB: Primary Dealer Credit Facility](#), [FRBNY: Historical Primary Dealer lists](#)).

⁹ The other entity reviewed was GE Capital, which was a much larger participant in the commercial paper market with \$90 billion outstanding. ([FCIC 2010, 345](#)).

with the firm's liquidity, the FRBNY concluded otherwise writing in an internal memorandum:

“AIG is under increasing capital and liquidity pressure” and “appears to need to raise substantial longer-term funds to address the impact of deteriorating asset values on its capital and available liquidity as well as to address certain asset/liability funding mismatches. [\(FCIC 2010, 346\)](#).”

By September, the FRBNY had begun to consider that a failure of AIG would have far-reaching consequences on a global financial system that was already weakened. A number of AIG risks were identified including: its limited cash and the potential for runs in its funding sources, “substantial off balance sheet liquidity needs,” contract terminations, and “the potential impact on prices of liquidating an \$835 billion securities portfolio to cover liabilities.” [\(FCIC 2010, 346\)](#).

The decision-makers were also being informed of how broad and deep AIG reached. FRBNY Assistant Vice President Alejandro La-Torre wrote to Geithner and others:

The key takeaway is that they are potentially facing a severe run on their liquidity over the course of the next several (approx. 10) days if they are downgraded. . . . Their risk exposures are concentrated among the 12 largest international banks (both U.S. and European) across a wide array of product types (bank lines, derivatives, securities lending, etc.) meaning [there] could be significant counterparty losses to those firms in the event of AIG's failure.”[\(FCIC 2010, 347\)](#).

By Tuesday, Paulson, Bernanke and Geithner had concluded that they had no choice but to lend to AIG. Paulson told the President that the already weakened financial system could not withstand its collapse. (Paulson 235-237).

Revolving Credit Facility

On September 16, 2008, the government announced that it would lend AIG up to \$85 billion, on a collateralized basis for a two-year period, pursuant to a Revolving Credit Facility (RCF). [\(Fed PR, 09/16/2008\)](#) The purpose for the loan as stated in the Fed's announcement was— “to assist AIG in meeting its obligations as they come due” and to “facilitate a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy” [\(Fed PR, 09/16/2008\)](#). The RCF, which closed on September 22, was authorized by the Board of Governors pursuant to the emergency authority under Federal Reserve Act Section 13(3) (12 U.S.C. § 343) and had the “full support” of the United States Treasury. [\(Fed PR 09/16/2008\)](#)

Figure 2 - Summary of AIG Revolving Credit Facility*

Maximum amount of commitment	\$85 billion
Term of commitment	24 months
Interest rate	LIBOR plus 8.5% (12%)
Interest rate floor	3.5% LIBOR floor
Annual commitment fee on undrawn funds	8.5%
Collateral	All assets of AIG and its primary non-regulated subsidiaries including the stock of regulated subsidiaries
Peak Utilization	\$72.3 billion on October 28, 2008
Equity kicker	Government received 79.9% equity interest in AIG
Dividends	Government could veto dividends of common and preferred shareholders
Management	CEO resigned/government appointed replacement

**Showing original terms*

Source: [Fed PR, 09/16/2008](#)

Given the tight time constraints, as a starting point for the RCF, the Fed relied on a term sheet that had been prepared by the private sector consortium, but ultimately the facility terms differed in significant ways. (Baxter and Dahlgren 2010, 4) (Alvarez and Dudley 2018, 19). (Court opinion).¹⁰ As shown in Figure 2, the RCF was a secured loan and with an interest rate on drawn amounts of the 3-month LIBOR plus 8.5%, for a rate of 12%, at a time when the Fed had lowered the Federal funds rate to just 2 percent.¹¹ The RCF also carried an annual commitment fee on undrawn funds of 8.5%, which the private sector terms did not have. (GAO 11-616 – pp. 125, 29). (U.S. Court of Federal Claims 2015 – pp. 16 – 17). The FRBNY did not provide an explanation for this particular fee but stated that

¹⁰ There were several differences between the private consortium proposal and the RCF such as the term (18 months vs. 24 months) and the interest rate (from LIBOR plus 6.5 percentage points to LIBOR plus 8.5 percentage points). “FRBNY officials could explain only the increase in the base rate. The officials said an advisor made that increase, on the theory that the loan had become riskier since the failed private-sector attempt.” (GAO September 2011 - p. 125).

¹¹ There was concern about the rate (which the Government Accountability Office later called “onerous” in its report) from government officials; although there were no changes by the time the FRB approved the loan to AIG on September 16. (GAO September 2011 - pp. 126). FRBNY discount window staff told the GAO that they felt they were “extremely high and a burden to AIG and thus seemed contrary to the idea of trying to sustain the firm,” according to FRBNY officials (Ibid. - pp. 125, FN 167). The Fed substantially lowered the RCF interest rate and commitment fees in the first restructuring plan of November 2008. (FRBNY PR –2008).

“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.” ([GAO 11-616 – pp. 125 – 126](#)). Section 13(3) requires that lending be secured to the FRBNY’s satisfaction and the RCF was secured by substantially all of AIG’s assets and those of its non-regulated subsidiaries (which included equity in its regulated subsidiaries. ([COP June 2010 – pp. 70](#), [GAO 11-616 – pp. 48](#))

As part of the Credit Agreement that established the RCF, the government was to receive a 79.9% equity interest in AIG through the issuance of Convertible Voting Preferred Stock and a warrant to purchase common stock, which was to be issued to and managed by an independent trust established for that purpose (collectively referred to as the “Trust Stock”), since neither the Fed nor Treasury had authority to own the shares. ([Credit Agreement – Exhibit D](#)). The AIG Credit Facility Trust (the ‘Trust’) was to be managed by three independent Trustees appointed by the FRBNY in consultation with Treasury who were to exercise the shareholder rights embodied in the preferred stock for the benefit of the Treasury and taxpayer ([COP 2010 – pp. 99 - 101](#)).

AIG’s needs were immediate and so on the day the RCF was announced, the FRBNY loaned the company \$14 billion on a fully collateralized basis, through a demand note secured on a portion of the AIG assets that were to secure the RCF ([Guarantee and Pledge Agreement – Preamble](#)). By the time the RCF closed on September 22, there had been three additional advances totaling \$23 billion. The four promissory notes, totaling \$37 billion, were rolled into the RCF. ([FRB Section 129, 09/16/2008 - pp. 4](#)).

By October 1, the total amount drawn under the RCF had already reached approximately \$62 billion ([FRB on Assistance to AIG.](#)) ([BDGOV Minutes 10/06/2008, pdf – pp. 42 - 44](#)). By October 28, it was at \$72 billion, and it was clear that the facility would not be sufficient to meet AIG’s liquidity needs. ([RCF Transaction Data](#), [COP 2010, 85](#)). Mounting losses on subprime RMBS investments and increased collateral calls on CDS contracts during the third quarter of 2008 caused AIG’s leverage ratios to rise, leaving the company vulnerable to another credit downgrade ([COP 2010 - pp. 85 - 86](#)). Although implementation of the RCF helped to relieve immediate liquidity concerns and temporarily avert further ratings downgrades, it did not directly address the sources of the cash drain or relieve counterparties’ concerns ([COP 2010 - pp. 84 - 87](#)).

Securities Borrowing Facility

As markets became dangerously unstable, borrowers who had engaged in securities lending with AIG increasingly returned their securities and, rather than roll over their positions, requested their cash collateral back ([US COP 2010- pp. 33 - 34](#)). However, AIG had invested this cash in RMBS, which were under significant devaluation pressures and which were becoming increasingly illiquid ([Peirce 2014 – pp. 26-28](#)). As a result, AIG used some of the borrowing under the RCF to meet these demands ([US COP 2010- p. 84n](#)). Nevertheless, this

Figure 3 - Summary of AIG Securities Borrowing Facility

Announcement Date	October 6, 2008
Termination Date	December 12, 2008
Maximum amount of commitment	\$37.8 billion
Peak Utilization	\$20.5 billion
Term of commitment	24 months
Interest rate	100 basis points above the average overnight repo rate offered on the relevant collateral type
Collateral	High-quality securities returned by AIG's SECLending clients

Sources: ([Report...Securities Borrowing Facility for AIG 2008 – pp. 3](#) ; ([AIG Securities Borrowing Facility data 2010](#))

Concerned at the rate of borrowing under the RCF, AIG sought additional assistance and on October 6, 2008, the Board of Governors – under Section 13(3) – authorized the FRBNY to establish the Securities Borrowing Facility (SBF) in order to ease the intense liquidity pressures stemming from these cash demands. ([Report...Securities Borrowing Facility for AIG 2008 – pp. 1](#)) ([COP 2010, 85](#)). Under the SBF, the FRBNY extended to AIG a maximum credit line of \$37.8 billion at any one time in exchange for collateral in the form of investment-grade debt obligations ([COP 2010 – pp. 85](#)). In essence, the FRBNY would step into the transaction being terminated by an AIG counterparty and accept the related lent securities as collateral. ([Report...Securities Borrowing Facility for AIG 2008 – pp. 3](#)). The interest rate applied equaled 100 basis points above the average overnight repo rate offered on the relevant collateral type ([Report...Securities Borrowing Facility for AIG 2008 – pp. 3](#)).

AIG would then use cash borrowed from the SBF to repay the SecLending Program counterparties' cash collateral and terminate their related securities lending agreements without being compelled to liquidate the related portfolio of RMBS. (COP 2010). The authorized amount under the SBF was sufficient to meet the cash collateral demands of all AIG's SecLending Program counterparties; maximum government exposure at the height of utilization of the SBF was \$20.5 billion in November 2008. ([AIG Securities Borrowing Facility data 2010](#)). The SBF was terminated with the establishment of Maiden Lane II as part of the November 2008 restructuring of federal assistance ([AIG Securities Borrowing Facility data 2010](#)).

The November 2008 Treasury Equity Investment

A major concern that quickly arose with AIG stemmed from the rating agencies. They were concerned about the burden that the RCF, with its high interest rate and short term, placed on the company, and about its impact on the company's leverage ratios. ([Alvarez and Dudley 2018, 19](#)). Also, potential asset devaluations and large losses on AIG's RMBS portfolio and

derivatives, and its collapsing stock price, were creating capital concerns. ([Alvarez and Dudley 2018, 19](#)). ([COP 2010 – pp. 69 – 70](#)). A downgrade would trigger higher collateral requirements and increased liquidity demands from counterparties. ([Alvarez and Dudley 2018, 19](#)).

Despite the government’s initial effort to assist AIG, on October 3rd Moody’s downgraded AIG’s senior unsecured debt rating to A3 from A2 and placed the company on credit watch ([COP 2010 – pp. 69](#)). The credit rating agencies notified the company that its November 10th fourth-quarter results, where it was expected to report losses over \$40 billion, would likely trigger an additional downgrade unless accompanied by “parallel announcement of solutions to its liquidity problems.” ([COP 2010 - pp. 70](#)). ([GAO 11-616 - pp. 49](#)). It was clear that further assistance was needed to address these concerns. The government had a new tool. On October 3rd Congress had passed the Troubled Asset Relief Program (TARP), which authorized the Treasury to purchase assets or securities of troubled financial companies ([P.L. 110-343](#)).

On November 10, 2008, the FRBNY, Treasury, and AIG announced a (first) restructuring plan for AIG (executing it on November 25, 2008). The Restructuring Plan amended the terms of the RCF to make them less aggressive, contingent on Treasury making a capital injection. ([Restructuring Report - pp. 4 - 5](#)). Additionally, two new facilities, Maiden Lane II and ML III, were designed to purchase the company’s residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs), respectively ([Restructuring Report - pp. 7 - 8](#); [FRB PR, 11/10/2008](#)). Also, in light of ML II, the SB Facility would be terminated.

Utilizing the Systemically Significant Financial Institutions (SSFI)¹² program, authorized under TARP, Treasury agreed to make a \$40 billion equity investment in AIG. ([COP: June 2010 Oversight Report](#)). In exchange, Treasury received 4 million shares of Series D Preferred Stock and a warrant to purchase approximately 2% of AIG’s outstanding common stock ([Term Sheet: Series D Preferred Stock - pp. 6](#)).¹³ These investments augmented AIG’s capital and AIG used some of the proceeds to pay back \$35 billion of the \$69.7 billion that AIG had drawn on the FRBNY’s RCF, reducing its debt to FRBNY to \$35.3 billion. ([FRB on Assistance to AIG, Millstein 2018](#)) The commitment under the RCF was also reduced to \$60 billion. ([FRB on Assistance to AIG.](#)) The November 2008 investment was intended to restructure AIG’s balance sheet, “stabilize [its] business and address rating agency concerns in order to allow [it to pursue] an orderly restructuring.” ([COP 2010 - pp.](#)

¹² The SSFI Program, later renamed to the AIG Investment Program (because AIG was the sole beneficiary), was announced on November 10, 2008 as part of the restructuring of AIG assistance.

¹³ To maintain Generally Accepted Accounting Principles (GAAP) standards of maintaining the government’s overall equity stake in AIG under 80%, Treasury’s purchase of the Series D Warrant decreased the equity stake of the Series C Preferred Stock that would be issued to the Trust by 2% from 79.9% to 77.9%. For more information on the changes implemented to the terms of the RCF and the preferred stock, please refer to Buchholtz & Wiggins 2019.

70). On an aggregate basis the government's investment increased, but the debt portion decreased.

Figure 4 - Summary of the November 2008 Treasury Equity Investment

Maximum amount of commitment	\$40 billion
Equity Received	4 million shares of Series D Preferred Stock
Warrant Received	To purchase approximately 2% of AIG's outstanding common stock
Use of Funds	\$35 billion used to pay down RCF debt
Other	Revolving Credit Facility commitment reduced by \$25 billion to \$60 billion

Source: [Fed PR, 11/10/2008](#)

The Maiden Lane Vehicles

Maiden Lane II. Maiden Lane II (ML II)¹⁴, the first SPV, was designed to address the AIG SecLending Program. Although the SBF assisted in relieving AIG's immediate liquidity pressures, it did not attend to the collapsing values of the related RMBS portfolio ([US COP – pp. 71, 137 – 138](#)). This portfolio was weighing down AIG's balance sheet and was just one of the areas that the rating agencies were closely monitoring ([US COP – pp. 137](#)). MLII would utilize a loan of \$19.5 billion from the FRBNY, with a \$1.0 billion equity contribution from AIG, to purchase the SecLending Program RMBS portfolio from AIG insurance subsidiaries consisting of RMBS with a total fair market value of \$20.5 billion and par value of approximately \$40.0 billion (as of October 31, 2008). ([Maiden Lane II Transactions, Section 129 2008 – pp. 7](#)). Proceeds from the establishment of ML II were used to refund cash collateral posted by the FRBNY through the SB Facility, effectively terminating both its operations and the AIG SecLending Program ([AIG RMBS LLC Facility: Terms and Conditions](#)).

¹⁴ The SPV was called ML II because the first (unnumbered) Maiden Lane had been formed in March 2008 to purchase assets from Bear Stearns in order to facilitate its merger with JPMorgan.

Figure 5 - Summary of Maiden Lane II

Maximum amount of commitment	\$19.5 billion
AIG Participation	\$1 billion
Securities Purchased	RMBS with a total fair market value of \$20.5 billion and par value of approximately \$40.0 billion (as of October 31, 2008)
Use of Funds	To refund cash collateral posted by the FRBNY through the SB Facility
Other	SB Facility terminated Sec Lending Facility Terminated

Source: [Fed PR, 11/10/2008](#)

Maiden Lane III. In addition to collateral calls related to AIG's SecLending Program, the company faced increasing collateral calls from counterparties looking to protect their CDS contracts written on failing multi-sector CDOs ([US COP 2010 – pp. 30 – 31](#)). The frequency of collateral calls had increased and AIG had already drawn down \$20.2 billion from the RCF to meet these calls ([GAO 11-616 – pp. 63](#)). Although the RCF provided cash for AIG to meet its obligations, the CDS posed a serious and continuing liquidity strain on the company ([US COP 2010 – pp. 29 – 30](#)). Unlike the Sec Lending Program, where the amount of the demands could be calculated, the demands under the CDS were less predictable, creating increasing uncertainty. The AIG Group thought that further measures had to be taken to address the falling values of the underlying CDOs.

Figure 6 - Summary of AIG Maiden Lane III

Maximum amount of commitment	\$85 billion
AIG Participation	\$1 billion
Securities Purchased	CDS on which AIG had written CDOs
Use of Funds	Not Specified
Other	Related CDS terminated

Source: [Fed PR, 11/10/2008](#)

The second SPV, Maiden Lane III (ML III), was established to purchase the underlying CDOs from AIG's CDS counterparties in order to terminate their related CDS agreements with AIG and halt mounting collateral calls ([US COP 2010 – pp. 73](#)). ML III was funded by a \$24.3 billion FRBNY senior loan and a \$5 billion equity contribution from AIG, with AIG absorbing the first losses ([US COP 2010 – pp. 74](#)). On November 25 and December 18, ML III purchased in two stages a portfolio of CDOs worth \$27.2 billion at fair market value, and \$62.1 billion at par ([US COP 2010 – pp. 74](#)). As part of the transaction agreement, counterparties retained the rights to \$35 billion in collateral previously collected from AIG

and thus effectively received full notional value for the CDOs despite their then-current market value of less than 50% of par value ([US COP 2010 – pp. 74](#)). This would become a sharp bone of contention with critics of the action. (See discussion at KDD—below).

The March 2009 Restructuring and Recapitalization

On March 2, 2009, the U.S. government announced a second restructuring plan for AIG, exchanging the dividend cumulating Series D Preferred Stock for the Series E Preferred Stock, which would “provide for non-cumulative dividends and limit AIG’s ability to redeem the preferred stock except with the proceeds from the issuance of equity capital.” ([SEA: Series E Preferred Stock - pp. 1](#)).¹⁵ ([Report to Congress \(March 2009\) – pp. 9](#)) It was thought that the Series E shares would better resemble AIG common equity and therefore improve the company’s financial leverage (Buchholtz and Lawson 2018). These more limited terms were helpful to the overall balance of AIG’s balance sheet as viewed by the rating agencies ([GAO 11-616 – pp. 48 – 49](#)). The Series E Preferred Stock permitted Treasury to elect new directors to AIG’s Board of Directors if dividends were not paid for four quarters, whether or not consecutive. ([COD: Series D Preferred Stock - pdf pp. 111](#))

In addition, as part of the restructuring, Treasury announced the commitment of an additional \$30 billion in TARP funds under an equity capital facility in exchange for 300,000 shares of Series F Preferred Stock and a warrant to purchase 3,000 shares of AIG common stock.

Figure 7- Summary of Key Terms-Treasury TARP Investments

	1 st	2 nd
<i>Announcement Date</i>	November 10, 2008	March 2, 2009
<i>Operational Date</i>	November 25, 2008	April 17, 2009
<i>Termination Date</i>	January 14, 2011	January 14, 2011
<i>Investment Amount</i>	\$40.0 billion	Up to \$30.0 billion
<i>Max. Amount Utilized</i>	\$40.0 billion	\$27.8 billion
<i>Type of Preferred Stock</i>	4,000,000 shares of Series D	300,000 shares of Series F
<i>Warrant Received</i>	2% common stock	1% common stock

Source: Buchholtz and Lawson 2019

¹⁵ The 400,000 shares of Series E Preferred Stock were valued at \$104,011.44 per share, up from the \$10,000 per share of the Series D Preferred Stock. The higher proportional value per share for Series E shares also included about \$1.6 billion in cumulative unpaid dividends that was due to Treasury on the Series D Preferred Stock. ([GAO September 2011](#))

The 2010 Recapitalization Plan

In September 2010, Treasury, the FRBNY, and AIG designed a Recapitalization Plan (Recapitalization) for all of the federal assistance provided to AIG ([Summary of Terms](#)). The plan was “designed to repay all its [AIG’s] obligations to American taxpayers” and would involve AIG using proceeds from asset sales and subsidiary transactions ([Webel 2017 – pp. 9 – 17](#)). The plan included several steps: (i) accelerated repayment and termination of the RCF, (ii) the acquisition by the U.S. Treasury Department of the majority of the FRBNY’s preferred interests in the AIA and ALICO special purpose vehicles ¹⁶, and (iii) conversion of the AIG preferred stock owned by the Treasury Department and the AIG Trust into common equity. ([FRBNY: Actions Related to AIG](#)).

As part of the Recapitalization, on January 14, 2011, Treasury converted the Series E Preferred Stock to shares of AIG common stock. ([Summary of Terms - pp. 2](#)). ([FRBNY PR 01/14/2011](#)). On that same day, AIG repaid all amounts due under the RCF, which was then terminated, and the AIG Trust converted the Trust Stock to AIG common and transferred these shares to Treasury, which pursuant to TARP authority could now hold such shares. With this transfer, Treasury held over 1.6 billion shares of AIG common stock equal to approximately 92.1% ownership in AIG, which was consolidated onto the government’s balance sheet. ¹⁷ ([UST PR, 01/14/2011](#)). This circumstance would anger AIG’s former largest shareholder, Starr International Company, who would sue, but eventually fail in its attempts to recover its lost investment from the government.¹⁸

¹⁶ In accordance with the March 2, 2009 Second Restructuring Plan, AIG released agreements to create two special purpose vehicles in the form of limited liability companies to hold the common stock of two of AIG’s largest foreign life insurance subsidiaries, AIA and ALICO, in anticipation of their sale or IPOs, establishing AIA Aurora LLC and ALICO Holdings LLC. With the formation of the SPVs, the FRBNY agreed to accept \$16 billion in preferred shares of the former SPV and \$9 billion in preferred shares of the latter SPV in exchange for reducing the outstanding debt under the RCF by \$25 billion and the commitment thereunder from \$60 billion to \$35 billion.

¹⁷ Despite earlier concerns about avoiding the need to consolidate AIG’s balance sheet with the government’s, given this percentage of ownership, consolidation did occur. For details on the other preferred stock Treasury purchased through various TARP investments in AIG, please refer to “The Rescue of American International Group, Module C: AIG Investment Program”.

¹⁸ The Treasury’s ownership of 92.1% of AIG’s equity, would be the source of a lawsuit brought by the company’s former largest shareholder, Starr International Company (SICO), whose Chairman and majority shareholder had been the CEO of AIG for more than three decades. Starting in November 2011, SICO sued the U.S. government and sought damages of \$40 billion, the amount SICO believed the Trust Stock was actually worth at the time of its sale to the Trust in March 2009. ([U.S. Court of Federal Claims, June 2015](#)) SICO claimed that the government’s acquisition of a majority stake in AIG “constituted a taking without just compensation and an illegal exaction” and was in violation of their Fifth Amendment rights. In June 2015, the Court of Federal Claims ruled that while the government did conduct an “illegal exaction,” no damages would be awarded to SICO and shareholders. ([Ibid.](#)) SICO appealed the case in the U.S. Court of Appeals for the Federal Circuit. The Judges in the Court of Appeals concluded that Starr failed to prove “its alleged injury was distinct from the remaining AIG shareholders’ injury” and “absent Government intervention, Starr’s shares would have been valueless.” ([U.S. Court of Appeals for the Federal Circuit, May 2017](#)). In March 2018, the

Outcomes

By December 2012, Treasury had sold off all the AIG common stock it had acquired through the Recapitalization Plan (both from the Trust and through its equity investments) ([UST PR, 12/14/2012](#), [CBO April 2019 – pp. 5](#)). In March 2013, Treasury sold its warrants back to AIG, officially ending all government investment in the company ([UST Financial Report 2013 – pp. 14](#)).

Maiden Lane II and Maiden Lane III were charged with the responsibilities of both selling off the RMBS and CDO assets, respectively, that they had purchased and repaying the FRBNY senior loans and AIG equity contributions. The New York Fed announced in March 2011 that it would offer the ML II assets for sale in a series of competitive auctions. ([FRBNY PR 03/20/2011](#)). Assets purchased by ML II were held until February 2012, at which point the FRBNY offered them for sale in a series of competitive auctions. Purchases by Goldman Sachs and Credit Suisse allowed for the repayment of the FRBNY senior loan to ML II, as well as AIG's equity contribution and all related interest, on February 28, 2012 ([FRBNY PR, 02/28/2012](#)).

Similarly, the CDOs held by ML III were sold off in competitive auctions to various financial institutions ([Maiden Lane III Transactions](#)). Proceeds from these sales enabled the repayment of the FRBNY senior loan, including all related interest, on June 14, 2012, as well as the repayment of the AIG equity contribution, including all related interest, on August 23, 2012 ([Maiden Lane III Transactions](#), [FRBNY PR, 08/23/2012](#)). The legal existence of ML II and ML III was formally terminated with the reimbursement of all trailing expenses on November 14, 2014 ([Maiden Lane Transactions](#)).

These final transactions ended all crisis-era government assistance to AIG. In aggregate, the government extended \$182.3 billion to AIG and recouped all amounts lent, or invested, including accrued interest and fees, while realizing a net gain of \$22.7 billion for the benefit of the U.S. public ([UST Financial Report \(FY 2013\) - pp. 14](#)).

United States Supreme Court declined to grant certiorari, leaving the lower court's ruling intact. (See <https://www.scotusblog.com/case-files/cases/starr-international-company-inc-v-united-states/>)

Key Design Decisions

1. What factors influenced the government’s determination that there was a systemic risk to the financial system?

The U.S. government’s strategy was not predicated on saving every institution that might fail, but on addressing those whose failure could jeopardize the stability of the system. ([Geithner 2019](#) – pp. 13). Thus, when considering whether to rescue AIG, the government first considered whether the company posed a systemic risk to the financial system that should be avoided and concluded that it did.¹⁹ Reasons considered in this deliberation included: (i) the size, presence and reach of the company risked sparking significant contagion throughout the financial system if it failed,²⁰ (ii) the complexity of AIG’s \$2.7 trillion derivatives book, which was more complex than Lehman’s, (iii) that much of AIG’s risk exposures were concentrated among the 12 largest international banks (both U.S. and European) across a wide array of product types (bank lines, derivatives, securities lending, etc.) ([FCIC 2010, 347](#)), (iv) that an AIG bankruptcy would be a bigger surprise than Lehman’s and would occur on the back of Fannie and Freddie being placed in conservatorship, the Lehman bankruptcy, and the Primary Reserve Fund “breaking the buck”, which had created significant market disruption ([COP 2010, 69, 132](#)), (v) that the firm’s failure would increase European bank capital requirements by \$18 billion as their credit default swaps became impaired,²¹ (vi) that the retail dimension of AIG’s business, reaching to pension plans and municipalities, would likely result in its failure having a greater systemic impact than Lehman’s ([COP2010, 129, Fn 499, 130](#)), and (vii) significant

¹⁹ For example: “This assessment was a function of the firm’s size, the importance of its role in the funding and credit markets, its linkages with the rest of the financial system, and the contagion that might accompany its failure. The risk to the financial system was in turn a function of the state of the world at that moment in time.” ([Geithner 2019](#)). The Federal Reserve’s actions were also informed by its judgment that an AIG collapse would have been much more severe than that of Lehman Brothers because of its global operations, substantial and varied retail and institutional customer base, and the various types of financial services it provided.” ([COP 2010, 129](#).)

²⁰ An internal FRBNY memo circulated to the Fed’s AIG monitoring group stated that “the Lead point” was that “the size, name, franchise and market presence (wholesale and retail) [of AIG] raise questions about potential worldwide contagion, should this franchise become impaired.” ([FCIC 2010, 349](#)). See also: “The primary fear of the Federal Reserve and Treasury was that defaults directly related to AIG would have spread throughout the financial system, affecting transactions between other counterparties, negatively affecting investor confidence, and further destabilizing the economy.” COP 2010, 130. “AIG’s role as one of the world’s largest and storied insurance companies meant that its failure likely would have had a contagion effect, causing damage as it spread throughout the insurance industry. Policy holders would be hurt.” [Baxter and Dahlgren, 2010](#).

²¹ “If AIG collapsed, it . . . would []lead to \$18B increase in European bank capital requirements.[] In other words, European banks that had lowered credit risk—and, as a result, lowered capital requirements— by buying credit default swaps from AIG would lose that protection if AIG failed.” ([FCIC 2010 - pp. 348](#)).

further disruption of the commercial paper market was likely to occur if AIG defaulted.²² (COP 2010, 132)

Once it became clear that the private-sector solution was no longer a possibility, the government “faced ‘a binary choice’ to either let AIG file for bankruptcy, or to provide it with liquidity,” according to FRBNY General Counsel Thomas Baxter ([COP 2010 - pp. 69](#)). Chairman Bernanke explained shortly after the decision to assist AIG:

In the case of AIG, the Federal Reserve, with the support of the Treasury, provided an emergency credit line to facilitate an orderly resolution. The Federal Reserve took this action because it judged that, in light of the prevailing market conditions and the size and composition of AIG’s obligations, a disorderly failure of AIG would have severely threatened global financial stability and, consequently, the performance of the U.S. economy ([Bernanke 09/23/2008](#))....

AIG was bigger than Lehman and was involved in an enormous range of both retail and wholesale markets. For example, they wrote hundreds of billions of dollars of credit protection to banks, and the company’s failure would have led to the immediate write down of tens of billions of dollars by banks. It would have been a major shock to the banking system. . . . Since nobody knew the exposures of specific banks to AIG, confidence in the entire banking system would have plummeted, putting the whole system at risk. (David Wessel, *In Fed We Trust*, pp. 25-26)

Scholarly and governmental authorities who have reviewed the government’s decision have concluded the same. See for example, Sjostrom 2011—“The bottom line is that nobody knew for certain the scope of damage that would result from an AIG bankruptcy. Because of AIG’s size and interconnectedness, and the fact that financial markets were already under serious distress, it was feared that AIG’s failure would lead to the collapse of the entire financial system. [Fn omitted] The federal government was unwilling to take this risk and, therefore, bailed out AIG” ([Sjostrom 2011 – pp. 979](#)).

2. What was the government’s purpose for intervening?

The government’s purpose for intervening was to avoid a disorderly failure, or bankruptcy, of AIG and the severe disruptions in the financial system that might have followed. It would do so by providing AIG the liquidity it needed to buy time to execute its plan to sell

²² “The Fed and Treasury had additional serious concerns about the potential impact of an AIG bankruptcy on MMMFs and the commercial paper market. AIG had issued \$20 billion of commercial paper, four times as much as Lehman. By September 16, 2008, an investor run on MMMFs had already begun as a result of Lehman’s default and the “break the buck” event at RPF. Federal officials therefore feared that an AIG bankruptcy would do even greater harm to MMMFs and the commercial paper market.” ([COP 2010 - pp. 132](#))

assets to improve its financial position. The purpose for the loan as stated in the Fed’s announcement was—“to assist AIG in meeting its obligations as they come due” and to “facilitate a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy.” ([FED PR 09/16/2008](#)) It was believed at the time that the AIG subsidiaries had value and could be effectively sold to raise funds. CEO Willumstad had discussed a plan for the firm to sell approximately \$40 billion in assets over a 6-12-month period, and the RCF loan was to be repaid with proceeds from these sales. ([COP 2010 - pp. 62](#)). The RCF loan was for a two-year period, which at the time was thought to be a sufficient period for AIG to avoid fire sales of devalued assets and to successfully complete the plan ([GAO 11-616 - pp. 125](#)).

3. What legal authority supported the government’s intervention?

Federal Reserve Assistance

The RCF was extended under Section 13(3) of the Federal Reserve Act, which allowed the Fed to lend to any entity or person in an “unusual and exigent” circumstance if certain conditions are satisfied.²³ It was a “broad and extraordinary authority.” ([Alvarez 05/26/2010](#)). The provision was enacted during the 1930s, used several times during this period, and although use was authorized twice during the 1960s, funds had not been lent under the provision in the 70 years prior to the crisis. ([Alvarez 05/26/2010](#))²⁴

In authorizing the FRBNY to lend to AIG, the Board of Governors considered:

“...the effect of AIG's disorderly failure on financial markets, the position of the Department of the Treasury on an extension of credit to AIG, and the circumstances presented by this situation as compared with situations recently confronted by the Board. Board members agreed that the disorderly failure of AIG was likely to have a systemic effect on financial markets that were already experiencing a significant level of fragility and that the best alternative available was to lend to AIG to assist it in meeting its obligations in an orderly manner as they came due.” ([BD Gov Minute 09/16/2008, PDF pp. 29-30](#))

²³ 12 USC 343 (prior to 2010 amendments).

²⁴ In 1991, Congress significantly strengthened the Fed’s 13(3) powers to make it easier for the Fed to lend to securities firms, responding to concerns that the Fed’s hands had been tied during the 1987 stock market crash ([Sastry, p. 28-29](#)). As revised, the law between 1991 and 2010 only required that discount window loans under Section 13(3) be “secured to the satisfaction of the Federal Reserve Bank;” it no longer stipulated the types of collateral that the Fed could accept. In 2010, Congress significantly limited Section 13(3) powers. The law now only allows the Fed to lend under emergency programs “with broad-based eligibility,” effectively preventing the Fed from again undertaking an AIG-style rescue for a specific institution. The law also now requires prior approval from the Treasury Secretary.

The Board determined that, in the then-existing environment, “a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance.” ([BD Gov PR 09/16/2008](#)) ([COP 2010 - pp. 129](#)).

Stock Ownership Controversy. The terms of the Credit Agreement that effectuated the RCF provided that the FRBNY would purchase shares of voting convertible preferred stock representing 79.9% of AIG’s outstanding common shares, to be issued to the AIG Trust. (It would also receive a related warrant) ([Credit Agreement – Exhibit D](#)). The Trust was administered by three trustees and was obligated to manage the shares for the benefit of the Treasury and taxpayer ([Credit Agreement – Exhibit D](#)).

The provision for the government to receive an equity interest in AIG originated in the private consortium term sheet, which provided that the lenders would receive warrants to purchase 79.9% of the common stock of AIG. (Private Term Sheet, email to Baxter). The provision was retained when the private term sheet was adopted as the basis for the Fed term sheet and was included in the term sheet reviewed and approved by the Board of Governors. ([U.S. Court of Federal Claims, June 2015 - pp. 25 - 26](#)). Thereafter, however, the provision was changed to provide for the issuance of voting convertible preferred stock, which is ultimately what ended up in the Credit Agreement ([Credit Agreement – Exhibit D](#)). This change was not approved by the Board of Governors; however, Chairman Bernanke was aware of it and General Counsel Alvarez was involved in working through the related legal issues. ([U.S. Court of Federal Claims, June 2015 - pp. 26](#)). (Alvarez email, Treasury memo).

The change of the equity interest term from a warrant to purchase common shares equal to 79.9% of AIG’s equity to voting convertible preferred stock equal to 79.9% of AIG’s common stock was significant. A warrant is a right to purchase shares at a stated “strike price” and requires payment of that price upon exercise and issuance of the shares (“[What is a Warrant?](#)”). Exercise of a warrant for 79.9% of AIG’s shares as originally described would have required payment of \$30 billion ([U.S. Court of Federal Claims, June 2015 - pp. 25](#)). Only upon exercise and issuance of the shares would the owner then have voting rights ([U.S. Court of Federal Claims, June 2015 - pp. 25](#)). By contrast, the Trust Stock had characteristics that granted voting authority, and in this case control over AIG (because of the 79.9% allocation), immediately upon issuance of the preferred, which required merely the payment of \$500,000 pursuant to the Credit Agreement. ([U.S. Court of Federal Claims, June 2015 - pp. 25, Credit Agreement – Exhibit D](#))).

Neither the Federal Reserve nor the Treasury had authority to own shares of a private corporation and this fact was soon recognized by counsel for the FRBNY, the Board of Governors, and the Treasury.²⁵ Nevertheless, the government did not choose to retreat

²⁵ Add letter to Baxter

from this term. The “equity kicker,” as it has been called (U.S. Court of Federal Claims, June 2015 – p. 60), was seen as a way to compensate the U.S. taxpayers for the extraordinary risk that the Fed was undertaking in lending to AIG ([FRB Minutes 2008 – pp. 4, Geithner 2014 – pp. 196 - 197](#)). In an (unlikely) worst case scenario, if AIG was unable to repay the loan and the collateral did not provide full recovery, the Fed’s contribution to the Treasury might be negatively impacted.²⁶ In the alternative, if the RCF successfully provided the lifeline that AIG needed to survive its crisis and restructure its business, emerging a healthy and sound business, the taxpayers would share in the success via the increase in the value of the AIG stock. (Geithner 2014 – pp. 196). Although this was not a practice that the Fed had utilized previously, it had been used by private firms and one that provided a chance of additional upside to the taxpayers in extraordinary circumstances ([U.S. Court of Federal Claims, June 2015 – pp. 2](#)).

From September 16, when the RCF was announced, to the closing on September 22, the government’s attorneys worked with outside legal experts to craft a workable solution to the legal problem. A number of options were considered and rejected before settling on the AIG Trust model ([U.S. Court of Federal Claims, June 2015 – pp. 20 - 31](#)).²⁷

Despite the work that went into its design, the “equity kicker” was challenged in court by AIG’s former largest shareholder, Starr International. The Federal Claims court ruled that the Fed had overstepped its authority in requiring the term and found that it represented an illegal exaction, which is an illegal act of taking property by government (U.S. Court of Federal Claims, June 2015 – pp. 1 – 2). However, the court also declined to award damages stating that the plaintiff had not suffered any economic loss—“While the taking of 79.9 percent equity ownership and the running of AIG’s business were not permitted under the Federal Reserve Act, the Government did not cause any economic loss to AIG’s shareholders, because as Mr. Studzinski said, ‘[twenty] percent of something [is] better than [100] percent of nothing.’” ([U.S. Court of Federal Claims, June 2015 – pp. 66](#)).

The lower court ruling was upheld on appeal and the U.S. Supreme Court declined to grant cert in March of 2018. ([SCOTUS 2018](#)).

In its 2015 ruling, the lower court expressed the opinion that the Trust was not truly independent, having been established by the Fed, with the “independent” trustees that were appointed by the Fed having close affiliations to the Fed, and with there having been close communications between the Fed and the Trust during its existence. ([U.S. Court of Federal Claims, June 2015 – pp. 62 - 63](#)) “The manner in which FRBNY controlled AIG with its handpicked CEO, carefully selected board members, and its hundreds of on-premises advisers belies any conclusion that the operations of the trust were independent.” ([U.S. Court of Federal Claims, June 2015 – p63](#))

²⁶ This was the reason that Fed had requested and received from Treasury Secretary Paulson a letter acknowledging this fact. See [Paulson, October 8, 2009](#).

²⁷ See Buchholtz and Lawson 2019 for a detailed discussion of the AIG Trust and the Trust Stock.

In conclusion, the equity kicker represented a stretch beyond the Fed's authority which was undertaken in extraordinary circumstances to better protect the taxpayers. Given the court's ruling, it would be reasonable to expect a similar challenge and ruling if the Fed were to try to secure similar terms in the future. Such a future attempt would likely also expose the government to an unknown damages determination depending on the circumstances. (See also [HLR: Starr International Co. v United States](#))]

Additional Federal Reserve Assistance. The Fed's additional programs to assist AIG, i.e. the Securities Borrowing Facility, ML II, and ML III, were also authorized under Section 13(3).²⁸ ([Alvarez. 05/26/2010](#)). The loans were collateralized by investment grade securities and carried an interest rate; a straightforward method of lending used frequently by the Fed. (BD Gov Minute 10/06/2008, PDF 43 - 44)](See Engbith and Jeffreis 2019A for more discussion of this program.)

There was some controversy regarding ML II and ML III given that the Fed's authority is legally limited to making secured loans. For ML II and ML III, the FRBNY made loans to newly created special purpose vehicles (SPVs) that were used to purchase assets, which then became the security for the loans ([Maiden Lane Transactions](#)). These assets were in the case of ML II, RMBS purchased from AIG subsidiaries, and in the case of ML III, CDOs purchased from counterparties that had purchased CDSs from AIG to protect the CDOs ([Maiden Lane Transactions](#)). There has been much criticism surrounding both the legality and fiscal soundness of ML II and ML III, with ML III being viewed as the more contentious of the two. See "The Rescue of American International Group, Modules D and E: Maiden Lane II and III" for a discussion.

The structure of ML II closely mirrored that of Maiden Lane (ML), the SPV that the FRBNY created to purchase assets from Bear Stearns to facilitate Bear's merger with JPMorgan in March 2008.²⁹ However, because of its "complicated structure," the Congressional Oversight Panel adjudged the creation of the ML II facility to be a "less straightforward fit with the Federal Reserve's authority under Section 13(3)" ([COP 2010 - pp. 228](#)).

In contrast, the FRBNY argued that the SPV was merely a valid use of its incidental authority and a vehicle for managing the RMBS:

²⁸ See Board of Governors meeting minutes for October 6, 2008 approving the Securities Borrowing Facility and recording a notation vote on November 7, 2008 authorizing the restructuring, with Treasury, of the government's financial support to AIG, which restructuring included the creation of ML II and ML III. ([BD Gov Minute 10/06/2008, PDF 43 - 44](#)).

²⁹ In that transaction the FRBNY loaned \$28.8 billion to ML, which it used along with approximately \$1.2 billion from JPMorgan to acquire a portfolio of "mortgage-related securities, residential and commercial mortgage whole loans and associated hedges (derivatives)" valued at \$30 billion from Bear Stearns ([Maiden Lane I Transactions](#)).

Thus, placing the assets into the SPV was “incidental” to purchasing those assets at a discount. Technically, an SPV is a “person,” even if wholly owned by the bank that created it (in this case, FRBNY); thus, it could be the recipient of a loan under Section 13(3). In substance, however, FRBNY was lending money to itself under Section 13(3) and then using the funds to purchase RMBS. The Federal Reserve Board staff further explained that you can “look through” the SPV to see that FRBNY was discounting the RMBS assets. Each RMBS was itself a promissory note or debt obligation so FRBNY was essentially purchasing a note or debt obligation at a discount (a practice that fits more neatly under its 13(3)-lending authority). ([COP 2010 - pp. 228 - 229](#))

Ultimately, the Panel concluded that the ML II could meet the provisions of Section 13(3).³⁰

The Panel also found ML III to also be “complicated” and not a natural fit under the Fed’s Section 13(3) authority:

The 13(3) analysis of the ML3 facility is more complicated because in ML3, FRBNY purchased the debt obligations from the counterparties to AIG’s CDS contracts, rather than from AIG or its subsidiaries. Even though the termination of the CDS contracts and the purchase of the CDOs from the CDS counterparties benefited AIG (an institution that could not obtain credit from alternative banking institutions), ML3 did not involve a loan to AIG or a purchase of notes or debt obligations owned by AIG. ML3 involved a loan to an SPV wholly owned by the FRBNY or a purchase of notes or debt obligations from CDS counterparties of AIG (institutions that likely could obtain adequate credit from other banking institutions). ([COP 2010 - pp. 268 - 269](#)).

In addition to the “disconnect”—that the assets were not purchased from AIG, or a related entity—the other major, and seemingly greater, controversy involving ML III is that the CDS counterparties were allowed to retain the collateral that they had previously been paid, which when paid amounts by ML III, resulted in them receiving par value, although the underlying CDOs were at the time worth less than par. (See Engbith and Jeffreis 2019B for more discussion of this program.) (Also see COP p89-94 and SIGTARP p29 for critical commentary regarding this issue.)

The controversy was intensified by the initial decision of AIG and the FRBNY to not disclose information about the payments or the names of the recipients due to the risk of negative consequences in the tumultuous market environment of November 2008. ([SIGTARP 11/17/2009 - pp. 21](#)). The counterparties include some of the largest U.S. financial institutions, resulting in claims of a “backdoor bailout,” despite the FRBNY’s contention that

³⁰ “Even so, however, one can see the structure in one of three ways: as a third party agreement to benefit AIG (a purchase of a discounted note “for” AIG, which is all the statute requires), a restructuring of the original loan made by the Federal Reserve using its incidental powers to buttress section 13(3), or a purchase by an SPV that could not otherwise obtain credit (an admittedly weak characterization).” ([COP 2010 - pp. 228 - 229](#))

the financial condition of the counterparties was not a consideration in deciding to form ML III and pay counterparties effectively at par. ([SIGTARP 11/17/2009 - pp. 29](#)). On March 15, 2009, ten days after declining to provide such information at a Senate Banking, Housing and Urban Affairs Committee hearing³¹, the FRBNY and AIG disclosed the names of the counterparties and much information regarding the ML III payments. ([SIGTARP 11/17/2009 - pp. 15](#)). There seems to have not been any negative consequences from this disclosure on financial markets. However, it should be noted that it was made four months after the first ML III payments were made during the height of the financial crisis. ([SIGTARP 11/17/2009 - pp. 21](#)). Therefore, it cannot be said with certainty that there would have been no negative fallout had such disclosures been made contemporaneously with the payments.

Treasury TARP Assistance

Prior to the passage of TARP on October 3, 2008, the Treasury had no authority to invest in the securities of AIG or to own its shares ([U.S. Court of Federal Claims, June 2015 - pp. 29](#)). This is why, as discussed above at p. 11, the Trust Stock received in connection with the RCF was issued to the newly formed AIG Trust, which held it for the benefit of the U.S. Treasury and taxpayer ([Credit Agreement - Exhibit D](#)). TARP authorized the Secretary of the Treasury to purchase or insure up to \$700 billion of “troubled assets,” defined as “(A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and (B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress ([P.L. 110-343 - p. 3767](#)).

The Treasury would in total invest approximately \$70 billion into AIG to stabilize it. These funds were used to make capital injections (\$40 billion in November 2008 and \$30 billion in March 2009) which provided funds to pay down the RCF and restructure AIG’s balance sheet in order to reduce its leverage ratios and stabilize it ([GAO 11-616 - pp. 10 - 11](#)). These investments were made under TARP and were in the form of the purchase of various series of preferred stock.

Treasury also eventually held and managed the AIG common stock resulting from conversion of the Trust Stock (that had been issued in connection with the RCF) after the payoff and termination of the RCF. Collectively the shares owned and managed by Treasury equaled approximately 92% of AIG’s equity ([Recapitalization Agreement, 09/30/2010 - pp.](#)

³¹ Fed Vice Chairman Donald Kohn appeared at the hearing and “expressed his judgement that giving the names would undermine the stability of the company and could have serious knock-on effects to the rest of the financial markets and the government’s efforts to stabilize them.” ([SIGTARP 11/17/2009 - pp. 21](#))

2). Although the ownership was contentious, Treasury was permitted to own such shares under TARP ([P.L. 110-343 – p. 3778](#)).

4. What tools did the government have available?

As AIG was a nonbank the Fed had limited tools with which to assist it. It could lend to AIG only under its emergency ending authority of section 13(3). Neither it, nor any government agency, had power to make asset purchases from, capital injections to, or to guarantee the obligations of AIG or any nonbank.³² ([Geithner 2019 - pp. 6](#)). The Treasury would only acquire such authorities with the passage of the EESA in October. ([COP 2010 - pp. 79](#)). There was no governmental authority to address the impact of an AIG bankruptcy “on its insurance subsidiaries, the cross-border implications for the foreign subsidiaries, *and* the potential systemic consequences for the financial system as a whole.” ([COP 2010 - pp. 79](#)). There also was no framework for managing the resolution of the failing company other than bankruptcy, an option that was considered³³ and rejected (although there is some debate as to how sufficiently it was considered). ([COP 2010 - pp. 79](#)).

Bankruptcy was considered and rejected. The bankruptcy process provides a framework for protecting assets, valuing them and equitably distributing them among all creditors. Because of its automatic stay, it avoids a grab for assets (similar to a run) that can lead to inequities ([COP 2010 – pp. 259](#)). Under the process, AIG could have bought time to sell assets and restructure itself without being cannibalized by creditors ([COP 2010 – pp. 259](#)).

For a vast insurance and financial company like AIG, however, a bankruptcy filing was not without risks. The bankruptcy process is not totally comprehensive. It exempts domestic and foreign insurance companies from its process. Other subsidiaries without a sufficient US nexus would also have been exempted ([COP 2010 – pp. 260](#)). While this might not have posed an issue for a smaller company with more contained operations, it was a problem for AIG with hundreds of subsidiaries around the globe. A bankruptcy could have resulted in a messy process that did not fully resolve AIG’s issues. ([COP 2010 – pp. 76 - 79](#)). Also, the company would have required debtor-in-possession funding and with the funding markets in the state of disruption, the Fed might have been the only lender willing and able to provide a loan of the needed size ([COP 2010 – pp. 78](#)).

³² “The Federal Reserve could only purchase Treasuries and agency securities. Unlike many other major central banks, the central bank of the United States had only limited authority to buy municipal government securities, and could not buy corporate bonds, commercial paper, non-agency ABS, or equities, which limited its ability in a crisis to address a breakdown in those important funding markets.” ([Geithner 2019, 6](#)).

³³ See Congressional Oversight Panel report citing an internal FRBNY email of September 15, 2008-- “[t]hrough Legal, we want to understand how the bankruptcy process will play out.” (p.129, fn 495) Also note-- “Through internal discussions and a dialogue with AIG and its state insurance regulators, the Board and FRBNY ultimately chose to provide AIG with assistance after identifying the systemic risks associated with the company and contemplating the consequences of an AIG bankruptcy or partial rescue.” (p. 129)

Bankruptcy would have been an event of default under AIG's many derivatives contracts and would have terminated the collateral calls by, and termination payments to, the counterparties under those contracts. (COP 2010 - pp. 76 - 77). However, because of a special exception, bankruptcy's automatic stay would not have applied to derivatives contracts, therefore, AIG's derivative counterparties would have been able to "close out their agreements, seize collateral that had been posted prior to the bankruptcy filing, mitigate their losses, and offset or net out other obligations." (COP 2010 - pp. 77). This could have led to a destruction in value as counterparties are not required to maximize value of collateral when selling it to cover their position. (See [McNamara and Metrick 2019](#) for a discussion of ISDA requirements.) These circumstances had the likelihood of resulting in a smaller pool of assets to be distributed among AIG's unsecured creditors through the bankruptcy process, which meant that they would have been subject to substantial discounts and would incur significant losses. (COP 2010 - pp. 117 - 119).

Lastly, the government was also concerned about the indirect impact that an AIG bankruptcy might have on the fragile financial system (COP 2010 - pp. 78 - 79). Just a day earlier, Lehman had filed for bankruptcy and the markets had reacted severely. The LIBOR-OIS (a measure of illiquidity in financial markets) "spiked significantly, providing one measure of the extent of the impact of Lehman's filing on the markets." (COP 2010 - pp. 78). And this was in the context that investors had been aware of the firm's difficulties for months and had had time to anticipate its failure. ([Bernanke, 09/23/08](#)).

AIG's bankruptcy would have been a bigger surprise than Lehman's, and such surprises are not well-received by markets and investors. (COP 2010 - pp. 69). FRBNY staffers also considered that AIG's bankruptcy might be even more systemic than Lehman's in part because of its retail businesses. (COP 2010 - pp. 69). And it was a much larger company with a more complicated structure, more subsidiaries, more counterparties across the globe and insurance companies that reached many individuals and small businesses as well as other larger companies.³⁴ (COP 2010 - pp. 78 - 79). Given these circumstances, which led it to its "binary choice", the Fed invoked Section 13(3) to arrange a revolving credit facility for AIG (COP 2010 - pp. 81).³⁵

Nevertheless, the Congressional Oversight Panel, while recognizing the extremely urgent and volatile circumstances in which the government was making these decisions, criticized it for deciding that the RCF (which provided full recovery to AIG's creditors) was the most appropriate solution. In its report, the Panel argues that there were other options available

³⁴ FRBNY internal memoranda show that the staff were concerned with AIG's brand name and broad reach and possible contagion beyond its counterparties. For example—AIG's bankruptcy, would likely be considered a default under Guaranteed Investment Contracts held by pension funds. AIG's guarantees on those contracts would need to be replaced, with no assurance that such replacements would be available, or would be available on the same terms without losses. (Baxter and Dahlgren 2010). See also Footnote 14 above.

³⁵ One FRBNY memo proposed the Fed purchase a \$38 billion portfolio of pension carve-out assets and allow the parent to fail. However, this option required an act of Congress and we have revealed no evidence that it was pursued. (COP 2010 - pp. 69)

that perhaps the government did not adequately consider such as: (i) provide a short-term bridge loan to allow AIG time to prepare a prepackaged bankruptcy or otherwise restructuring, (ii) impose terms on its lending to require concessions from AIG's creditors who were insolvent, (iii) provide a guarantee for a private loan to AIG. ([COP 2010 - pp. 82 - 84, 139 - 152](#)).

The FRBNY officials largely responded that given the tight timeframes involved, and the state of the markets, they did not have adequate time to consider or fully develop these options. ([COP 2010, 128 - 129](#)). AIG was not one of the "top 10 exposures" for the institutions that the FRBNY supervised, and it became fully aware of the extent of AIG's problems only on September 12, 2008.³⁶ ([COP 2010, 128, Fn 493](#)). It also did not lend to the company or have a relationship such as it has with a primary dealer.

In their written testimony before the panel, FRBNY General Counsel Baxter and Executive Vice president Sarah Dahlgren stated this:

We also did not have the luxury of time. AIG needed liquidity and it needed it that day. In the early days of the intervention, when we knew precious little about AIG, but knew that it needed billions of dollars, we were truly facing a binary choice to either let AIG file for bankruptcy or to provide it with liquidity. ([Baxter and Dahlgren 2010 - pp. 3](#)).

5. What additional tools did the government seek to acquire?

In September 2008, the government had limited tools with which to address the possible failure of AIG. The Fed could lend to it under Section 13(3), but there was no ability to make capital investments, to purchase assets, nor was there an alternative resolution scheme to minimize the impact of an AIG failure ([U.S. Court of Federal Claims - pp. 29](#)). These tools could have been useful. The bankruptcy code was available as an option, but, as discussed above, there were many reasons why the government did not want to utilize this option.

Early on, Chairman Bernanke and President Geithner considered that rescuing AIG might require more than the Fed's lending and also that the situation, was by its nature, on the periphery of the central bank's responsibility.³⁷ Even as the Fed was entering into the RCF, there was uncertainty about whether AIG had solvency issues in addition to its liquidity

³⁶ CEO Willumstad did speak with President Geithner on September 9th about becoming a primary dealer so that AIG might gain access to the discount window, but he did not state that "AIG was facing serious issues" and "he made no progress." ([COP 2010, 128, Fn 494](#)).

³⁷ See Geithner's comments on AIG - "Lending to an insurer still felt like a serious Rubicon to cross, but we had crossed plenty of Rubicons...the troublesome parts of AIG behaved more like an investment bank than an insurer, and we were already lending to investment banks." CEO Willumstad first approached Tim Geithner, President of the FRBNY to request access to the discount window on July 29, but Geithner thought that to do so would create a run on AIG. ([COP 2010 - pp. 58](#)).

issues.³⁸ ([GAO 11-616 – pp. 45](#)). The Fed had no ability to address such issues, however, when companies begin to experience financial strains, the two types of issues often coexist. ([Geithner 2019 – pp. 15](#)).

In entering into the RCF, Bernanke consulted with Secretary Paulson and specifically asked for a letter of support of the Fed’s action to lend. The effort was announced as “with full support of Secretary Paulson.” ([Bd GOV PR 9/16/2019](#)). Concurrent with the Fed’s announcement of the RCF, Secretary Paulson had been considering pursuing with Congress additional authority that would provide a broader range of tools to address the continuing crisis. These efforts resulted in the Troubled Asset Relief Program (TARP) (established under the EESA), which Congress passed on October 3, 2008, providing \$700 billion to address the financial crisis by buying the assets and securities of troubled financial companies so as to prevent collapse of the financial system ([P.L. 110-343 – pp. 3767, 3780](#)). By this day, AIG had drawn down \$63 billion under the RCF and it was clear that additional assistance would be needed ([RCF Transaction Data](#)). Among other things, the significant amount of the RCF borrowings and the high interest rate were having a negative impact on AIG’s balance sheet and more than one credit agency had indicated concern ([SIGTARP November 2009 – pp. 12 – 13](#)). These developments led the government to determine, that at a minimum, it needed a way to invest capital in AIG and to reduce its RCF borrowing. The opportunity to do this was provided by the TARP and shortly after its passage Chairman Bernanke approached Secretary Paulson about doing so. The Treasury would eventually invest an additional \$70 billion in AIG through a series of capital injections.

6. What was the government’s initial strategy?

Despite the limited tools available to the government, when it became clear that the private sector lending option would not be viable, the FRBNY decided to provide liquidity to AIG rather than have it file bankruptcy ([COP 2010 – pp. 69](#)). Despite its limited knowledge of AIG’s business at the outset, the FRBNY was able to be comfortable that AIG, despite its liquidity problem, had value in its regulated insurance subsidiaries that could adequately secure a loan ([Geithner 2014 – pp. 193](#)).

The Board of Governors authorized FRBNY to extend a revolving credit facility of \$85 billion to AIG, collateralized by most of the assets of the parent company and its subsidiaries, which included the equity of most of its insurance subsidiaries. ([Bd GOV PR 09/16/2008](#)) The purpose of the loan as stated in the Board of Governors press release was “to assist AIG in meeting its obligations as they come due. This loan will facilitate a

³⁸ The FCIC concluded that –“On September 12, FRBNY President Geithner and Treasury Secretary Henry (or Hank) Paulson learned that AIG would be insolvent within a week if it could not raise additional capital.” ([2B2F, p.26](#)). ([COP 2010, 128, Fn 493](#)).

process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy.” ([Bd GOV PR 09/16/2008](#)). On this point, Willumstad had discussed a plan for the firm to sell approximately \$40 billion in assets over a 6-12-month period, and the RCF was to be repaid with proceeds from these sales. ([COP 2010 - pp. 62](#)). The RCF loan was for a two-year period, which at the time was thought to be a sufficient period for completion of the plan ([Bd GOV PR 09/16/2008](#)).

7. How did the government implement its initial strategy?

The decision to provide liquidity to AIG led to the announcement of the RCF on September 16, 2008. ([Bd GOV PR 09/16/2008](#)) However, as is usual, it would take several days to draft and sign the related agreements. But AIG’s needs were immediate; it needed funds that day to meet collateral calls and for general corporate purposes. ([FRB Section 129, 09/16/2008 - pp. 3 - 4](#)). Therefore, following the Board vote, the FRBNY advanced AIG \$14 billion that same day on a demand promissory note. Prior to the signing of the RCF on September 22, the FRBNY would make four advances to AIG for a total of \$37 billion. These loans carried an interest rate of 14 percent, were secured by “Equity Interests in certain Subsidiaries and certain additional assets,” ([Guarantee and Pledge Agreement - pp. 1](#)), and had an initial 2% commitment fee, or \$1.7 billion, of the aggregate \$85 billion credit line. ([FRB Section 129, 09/16/2008 - pp. 4](#))

On September 22, 2008, the FRBNY and AIG signed the formal documents entering into the RCF ([Credit Agreement - Pdf pp. 1](#)). As part of that transaction the agreements rolled the demand notes and their fees into the RCF, deeming that a loan equal to the aggregate amount of the demand notes (\$37 billion) had been made under the RCF. As a result, the four demand notes were cancelled ([FRB Section 129, 09/16/2008 - pp. 4](#)).

8. How did the government decide on the specific terms of its initial interventions?

The RCF had a maximum commitment of \$85 billion and a term of two years, an amount and period that the FRBNY thought would be sufficient for AIG to complete its plan of restructuring by selling assets; it would use the proceeds from such sales to repay the FRBNY ([Bd GOV PR 09/16/2008, GAO 11-616 - pp. 44](#)). Given the severe time constraints that existed and the timing and criticality of the situation that AIG faced, in designing the RCF the FRBNY used as its beginning framework the term sheet that had been prepared by the private consortium. ([COP 2010 - pp. 71](#), Dahlgren Interview, Baxter emails). This gave the FRBNY a starting point that was responsive to AIG’s needs and which was reflective of a commercial deal.

On September 16, 2008, a modification of this private term sheet was presented to the Board of Governors for approval (the FRBNY term sheet), as shown in Figure 8. (U.S. Court

of Federal Claims 2015 – pp. 26). Major changes from the private term sheet to the FRBNY term sheet included:

- Commitment increased by \$10 billion
- Interest rate increased by 2%
- Term increased by 6 months
- Duration fees eliminated
- Addition of an 8.5% undrawn fee, and
- Commitment fee lowered by 2%. (Private Term Sheet-Exhibit JX-65, 3-4)

With respect to the altered terms, FRBNY officials have stated that the \$75 billion commitment amount of the private sector term sheet was increased by \$10 billion, to \$85 billion, in light of AIG’s still uncertain liquidity needs to provide some cushion and to avoid AIG having to come back for additional funding. (COP 2010 - pp. 71). (Dahlgren Interview) (Millstein 2018, p.4). The increase in interest rate was intended to compensate the FRBNY for perceived additional risk in the wake of Lehman’s failure and as the lone lender.³⁹ (COP 2010 - pp. 125-26). No individual explanations were given for the changes in the other terms, but the FRBNY indicated a general intent for the terms of the RCF to be onerous so as to motivate AIG to seek private funding as soon as possible. (COP 2010 - pp. 126) (Millstein Interview 2019)(Bernanke, 09/23/08).

Figure 8
Comparison of the Terms of the Private Sector Term Sheet
and the FRBNY’s RCF over time

³⁹ “The [FRBNY] 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 amount fee.” (COP 2010 - pp. 125-26). See also the GAO Report— “The FRBNY had wanted a high rate to mimic commercial terms and create an incentive for AIG to seek private funding as soon as possible.” (GAO 11-616 – p. 126). (Bernanke, 09/23/08).

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 ^a	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% ^b	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%

^a Rate on private plan stated generally as LIBOR; FRBNY loan specified 3-month LIBOR.
^b AIG received \$500,000 credit on FRBNY commitment fee, related to payment for preferred shares.
Note: N/a=not applicable
Sources: [GAO 11-616 – p. 125](#)

Eventually the high interest rate on the RCF would become problematic and of concern to the rating agencies ([SIGTARP November 2009 – pp. 12 - 13](#)). Another important detail was that the RCF placed the government in the senior secured position ahead of AIG's other senior unsecured creditors.

Both the Private Term Sheet and the initial FRBNY Term Sheet presented to the Board provided that the loan would include an equity interest and, following the September 16 announcement, the public would have understood it to be warrants, ([U.S. Court of Federal Claims 2015 – pp. 23](#)). However, an additional significant change that occurred after the Board's approval and prior to signing was the change in the equity interest from warrants to senior preferred stock with voting rights equal to 79.9% of AIG's common stock. It appears that change was made to provide the government with control over AIG immediately upon signing the RCF ([U.S. Court of Federal Claims 2015 – pp. 25](#)). Warrants would have required payment of an exercise price, which was calculated to be \$30 billion (12 billion shares at the par of \$2.50) ([U.S. Court of Federal Claims 2015 – pp. 25](#)). The preferred stock carried voting rights upon issuance which, along with several other aspects of the final RCF, gave the government immediate control of the company, effectively nationalizing the company. (See discussion below at pages---Nationalization of AIG).

The equity interest posed a legal problem in that the Federal Reserve was not authorized to acquire and hold equity shares in a commercial company. There was also no authority for the Treasury to hold such shares ([U.S. Court of Federal Claims 2015 – pp. 29](#)). It appears that Fed attorneys and officials recognized this but worked to maintain the interest to more fully compensate the FRBNY for the risk involved in the RCF and for the benefit of the Treasury and the taxpayers. In the best of outcomes, AIG would repay the RCF with interest and fees, and recover in which case its stock price would increase providing a gain to the government when it sold its shares; in essence, the taxpayers are sharing in the fruits of a recovery that they funded. ([U.S. Court of Federal Claims 2015 - pp. 60](#)). But first, there was the question of how to structure the ownership of the shares. Consultations between

Baxter, the general counsel at the FRBNY, Alvarez, general counsel at the Board, and outside attorneys resulted in the idea to form a trust, managed by three “independent” trustees to hold the shares for the benefit of the Treasury and the taxpayer ([U.S. Court of Federal Claims 2015 - pp. 29 - 30](#)).

The trust was formed by the FRBNY, which appointed three trustees well-known to it ([U.S. Court of Federal Claims 2015 – pp. 30](#)).⁴⁰ The Trustees were to exercise their rights under the Trust Shares in the interest of supporting repayment of the RCF. The Trustees were also to nominate Board members, which they did. Given the authorities that the Trust had, and how it operated, the court in the Starr case would find that the Trust was effectively not independent but under the control of the Fed. ([U.S. Court of Federal Claims 2015 – pp. 30, x - 63](#)).

AIG’s former majority shareholder would bring a lawsuit challenging the government’s right to gain control of AIG. The court was critical of the government for a number of reasons, pointing out that its mandate as central bank was not to act like a commercial lending party and that its rates were punitive and harsher than those for loans that it made to other entities. The court also found that, despite the government’s equity interest amounting to an illegal exaction, ultimately, the plaintiff shareholder suffered no economic loss and was not entitled to any damages. ([U.S. Court of Federal Claims 2015 – pp. 65 - 67](#)). Further, the appellate court found that the plaintiff did not even have grounds to bring the suit--“Starr has not established any ground for direct standing under either federal or Delaware law. The alleged injuries to Starr are merely incidental to injuries to AIG, and any remedy would go to AIG, not Starr.” [U.S. Court of Federal Claims 2015 – pp. 35](#)).

Given the court ruling, in the future, the government might do well to consider the court’s comments and the potential negative fallout from taking control of or nationalizing a commercial company as it did with AIG.

9. Did the government’s strategy change over time?

Implementation of the RCF provided AIG with the liquidity it needed to meet its pressing needs. However, by October 1, 2008, total debt outstanding under the RCF had reached \$61.2 billion. ([RCF Transaction Data](#)). The unexpectedly fast rate of usage signaled that there were problematic sources of cash drain that needed to be addressed and created the risk that the \$85 billion might not be sufficient to see AIG to stability. ([COP 2010 – pp. 85 – 86](#)). Further, the size and terms of the RCF would almost immediately become problematic for AIG, engendering scrutiny rather than relief from rating agencies ([SIGTARP November 2009 – pp. 12 – 13](#)). The size of the loan had raised AIG’s leverage ratio beyond what the

⁴⁰ The Trustees were Jill M. Considine, former Chair of the Depository Trust & Clearing Corporation, Chester B. Feldberg, former chairman of Barclays Americas, and Douglas L. Foshee, Chair of the Board of Directors of the Federal Reserve Bank of Dallas, Houston Branch, and Central Houston, Inc.

rating agencies expected of an investment grade company ([SIGTARP November 2009 – pp. 12 – 13](#)). Also, there was concern over the company’s ability to pay the significant carrying fees and interest rate. ([GAO 11-616 – pp. 123 - 128](#), FCIC, Millstein interview)

The company was expected to report losses on November 5; the major causes of losses were the securities lending program and AIGFP’s CDSs. Rating agencies signaled that a downgrade would be forthcoming unless there was some compensating action announced at the same time. ([COP 2010 - pp. 87](#))

Given these developments, the first change in the government’s strategy was to recognize that more assistance beyond the RCF was going to be needed to address the major sources of AIG’s liquidity drains - the SL Program and the CDS collateral calls, the troubled assets that were weighing on its balance sheet, and the concerns about the terms of the RCF. These concerns led to the first restructuring in November 2008, which was designed to restructure AIG’s balance sheet in a way that addressed the rating agencies’ concerns and avoid a downgrade ([COP 2010 – pp. 86 – 87](#)).

10. How did the government implement its amended strategy?

In October the SBF was implemented, under which the FRBNY could borrow up to \$37.8 billion of high-quality securities from AIG in exchange for cash; AIG could use that cash to repay securities borrowers in its SL Program who did not intend to renew their contracts ([Report...Securities Borrowing Facility for AIG 2008 – pp. 1](#)). Although it did not address the devaluation of the RMBS portfolio, this move eliminated AIG’s need to borrow under the RCF for this purpose ([Report...Securities Borrowing Facility for AIG 2008 – pp. 2 - 3](#)).

In November 2008 the government announced the First Restructuring, which included a restructuring of the terms of the RCF by the FRBNY and TARP equity investments by the Treasury. The RCF was amended in important respects. The term was extended from two to five years to provide AIG with more flexibility in implementing its restructuring plan. ([FRB Section 129, 11/10/2008 – pp. 6 - 7](#)). The interest rate, which had been specifically called out as problematic by one rating agency (S&P), was reduced by 5.5% ([FRB Section 129, 11/10/2008 – pp. 6 - 7](#)). The FRBNY had wanted a high rate to mimic commercial terms and create an incentive for AIG to seek private funding as soon as possible ([GAO 11-616 – pp. 126, Bernanke, 09/23/08](#)). However, the Congressional Oversight Panel pointed out that while this may have been a commercial rate, the Fed had in many other circumstances forgone commercial terms and that the primary credit rate at the discount window was just 2.25 percent.⁴¹

With intent to further strengthen AIG’s balance sheet, Treasury invested \$40 billion in preferred stock. Some of this funding was used to pay down debt outstanding under the

⁴¹ By comparison, the bridge loan to Bear Stearns was at 3.5%, and PDCF rates ranged from 0.5% to 3.25%. ([Bridge Loan Transaction Data](#), [PDCF Transaction Data](#)). However, it was later criticized by AIG shareholders and formed part of a lawsuit against the government. (Starr International)

RCF so as to lower AIG's leverage from a level which "was not consistent with investment grade companies." ([FRB Section 129, 11/10/2008 – pp. 6](#), Morgan Stanley Pres. 10/23/2008, III).

Officials from FRBNY and Treasury continued to regularly meet with AIG to design additional measures that would stabilize the company. As described above, these additional measures were implemented through the First Restructuring that was announced in November 2008 and the Second Restructuring and Recapitalization announced in March 2009 and included: additional equity investments by Treasury, accelerated paydowns of the RCF, the establishment of two SPVs funded by the FRBNY to purchase the SecLending Facility RBMS portfolio (Maiden Lane II) and the CDOs underlying the CDS portfolio (Maiden Lane III), the exchange of equity shares, and the sale of selected subsidiaries. **The government's investment to rescue AIG totaled \$182.3 billion, with the last step taking place in January of 2011 when Treasury received approximately 1.65 billion shares of common stock from the exchange of its equity holdings, as well as those of the Trust.**⁴²

11. How did the government determine the specifics of its amended interventions?

In considering the additional assistance to AIG, the government was concerned with maintaining the company until it could implement its plan to sell assets. Its actions sought to end the liquidity drains, and to address the rating agencies' concerns so as to avoid further downgrades, which would jeopardize the sales strategy and risk the government's assistance (GAO 11-616 – pp. 53).

Key terms of the RCF were amended in November 2008 to bring it into line with terms more expected of an investment grade company; the interest rate was cut more than half, the commitment fee dropped, and its term extended to five years ([GAO 11-616 – pp. 125](#)). The interest rate and fee cuts greatly reduced the cost of AIG's loan and the term extension provided it enhanced flexibility to pursue its announced sales strategy ([GAO 11-616 – pp. 129](#)).

The FRBNY-funded SB Facility provided that the government could borrow up to \$37.8 billion providing high -quality securities as collateral ([Report...Securities Borrowing Facility for AIG 2008 – pp. 1 - 2](#)). If AIG did not return the cash when due, the Fed had the right to keep the securities, which exceeded the value of the funds loaned. Moreover, the maximum authorized amount of \$37.8 billion would have enabled the FRBNY to replace all of AIG's SL Facility counterparties, however, only \$20.5 billion was used. ([AIG Securities Borrowing Facility data 2010](#)) With the implementation of Maiden Lane II, which purchased the RMBS portfolio associated with the SL Facility, the remaining outstanding securities borrowing contracts were terminated and paid off and the program ended ([US COP 2010 – pp. 87](#)).

⁴² See Introduction at page X and accompanying footnote 3.

As part of the First Restructuring announced in November 2008, ML II was formed to relieve the downward pressure on AIG's balance sheet from the lowered valuations of the RMBS portfolio connected with the SecLending Program. ML II purchased the RMBS portfolio using a loan from the FRBNY ([US COP 2010 – pp. 87](#)). AIG then used the cash received from ML II to repay the remaining SL Facility counterparties as their contracts expired ([Report...Securities Borrowing Facility for AIG 2008 – pp. 3](#)). The SL Facility was terminated along with the FRBNY SEC Borrowing facility which was then no longer needed ([FRB Section 129, 11/10/2008 – pp. 7 - 8](#)).

Another source of AIG's rapid use of the RCF was to meet the collateral calls from counterparties of CDS as their insured CDOs were devalued ([COP 2010 – pp. 89 – 90](#)). ML III was conceived to remove this source of liquidity drain (GAO 11-616 – pp. 78). Using a loan from the FRBNY, ML III would purchase from counterparties the underlying CDOs so that AIG could then cancel the related CDSs eliminating future collateral calls ([COP 2010 – pp. 171 – 172](#)). ML III was funded with a \$24.3 billion senior loan from the FRBNY and a \$5 billion equity contribution from AIG ([GAO 11-616 – pp. 64](#)). AIG was to absorb the first \$5 billion in losses ([GAO 11-616 – pp. 64 - 65](#)). ML III would hold the CDOs until maturity or until the FRBNY decided to sell them ([GAO 11-616 – pp. 9](#)).

Why Did the Fed undertake ML II and ML III rather than the Treasury?

ML II and ML III were announced on November 2008 as part of the first restructuring of the government's AIG assistance ([Bd GOV PR 11/10/2008](#)). [The TARP had been passed on October 3, providing authority for the Secretary of the Treasury to purchase assets and securities from financial companies \(P.L. 110-343 – pp. 3767\)](#). Therefore, it is useful to ask [why were ML II and ML III undertaken by the FRBNY instead of the Treasury?](#) Review of the various records, testimony and government reports reveal a few items that shed light on this decision.

First, the Fed was more connected to AIG than the Treasury. During the early stages of considering whether to assist AIG the Fed consulted with Secretary Paulson; there was no doubt that the Treasury and administration might feel blowback from any action taken to assist the behemoth. However, the Fed was the first governmental entity to actually provide assistance to AIG, because it was the only one that could. As soon as the RCF was agreed upon, FRBNY staff were assigned to AIG offices to gather information and to monitor its operations ([GAO 11-616 – pp. 31 – 32](#)).⁴³ After the close, the FRBNY effectively was in control of the company. Geithner charged senior FRBNY officer Sarah Dahlgren with overseeing AIG ([U.S. Court of Federal Claims 2015 – pp. 74](#)). To do this, she formed a group of 25 employees supported by hundreds of outside experts in law, finance, accounting and

⁴³ Such was a customary action with the FRBNY when it was a potential lender. It had acted similarly with respect to the four independent investment banks after it implemented the Primary Dealer Credit Facility. (FCIC). However, in the case of AIG, the FRBNY was more than potential lender. Even before the RCF closed on September 22, the Fed had lent AIG tens of billions of dollars.

tax. ([COP 2010 – pp. 180](#)). Although Treasury, and to some extent the New York State Insurance Department, had a role in the rescue, the FRBNY was on the scene day in and day out and was the main governmental actor, at least in the beginning ([U.S. Court of Federal Claims 2015 – pp. 27 – 28](#)). This was the team that joined AIG in the rating agency meetings and worked with it to design additional assistance that might forestall downgrades. (COP 2010, Dahlgren YPFS Interview).

A second reason that the FRBNY might had taken the role of establishing MLII and ML II was that in large part they were solutions modelled closely after the Maiden Lane transaction that the Fed had undertaken just a few months earlier in connection with JPMorgan’s purchase of Bear Stearns. ([Alvarez, Baxter, Hoyt 2018 – pp. 10](#)). That being said, while it may not have been particularly difficult to have the Treasury create the two SPVs, given its broad authority under TARP, the basic groundwork and legal questions regarding the transaction’s structure had already been answered.

Lastly, Treasury received authorization of up to \$700 billion under TARP, however, only roughly half, \$350 billion, was released at first. ([P.L. 110-343 – pp. 3780](#)) Treasury would have to return to the Congress and request release of the second half. ([P.L. 110-343 – pp. 3780](#)) While the amount authorized was extraordinary and unprecedented, there is also information in the record that Treasury was not sure that it would be enough to stabilize the financial system and prevent its collapse (Paulson 2010 – pp. 333 – 334). The ML II (\$19.5 billion) and ML III (\$24.3 billion) proposals would have required an aggregate of \$43.8 billion, more than 10% of the released TARP funding, right away and for one company.

Lastly, having the Fed undertake the creation of the SPVs, created a division of roles that saw the Fed initially act to provide liquidity, followed by the Treasury’s to acting when only it could to make much needed capital injections into AIG ([Alvarez, Baxter, Hoyt 2018 – pp. 14](#)). This division of labor not only reinforces the proposition that cooperation between the monetary and fiscal authorities is key to fighting a crisis, but also that the tools required vary.⁴⁴

Treasury Equity Investments

⁴⁴ As described by Secretary Geithner--“[The Fed’s liquidity efforts] could mitigate a loss of funding, but they could not make up for a lack of adequate capital, and they did not have the force of a guarantee. They could help keep a viable firm liquid and functioning, but they had limited power in sustaining the weakest parts of the financial system. Ultimately it took a much broader mix of guarantees and capital injections—together with a powerful set of monetary policy action and fiscal stimulus—to prevent the collapse of the financial system.” (Geithner 2019, p. 13)
<https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=1011&context=journal-of-financial-crises>

The amount of the Treasury's equity investments was determined in consideration of the associated restructuring packages, which took into consideration comments from meetings with at least two rating agencies, Fitch and Best. (MS Pres. 10/23/2008). In all, there is a limited record regarding why the particular mix of adjustments in the decided amounts was undertaken. In interviews Fed and Treasury officials also indicated that there was no specific formula; however, some bits of background and motivations are revealed. Government officials worked diligently with AIG executives and Morgan Stanley (that had been hired by the FRBNY) to decipher the right mix of features. Morgan Stanley presented a number of options to address the identified problems. (MS Pres. 10/23/2008).

As for the first Treasury equity injection in November 2008, the underlying intent was to be responsive to the concerns of the rating agencies ([GAO 11-616 – pp. 8](#)). The RCF had greatly impacted AIG's debt to equity ratio beyond what was normally expected of an investment trade company ([SIGTARP 11/17/2009 – pp. 12 – 13](#)) ((Millstein 2018, p.3). So, Treasury's first TARP investment was intended to alter this mix. The investment of \$40 billion was made by Treasury and \$35 billion of that was used to pay down amounts outstanding under the RCF ([FRB on Assistance to AIG](#)). The amount of this investment was likely informed by the expected \$25 billion third-quarter loss the AIG was to report for which the rating agencies wanted to see some "counterbalancing measures" ([GAO 11-616 – pp. 52](#)).

12. How did the government protect the taxpayers?

Collateralized loans. FRA Section 13(3) requires that emergency lending be secured to the satisfaction of the lending Federal reserve bank. ([GAO 11-616 – pp. 87 – 88](#)). The RCF was secured by substantially all of AIG's assets including interest in its insurance subsidiaries (which held reserves), placing the government in a senior secured position. ([FRB Section 129, 09/16/2008 - pp. 5 - 6](#), [COP 2010 - pp. 71](#)). There seemed to be confidence in AIG's divestiture plan and real value in its subsidiaries, if timing issues could be managed to provide AIG flexibility beyond the original two-year term (Geithner 2014). As a result, the term was extended to 5 years. ([FR Section 129, 11/10/2008 - pp. 6](#)). The initial interest rate and fees under the RCF were aggressive and of a commercial dimension returning to the FRBNY more generous payments that it usually received for acting as Lender of Last Resort. ([GAO 11-616 – pp. 125 – 126](#)). Even after modification, the fees were greater than on loans made under the Fed's broad-based liquidity facilities such as the TAF, TSLF and PDCF, and also under other extraordinary loans made to single entities. (See footnote 41). This was intended to mitigate against moral hazard and to incentivize AIG to repay the loan quickly, whether it used all the available funds or not ([GAO 11-616 – pp. 89 – 90](#)).

The loans under ML II and ML III were also made under Section 13(3) and secured to the satisfaction of the lending reserve bank ([GAO 11-616 – pp. 87 – 88](#)). In the case of ML II, the FRBNY had Morgan Stanley value the RMBS that it was purchasing under various scenarios and was purchasing them at a 50% haircut, paying \$19.5 billion for assets with a par value of \$40 billion. In the case of ML III, the FRBNY had Morgan Stanley value the CDOs that it was purchasing at various scenarios, including several worst-case scenarios. In each case, the valuations found that even in a worst case scenario, the CDS would be worth more than the amounts due to the FRBNY under the ML III loan. ([GAO 11-616 – pp. 64](#)). By implementing ML II and ML III, the Fed’s exposure to AIG was not reduced but it was restructured in a way that made it more secure. Instead of having \$85 billion in short term loans collateralized by equity in AIG insurance subsidiaries, it had \$70 billion of long-term loans outstanding secured by pools of dedicated assets, each of which had AIG standing in place to absorb the first losses (\$1 billion in the case of ML II and \$5 billion in the case of ML III). ([GAO 11-616 – pp. 8 – 9](#), Millstein 2018, p. 6)

Governance Rights. The terms of the RCF required CEO Willumstad to resign ([U.S. Court of Federal Claims 2015 – pp. 2](#)). He was replaced with Mr. Liddy who was suggested by the government and appointed by the Board of Directors ([U.S. Court of Federal Claims 2015 – pp. 4](#)). Similarly, the Treasury had forced the resignation of Fannie Mae and Freddie Mac in nationalizing those institutions earlier in September.

The Trust Stock entitled the Trustees to vote for Board members. The preferred shares that Treasury received provided the right to nominate Board members if dividends were not paid after four quarters (consecutive or not), and the number of directors that Treasury could nominate was the greater of two new directors or a number equal to 20% of the size of their current board in some circumstances. And over the course of the rescue (through 2011), the government nominated 2 new AIG directors, not including the directors that the trustees had nominated.

The RCF also included a provision prohibiting AIG from paying dividends on any of its preferred or common stock until the RCF was repaid ([Credit Agreement - pp. 23](#)). The Treasury preferred required that its dividend would be paid before any other (except on the senior preferred) would be paid.

Equity Interests/Operating Control/Nationalization. Despite it being ruled an illegal extraction, the most significant way that the government protected the taxpayers was through the equity interests—the equity kicker and Treasury shares--which gave the government controlling interest over AIG and “effectively nationalized” it⁴⁵ ([U.S. Court of Federal Claims 2015 – pp. 26](#)).

⁴⁵ There is no clear consensus of whether the AIG rescue amounted to a “nationalization” or not, which is indicative of how this term can easily encompass various meanings based on the prescribed point of view.

FRBNY officials put significant effort into ensuring that the government receive equity interests in the firm so that the taxpayers would participate in any upside potential that might result from the government's assistance ([U.S. Court of Federal Claims, June 2015 – pp. 6 – 7](#)). () This was customary in private deals of a similar nature, especially bankruptcy DIP financing⁴⁶, and something similar was also done in the recent conservatorships of the GSEs in connection with which the Treasury provided funding to guarantee solvency⁴⁷.

Changing the equity kicker from a warrant to voting preferred stock from the outset immediately gave the government a 79.9% interest in and effective control over AIG ([U.S. Court of Federal Claims 2015 – pp. 25](#)). (Later, this ownership percentage would rise to 92.1% of the outstanding equity stock of AIG.) This allowed the government to be involved intimately in internal AIG meetings regarding its financial stability (and therefore its ability to repay the RCF) and the impact of certain operations on that stability ([U.S. Court of Federal Claims 2015 – pp. 27 – 28](#)). The government also was able to effectuate a change in the AIG Board over time and was included in many meetings with third parties, e.g., creditors, state insurance officials, and counterparties that AIG met with ([U.S. Court of Federal Claims 2015 – pp. 27 – 28](#)).

Despite the government's significant ownership interest, the pre-rescue shareholders were not wiped out, although their interests were clearly significantly impacted. Secretary Paulson has referred to the rescue as a nationalization ("...my definition is, when the government owns more than 50 percent, it's a nationalization"). (Starr Transcript-Monday, October 6, 2014, Trial Volume 6, PDF 41). And the Starr case trial court concluded that the company had been nationalized (i.e., "the Government usurped control of AIG without ever allowing a vote of AIG's common stock shareholders"). (U.S. Court of Federal Claims 2015 – pp. 3) On the other hand, Chairman Bernanke's comments lamenting that the government lacked the ability to "put AIG into conservatorship or receivership, unwind it slowly, protect policyholders, and impose haircuts on creditors and counterparties as appropriate," have been viewed as describing the rescue as something other than a nationalization. ("Bernanke: Nationalizing AIG 'Would Have Been Far Preferable' To The Current Situation"). (Bernanke 03/24/2009) (ThinkProgress). See also a September 2008 NYTimes 09/18/2008 article speculating under what circumstances the government would have "nationalized" Lehman "just as it nationalized AIG, Fannie Mae and Freddie Mac," and a Reuters update entitled –"Why the government should have nationalized AIG." Felix Salmon, (<http://blogs.reuters.com/felix-salmon/2010/02/07/why-the-government-should-have-nationalized-aig/>) We sometimes use the term "effectively nationalized" herein to describe the rescue to acknowledge that the government owned a controlling and voting interest and that while it did not have formal powers as under a conservatorship regime, it did have significant control through its equity and lending roles.

⁴⁶ See the GAO Report at page 90 where the describing how one Fed official compared the RCF to DIP financing. ([GAO 11-616 – p. 90](#)).

⁴⁷ The conservatorships, implemented on September 7th, provided the government control over the GSEs through the conservator, the Federal Home Finance Administration (FHFA) and certain terms of the Treasury funding, which guaranteed the companies' solvency. Pursuant to the Treasury funding the government also received from each GSE dividend paying preferred stock and a warrant to purchase 79.9% of its common stock. To date, the government has received from each company dividends in excess of the amounts invested. (Wiggins, Henken, Thompson and Metrick 2019, p.15).

However, while the government was able to exercise a great deal of influence over AIG's operations, it was not in total control. The RCF provided that it could block mergers or asset sales but it could not block bonus payments to the employees of the Financial Products division responsible for the CDS ([Credit Agreement – pp. 45 – 46](#), [Geithner 2009 – pp. 1](#)). The multimillion-dollar bonuses would create a public outrage when paid.

13. How did the government administer the rescue?

As the first governmental entity that could act, the Federal Reserve took the lead in lending to AIG and also in coordinating the balance of the rescue. After the passage of TARP and the Treasury's agreement to provide additional assistance a more coordinated effort emerged, with Treasury being primarily in charge of managing and selling the AIG shares for the government's benefit as shareholder.

Under the leadership of FRBNY official Sarah Dahlgren, the reserve bank built a team of approximately 25 employees that monitored AIG's financial stability and use of RCF funds by reviewing AIG data, sitting in on AIG meetings, and liaising with the company and the hundreds of tax, legal and accounting experts that the FRBNY hired (and for which AIG was obligated pursuant to the RCF to pay). (COP 2010 – pp. 180, [U.S. Court of Federal Claims 2015 – pp. 27 - 28](#)). And it was a daunting task, a reserve bank taking on the oversight of a trillion-dollar insurance company with which it had not had much interaction with before. There was an immediate need to try to get a hand on the complicated structure of the decentralized company in order to identify its weaknesses and the substantial liquidity drains ([GAO 11-616 – pp. 31 – 32](#)). (There was some evidence that AIG did have weak internal controls and procedures; for example, in the week before September 16, its estimates of its liquidity needs kept escalating and were shared with the private consortium and the FRBNY with only a limited amount of certainty ([GAO 11-616 – pp. 26 – 27](#))). Another challenge was that almost immediately, the government team was inundated with calls from state insurance commissioners, rating agencies and counterparties requesting information and expressing concerns. (Dahlgren). The FRBNY hired a communications professional to address these latter issues. (See also KDD 15).

14. How did the government coordinate its actions?

The government's rescue effort for AIG was at first coordinated by the FRBNY. AIG's CEO Willumstad approached FRBNY President Geithner in summer 2008 seeking access to the discount window ([GAO 11-616 – pp. 20](#)). **The Fed was not AIG's regulator, and did not have**

a relationship with the company otherwise⁴⁸, but it was the only government entity able to provide AIG assistance. (See discussion at KDD 2 above.) The Fed had coordinated with the Treasury in the rescue of the GSEs and the efforts to save Lehman ([Frame et al. 2015 – pp. 38, Wiggins, Piontek, and Metrick 2014 – pp. 10 – 11](#)). This cooperation continued with respect to AIG. When it became clear that Lehman would file for bankruptcy, Secretary Paulson returned to Washington from New York but left two of his most trusted lieutenants, Dan Jester and Jeremiah Norton, to assist Geithner in encouraging a private solution. (Paulson 2010, 220, 229). FRBNY and Treasury were present for the meetings of the private consortium, although the efforts were led by JPMorgan and Goldman.⁴⁹

The Fed consulted with the Treasury before deciding to extend the RCF. (Paulson 2010, 217-221, 235-237) In particular, Treasury’s participation was required when options for the AIG Trust shares, of which the department became beneficiary, were being decided. (FRBNY emails) The Board of Governors in its meeting authorizing the RCF discussed the Treasury’s position on an extension of credit to AIG. ([BD Gov Minute 09/16/2008, PDF 304](#)). The announcing press release also stated that the loan was made with “with the full support of the Treasury Department.”⁵⁰ Geithner specifically asked Paulson to provide him a letter of support, which he did.⁵¹ He had done similarly in the rescue of Bear Stearns. ([Geithner 2019 – pp. 19](#)). If Bear had failed to repay the government its bridge loan, the loss would eventually be borne by the taxpayers in reduced transfers from the Fed ([Geithner 2019 – pp. 19 – 20](#)). Paulson’s letter to Geithner stated that the FRBNY’s action was “necessary to prevent the substantial disruption to financial markets and the economy that well could have occurred from a disorderly wind-down of AIG” and that– “I fully support the FRBNY’s action and acknowledge that, if any losses arise out of this facility, the loss will be treated by the FRNNY as an expense that may reduce the net earnings transferred by the FRBNY to the Treasury general fund. ([Paulson, October 8, 2009](#)).

In light of AIG’s rapid use of the RCF, the Fed and Treasury recognized early on that additional government assistance might be needed and might need to be something other than liquidity. Within weeks, TARP had been passed providing new tools and \$700 billion

⁴⁸ The Fed was not the regulator of Bear Stearns, Lehman Brothers, or any of the independent investment banks. They were regulated by the Securities and Exchange Commission under its Consolidated Supervised entity Program. However, the Fed did have some intimate knowledge and working relationship with the investment banks since they were primary dealers under its Open Market Operations (OMO) desk.

⁴⁹ ([COP 2010 - pp. 72 - 75](#)) Also see attendance sheets for meetings o --- and – listing representatives of the FRBNY, Treasury and the NYDI. AIG’s regulator OTS was also present but not having any funding to contribute, took a limited role.

⁵⁰ The first sentence of the press release reads – “The Federal Reserve Board on Tuesday, with the full support of the Treasury Department, authorized the Federal Reserve Bank of New York to lend up to \$85 billion to the American International Group (AIG) under section 13(3) of the Federal Reserve Act.” The title is almost identical. ([BdGov PR 09/16/2019](#))

⁵¹ In a letter dated October 8, Secretary Paulson stressed that “the situation as AIG presented a substantial and systemic threat” to our financial markets, and that the government’s decision to assist AIG “was necessary to prevent the substantial disruption to financial markets and the economy that could well have occurred from a disorderly wind-down of AIG.” ([Paulson, October 8, 2009](#)).

to fight the crisis ([P.L. 110-343 – pp. 3767, 3780](#)). Chairman Bernanke met with Secretary Paulson shortly after the TARP passed and reported to his staff that the Secretary “has agreed to do whatever is necessary to stabilize AIG using the TARP” (Bernanke email 10/24/2008). The Fed anticipated that any future assistance might require a Maiden Lane-type arrangement.⁵² At this stage, Treasury’s participation in coordinating assistance to AIG increased and it played an active role in designing and implementing the later restructuring of AIG to address its longer-term issues. ([COP 2010 - pp. 73](#))

Early on, the Fed created a Trust to manage the equity interests that the government received from AIG, but the shares and authority to manage them eventually shifted to the Treasury itself. (COP 2010,) At the time of the RCF, neither the Fed nor Treasury was authorized to hold shares representing equity interests in the company, so it was determined that AIG would issue such shares to the AIG Trust, which would hold them for the benefit of the U.S. Treasury, that is, the taxpayers. ([U.S. Court of Federal Appeals 2015 – pp. 29 - 30](#)) By October, when the first restructuring was being proposed, the TARP had passed, giving the Treasury this authority. The trust eventually transferred the Trust Shares (preferred) and the common shares received upon converting the preferred shares to Treasury ([Recapitalization Terms – pp. 12](#)). The Trustees were originally tasked with developing a plan of disposition of the Trust Shares ([Trust Agreement – pp. 8](#)). However, after the Treasury acquired AIG shares, it took direct control of the disposition of the government’s stake.⁵³

15. How did the government communicate the terms of the intervention?

The Board of Governors of the Federal Reserve announced, on September 16, 2008, that it had authorized the FRBNY to extend up to \$85 billion in credit to AIG. ([BD PR 09/16/2008](#)). The press release stated the purpose of the RCF and provided basic details regarding the loan such as term, interest rate and security for the loan. ([BD PR 09/16/2008](#)). The announcement also disclosed that the FRBNY had extended on that same day \$14 billion in credit to AIG. ([U.S. Court of Federal Claims 2015 – pp. 22 – 23](#)).

Thereafter, the FRBNY followed a pattern of disclosing developments in the details of major elements in the government’s funding to AIG as they occurred. For example, developments were announced as approved even if the actual structuring and closing of the transactions would require additional time to complete. To an extent, the announcements included a stated purpose and some insight into the factors influencing the government’s decision.

⁵² The possibility of additional Maiden Lane type assistance was discussed at a meeting held on October 23 where Morgan Stanley, whom the FRBNY had hired as a consultant, presented to the FRBNY various options for addressing AIG’s capital structure including removing the RMBS portfolio from the balance sheet (Morgan Stanley Pres. 10/23/2008).

⁵³ [Confirm with Trustee Feldberg.] The AIG Trust transferred the resulting common shares and the trust shares to Treasury on January 14, 2011 as part of restructuring final restructuring agreement when the RCF was paid off and terminated ([UST PR, 01/14/2011](#)). (See Buchholtz 2018 and Lawson for more discussion of the AIG Trust.)

For example, the release announcing the creation of the SB Facility stated that a purpose for enacting it was to “settle transactions with counterparties returning these third party securities to AIG. This new program will allow AIG to replenish liquidity used in settling those transactions, while providing enhanced credit protection to [FRBNY] and U.S. taxpayers in the form of a security interest in these securities” ([BD PR 10/08/2008](#)). (See Appendix A for a list of major press release announcements.)

Following the creation of the Revolving Credit Facility, the Board of Governors also filed reports pursuant to Section 129 of the EESA with the Senate Committee on Banking, Housing, and Urban Affairs, as well as the House Committee on Financial Services. As assistance to AIG evolved to include Treasury investments under TARP, the Treasury also made contemporaneous announcements regarding its participation and the reasons why. However, given the intertwined nature of the various elements of the AIG rescue, as discussed above, very often many if not most announcements regarding the company were made on a joint basis by the Fed and Treasury. (See for example [the press release dated November 10, 2008](#) regarding the First Restructuring and [press release dated March 2, 2009](#) regarding the Second restructuring.) These announcements were with respect to TARP funds, governed by TARP requirements for disclosure and reporting and thus in some instances, the information released by the Fed was greater than it might have been.

However, in at least one instance, the Fed disclosures seemed to have differed from the TARP requirements. The most notable was with respect to disclosure of the counterparties involved in the ML II and ML III transaction. [As discussed above, at page 27, the FRBNY at first refused to disclose the names of the counterparties from which it purchased CDS through ML III. \(SIGTARP 11/17/2009 - pp. 15, 21\). Fed officials explained that it did this because of fears of negative impacts to the counterparties, however, as noted above, it produced quite a public outcry and led to a report by the Government Accountability Office \(GAO 11-616 - pp. 95 - 98\).](#)

A second situation of challenge for the Fed’s communications regarding AIG was with respect to the payment by AIG in March of 2009, of significant bonuses to AIG Financial Products Division employees. ([Geithner 2009 - pp. 1](#)).

Given the size and range of AIG’s activities, the government’s actions spurred many requests for information, challenging the FRBNY’s communications resources. (Dahlgren interview 2018). FRBNY officials took unique steps, such as attending the conference of the State insurance commissioners, to inform the public about AIG. (Dahlgren interview 2018). Soon too, they hired an experienced communications professional to build an internal FRBNY team to handle all AIG-related communications. (Dahlgren interview 2018)(Gutt Interview 2018). A detailed webpage was created with detailed information regarding the government’s assistance and one could eventually also access copies of all the implementing documents. ([Actions Related to AIG](#)).

Given the government’s unprecedented investment in saving AIG (besides the GSEs it was the largest investment of taxpayer funds in any one company), it is also not surprising that Congress was particularly interested in reviewing it. AIG was the subject of hearings by the

Congressional Oversight Panel, the subject of a Government Accountability Office report, and featured prominently in the Financial Crisis Inquiry Commission (FCIC) report ([GAO 11-616](#), [HOGRC 2009](#), [FCIC 2011](#)).

16. What was the government's exit strategy?

Equity Ownership Strategy.

In order to recoup the investment by the FRBNY and American taxpayers, the Trustees were tasked to create a Divestiture Plan, a written plan to sell or otherwise dispose of the Trust Stock. ([Trust Agreement - pp. 8](#)) The Trust Agreement describes that the divestiture of the Trust Stock would have to be done in a value-maximizing manner. Furthermore, the sale or disposition of Trust Stock could only be completed after the FRBNY was fully repaid for funds drawn under the RCF, and after Treasury no longer owned any TARP-related preferred stock of AIG.⁵⁴ ([Ibid. - pp. 18](#)) Even with a Divestiture Plan, the Trustees could only sell or dispose of any stock after the FRBNY, in consultation with Treasury, granted approval to the Trust. ([Ibid. - pp. 8](#)) However, we have not been able to secure a copy of this plan.

On January 14, 2011, as part of the Recapitalization Plan, AIG fully repaid the FRBNY the outstanding balance under the RCF, effectively terminating that facility ([AIG, February 2012](#)). On this same day, the Trust converted the Trust Stock into shares of AIG common stock and transferred the newly issued common stock to the U.S. Treasury General Fund, subsequently dissolving the Trust.⁵⁵ ([FRBNY PR, 01/14/2011](#), [U.S. Court of Federal Claims, July 2012 - pp. 16](#)). Together with the shares that Treasury had acquired directly, Treasury then held over 1.6 billion shares of AIG common stock equal to approximately 92.1% ownership in AIG and the company was consolidated on the government's balance sheet. ([UST PR, 01/14/2011](#))

Over the next two years, through December 2012, Treasury disposed of the AIG common stock through a series of six public offerings ([UST PR, 12/11/2012](#)). Treasury reported net proceeds from the stock offerings of over \$51.6 billion, a \$4.1 billion positive return for taxpayers. ([Ibid.](#)) (Monthly Report to Congress (January 2013) - Pp. 18). A return of \$0.9 billion was also recognized from preferred stock. ([UST PR, 12/11/2012](#))

⁵⁴ The preferred stock references the more senior Series D Preferred Stock (later Series E Preferred Stock) and Series F Preferred Stock that Treasury acquired through the AIG Investment Program. See Buchholtz 2018 for further discussion.

⁵⁵ Upon receipt of the shares resulting from conversion of the Trust Stock, and following the --- Recapitalization, Treasury held over 1.6 billion shares of AIG common stock equal to approximately 92.1% ownership in AIG and consolidated on the government's balance sheet. ⁵⁵ ([UST PR, 01/14/2011](#)) For details on the other preferred stock Treasury purchased through various TARP investments in AIG, please refer to Buchholtz 2018.

17. Were there unique factors that influenced the government's actions?

A. Because of a limited tool kit, the Fed was the only government entity that could assist AIG, even though it was not its regulator and knew little about the company.

In September 2008, the government did not have a way to conduct an orderly resolution of AIG, a nonbank. (Geithner 2019). Therefore, when the company began to experience liquidity concerns it sought assistance from the Federal Reserve, even though the Fed was not its regulator. The Fed was able to loan to it under its emergency LOLR authority pursuant to FRA Section 13(3), but this meant potentially extending billions of dollars to an entity of which it knew little and which it considered on the periphery of its mandate. When the Fed first lent to AIG, it did so on few facts and in a short time frame. Given these circumstances, the Fed coordinated with the AIG's regulator, the OTS, to gain as much information as possibly as quickly as possible.

B. The threat of ratings downgrades was a major influence on the rescue.

The threat of further downgrades by the three major credit ratings agencies (S& P, Moody's and Fitch) and the insurance rating agency Best loomed over AIG throughout the period of government assistance. From the very beginning, although the RCF was a lifeline for the company, it was also an anchor in that its size and terms were inconsistent with those expected of an investment grade company, causing major concern from the agencies. Through much of the rescue the focus was on avoiding a downgrade, the result of which could well have led to AIG's failure despite the government's assistance.

As stated by Millstein in a 2018 interview—"What all of the people who were harping about what we were doing at the time missed is the centrality of the rating agencies as a constraint on how bailouts were structured, because a financial institution cannot operate without at least an investment grade rating." (Millstein 2018, p.6). A downgrade can trigger collateral calls under various contracts and that would only have exacerbated AIG's already aggravated cash needs. The other dimension of a downgrade was that it could cause a run by many of its counterparties and remaining creditors.

C. Even in the face of limited information, an initial commitment may lock the government in for success despite the cost.

Once the government decided to assist AIG, doing anything less than "whatever it takes" might not have been a realistic option. The purpose of the RCF was "to assist AIG in meeting

its obligations as they come due” and allow it to restructure its business “in an orderly manner, with the least possible disruption to the overall economy.”⁵⁶ (F PR 09/16/2008).

An AIG failure after the government invested \$85 billion into the company, would have been contrary to the overall purpose, and would have risked a loss of confidence in the government’s ability to address systemic risks and rescue nonbank entities that posed that risk. Had this occurred while the financial system continued to be weakened and fragile, it would have added stress to the situation. At least one member of the COP, A. J. Mark McWatter, expressed the view that walking away from AIG was not a viable option--

In my view, the liquidity and solvency of AIG were most likely assured once the FRBNY advanced \$85 billion to AIG and it seems unlikely – although not without possibility – that the government would have walked away from such a substantial investment of taxpayer funds and allowed AIG to fail. (COP Report p.288).

Sjostrom also acknowledges that such a situational bias may exists:

One could conclude from the fact that the government has twice restructured the bailout after having weeks and months instead of 48 hours to make a decision indicates that AIG's bankruptcy truly does pose significant systemic risk. The decisionmakers (Treasury Secretary Geithner and Fed Chairman Bernanke), however, may have believed it politically unfeasible to reverse course given the billions of taxpayer dollars already sunk into AIG, or they may have been subject to cognitive biases such as the confirmation trap.⁵⁷ (Footnotes omitted). ([Sjostrom page 983](#)).

The government didn’t walk away, it worked with the company to consider restructuring options that stabilized it, although requiring additional investments by the government.⁵⁸

⁵⁶ See also Millstein Interview (2018)—“The whole purpose of the bail-out was to enable AIG to meet its obligations in the ordinary course of business and not default on anyone.” He also discusses this concept as it relates to the controversy surrounding payments to the CDS counterparties and expounds on why paying anything less than all creditors in full in such a situation poses unmanageable challenges for government in the midst of a crisis. (p.6).

⁵⁷ The confirmation trap is a cognitive bias “whereby the decision maker seeks confirmation for what is already thought to be and neglects opportunities to acknowledge or find disconfirming information.” JOHN R. SCHERMERHORN ETAL., ORGANIZATIONAL BEHAVIOR 364 (2002) in [Sjostrom page 983, fn 252](#).

⁵⁸ But see Wiggins, Thompson, Metrick 2019 for a discussion of the Treasury’s concern about the limits of its indirect influence over the GSEs given its significant funding commitment.

Evaluation

Judged from the standard of— Did the government’s intervention enable AIG to meet its obligations as they became due, provide it time to sell certain of its businesses in an orderly manner, and minimize disruption to the overall economy?⁵⁹ — then the AIG rescue was a success. The company continued to operate throughout the crisis; it paid its creditors, avoiding knock-on effects. It was able to sell assets at a pace slower than originally anticipated and reduce its size significantly (from total assets of \$1.02 trillion in September 2008 to \$551 billion four years later) ([US Treas Dept website](#)). It also repaid to the government all amounts borrowed, the net proceeds of which, including the sale of AIG stock held by the government, totaled \$22.7 billion. ([US Treas Dept website](#)).

Throughout the rescue the Fed and Treasury Department worked with the company craft creative solutions that would forestall credit ratings downgrades and buy the company the time that it needed to survive to stability. Assistance from the government to the company spanned the period September 2008 through August 2012 when ML III sold the last securities that it held; the government’s involvement after this date was selling the AIG shares that it held. ([Treasury Website](#)). The rescue thus demonstrates that in seeking to rescue an operationally complex, systemically important nonbank, the government must be prepared to invest significant resources for oversight and to deploy a variety of tools, including crafting unique facilities⁶⁰, to address the entity’s circumstances and risks, which may not be fully known at the beginning of the government’s involvement.

However, despite the outcome, the case has also been the subject of various criticisms from shareholders, academics, market commentators, and government officials.

As discussed above at KDD 3, AIG’s largest shareholder took exception to the government’s taking control of the company and the equity kicker in particular and sued to have the

⁵⁹ The Federal Reserve press release announcing the RCF described its purpose like so—“The Board determined that, in current circumstances, a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance.

...The purpose of this liquidity facility is to assist AIG in meeting its obligations as they come due. This loan will facilitate a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy.” These themes were echoed in later releases as the assistance was augmented and amended. ([Fed PR, 09/16/2008](#))

⁶⁰ It is useful to note that in October 2008, four AIG subsidiaries began utilizing a broad-based program established by the Fed to spur the issuance of commercial paper, the Commercial Paper Funding Facility(CPFF), which purchased three-month unsecured and asset-backed commercial paper directly from qualified borrowers. ([COP 2010, 69](#)). ([FRBNY website](#)). Usage by AIG subsidiaries was limited but consistent with the government’s efforts with respect to other nonbank entities, where all available resources/facilities may be employed; their usage was limited to an authorized aggregate of \$15.2 billion. ([COP 2010, 69](#)).

interest proved illegal. Ultimately the government was sanctioned, but no economic damages were awarded. ([U.S. Court of Federal Claims, June 2015 – pp. 66](#)).

An examination of the reports of the Congressional Oversight Panel and the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) reveal the general themes of the government’s criticism. In a June 2010 report, the Panel summarized the rescue as thus:

Through a series of actions, including the rescue of AIG, the government succeeded in averting a financial collapse, and nothing in this report takes away from that accomplishment. But this victory came at an enormous cost. Billions of taxpayer dollars were put at risk, a marketplace was forever changed, and the confidence of the American people was badly shaken.
(COP 9)

SIGTARP conducted two studies focusing on issues arising from the assistance to AIG. The first was regarding compensation and the payment of bonuses ([SIGTARP 10/2009](#)), and the second regarded Maiden Lane III ([SIGTARP 11/2009](#)). A third report, issued in 2012, examined issues facing the government in regulating AIG on an ongoing basis. ([SIGTARP 7/2012](#)).

The major criticisms of the rescue seem to fall into three categories: (1) the outsize risk undertaken by the government in rescuing AIG, (2) the absence of a sense of fairness about the rescue, and (3) dissatisfaction with the mechanics of the rescue and the level of transparency adhered to.

(1) The outsize risk undertaken by the government

The rescue revealed some of the weaknesses in the U.S. regulatory system and arsenal of crisis-fighting tools. In September 2008, the federal government’s regulation over AIG, as a large insurance company, was by the Office of Thrift Supervision (OTS), on the basis of its jurisdiction over a thrift subsidiary (it was also regulated by the state insurance commissioners). ([FCIC 2010, 345-351](#)). The OTS had no authority to provide liquidity to AIG. Nor did it, the Federal Reserve, nor any other governmental agency, have authority to inject capital into, resolve, or guarantee AIG’s debts once it began to experience liquidity problems. ([Geithner 2019 - pp. 6](#)). Thus, once the prospect of a private sector solution failed, the Federal Reserve, under its emergency authority of FRA Section 13(3), provided liquidity in the form of the Revolving Credit Facility (RCF), an unprecedented size loan with “onerous terms” and an “equity kicker” that effectively nationalized the company⁶¹. ([U.S. Court of Federal Claims 2015 – pp. 31](#))

After the RCF was extended, the Fed quickly learned just how little it knew about the operations and financial position of AIG. Usage of the RCF was at a rate far higher than

⁶¹ See footnote 50.

expected, and despite this, AIG continued to face possible ratings downgrades that could send it into bankruptcy. In fact, the RCF was itself a disturbing factor for AIG's financial position as it skewed its debt to equity ratio beyond what was normally expected of an investment trade company as viewed by the rating agencies (SIGTARP 11/17/2009 – pp. 12 – 13) (Millstein 2018, p. 3). It would take almost \$100 billion more and two restructurings before the company stabilized. (See discussion at pages 12-18 above.)

Although acknowledging that the Fed was not AIG's regulator and the tight time frames, the Congressional Oversight Panel criticized the Fed's decision to provide the RCF rather than other possible options that might have meant fewer funds expended or less risk undertaken by taxpayers, e.g., a short-term bridge loan, a public-private facility, or a plan for a prepackaged bankruptcy. (COP 2010, 114-120, 128 - 129).

The COP also criticized the risk assumed by the government in ML II purchasing the RMBS portfolio and with ML III's payments for CDOs and to CDS counterparties, even while acknowledging that the Fed had considered other options. (COP 2010, 89-94). Moreover, these decisions were considered riskier because of underlying weaknesses that were revealed about AIG. The Panel also [concluded that AIG had poor risk-management and that it had reported a material weakness in its internal oversight and monitoring of the financial reporting related the valuation of the CDO portfolio.](#) (COP 2010, 45). It saw the decision to [invest the proceeds from the SecLendig program in RMBS, as a "a misjudgment of the volatility and liquidity risks in the mortgage market."](#) (COP 2010, 46).

The Fed disagreed with the Panel's position, citing the extremely tight timeframes in which decisions had to be made with respect to the RCF – "We also did not have the luxury of time. AIG needed liquidity and it needed it that day. . . we were truly facing a binary choice to either let AIG file for bankruptcy or to provide it with liquidity." (Baxter and Dahlgren 2010, 3). And with respect to the Maiden Lane SPVs, the Fed pointed out that other options were considered and rejected before deciding that the Maiden Lane facilities provided the best permanent solutions to AIG's major liquidity drains. (Baxter and Dahlgren 2010, 10-11, [COP 2010, 196](#)).

(2) The absence of a sense of fairness

The broad sense of unfairness that pervades over the AIG rescue seems to stem largely from the payment of bonuses to AIG employees (and in particular, to Financial Products Division employees responsible for the CDS business), a fact that its creditors were paid in full, and that ultimately, its shareholders recovered value as the company stabilized, a very different outcome than might have resulted from a bankruptcy action. (Brady 2009, [Wilson 2009](#).)

Through its funding and equity ownership, the government was able to exercise a great deal of influence over AIG's operations, however, it was not in total control of the company's actions. In March of 2009, AIG paid \$165 million in bonuses to AIG Financial Products Division employees (the division responsible for the ML III-related CDS), which caused a significant public outcry that was taken up by the Congress, the media and others. ([Geithner 2009 – pp. 1](#)) ([Credit Agreement – pp. 45 – 46](#)). ([Yellin, CNN Politics](#)).

One paper responded- “No aspect of the current financial crisis has infuriated average Americans and lawmakers more than the AIG bonus issues.” ([Brady 2009](#)) [Wilson 2009](#). President Obama said that the prospect of AIG awarding bonuses runs counter to “our values” and congress called for the administration to somehow recover the money, which might not have been an easy thing to do given that they were paid pursuant to contracts. [Wilson 2009](#).

SIGTARP, however, found the bonuses to be “consistent with the law in place at the time the payments were made and AIG's contractual obligations to the government. These payments were not prohibited under ESSA and the American Recovery and Reinvestment Act.” ([SIGTARP 10/2009.pdf](#). 1). It also found that the Fed had made efforts to understand AIG's compensation programs and found a “staggeringly complex, decentralized system consisting of hundreds of separate compensation and bonus plans.” ([SIGTARP 10/2009.pdf](#). 1). SIGTARP recommended that the Treasury and the FRBNY work collaboratively on future compensation decisions and offered additional suggestions on how Treasury might increase oversight of institutions in which the government has a substantial investment. (*Ibid*).

Nevertheless, the public outcry was considerable warranting public hearings by the Committee on Oversight and Government Reform in connection with the SIGTARP report ([Oversight Committee 10/2009](#)). [VOAX News 2009](#)). However, a bill that would have taxed the bonuses at 70% failed to get support. ([Lerer, 2009](#))

Maiden Lane III. The Maiden Lane facilities were also the subject of criticism; both were seen as “complicated” and not an easy fit within the Fed's Section 13(3) authority. ([COP 2010 – pp. 228, 268-69](#)). In particular, ML III fed into the sense of unfairness. The SPV funded the purchase of CDOs from third parties so that the CDS written by AIG ensuring such securities could be cancelled. The controversial decision was to have ML III purchase the CDOs at par, when at the time, the market values of the CDOs were less than par. ([COP 2010 – pp. 89-94](#), [SIGTARP 11/17/2009 - pp. 29](#)). The Fed was criticized for not using its authority to negotiate or compel concessions from the CDS counterparties, which included some of the largest U.S. financial institutions. This resulted in claims of “crony capitalism” and that the government was orchestrating a “backdoor bailout,” despite the FRBNY's contention that the financial condition of the counterparties was not a consideration in deciding to form ML III and pay counterparties effectively at par. ([Salter 2013 - pp. 20](#), [SIGTARP 11/17/2009 - pp. 29](#)). The controversy regarding ML III was intensified by the initial decision of AIG and the FRBNY to not disclose information about the payments or the

names of the recipients due to the risk of negative market consequences. ([SIGTARP 11/17/2009 - pp. 21](#), [Oversight Committee 2010, 15-16](#)). The FRBNY was also criticized for commenting on some of AIG's SEC filings along these lines and requesting that certain identifying information not be included.

The Committee on Oversight and Government Reform also held a hearing on ML III on January 27, 2010 ([HCOGR, 01/27/2010](#)). The documents produced by the Fed with respect to the hearing were made public by the Committee in 2012 accompanied by wording that echoed its prior special report⁶²:

“AIG’s counterparties received a far better deal from the New York Fed – funded by taxpayers’ money – than they would have received if AIG had gone through an orderly bankruptcy. To conceal this fact, New York Fed officials managed all of AIG’s public statements and SEC filings and intentionally sought to prevent the public from discovering the truth about the bailout. The documents produced by the New York Fed tell the story of an insider-friendly transaction planned and executed in secret – and the New York Fed hoped to keep it that way” ([HCOGR, 01/27/2012](#)).

While the critics raise issues of fairness and transparency, much of this complaint rests of the identity of the counterparties as other major financial institutions. The COP captures this bias in the passage below:

One consequence of this approach was that every counterparty received exactly the same deal: a complete rescue at taxpayer expense. Among the beneficiaries of this rescue were parties whom taxpayers might have been willing to support, such as pension funds for retired workers and individual insurance policy holders. *But the across-the-board rescue also benefitted far less sympathetic players, such as sophisticated investors who had profited handsomely from playing a risky game and who had no reason to expect that they would be paid in full in the event of AIG’s failure.* (Emphasis added) ([COP 2010, p.3](#))

As further explored below, the criticisms aimed at ML III raise questions regarding what it means for the government to provide assistance to a company to “enable it to pay its debts.”

Unfair Market Distortion. The COP also makes a broader argument that goes to the fairness and validity of the assistance to AIG. The claim is that the rescue fundamentally distorted the derivatives markets and thus protected all of AIG’s counterparties equally, an aberrant result—“a [derivative] marketplace was forever changed” through the government’s rescue efforts, which “backed up the entire derivatives market, as if these trades deserved the same taxpayer backstop as savings deposits and checking accounts.” The government’s rescue had

⁶²Public Disclosure As A Last Resort: How the Federal Reserve Fought to Cover Up the Details of the AIG Counterparties Bailout From the American People Special Report , U.S. House of Representatives, Committee on Oversight and Government Reform , January 25, 2010. <https://republicans-oversight.house.gov/wp-content/uploads/2012/01/20100125aigstaffreportwithcover.pdf>

the effect of “distort[ing] the marketplace by transforming highly risky derivative bets into fully guaranteed payment obligations.” (COP 2010, p.3). The Panel also notes that the outcome would have been different “under the well-established rules of bankruptcy” with AIG’s inability to meet its derivatives obligations being borne by shareholders and creditors. (COP 2010, p.3) “By providing a complete bailout that called for no shared sacrifice among AIG and its creditors, FRBNY and Treasury fundamentally changed the rules of America’s financial marketplace.” (COP 2010, p.195).

Thus, the Panel would favor the government delivering bankruptcy-like results while it is also trying to avoid a bankruptcy of a systemically important institution because of the potential damage to the system that would result. However, while a sense of “shared sacrifice” might have helped to mitigate the sense of preferential treatment that attends the AIG rescue, as a practicable matter, it may not always be possible to achieve bankruptcy-like concessions outside that arena, especially in the midst of a system-wide crisis.⁶³

Furthermore, it is not a settled argument that government assistance should require haircutting the recipient’s creditors. Secretary Geithner and have expressed the opposite opinion. (CITE). If haircutting is to be required, then to what extent should the government micro-manage the use of funds that it provides in a crisis? And if the government is to have a greater and more direct role in managing the downstream payout of assistance to troubled firms, on what basis would the government make such value judgements about which creditors were more deserving? These are all tenacious policy issues that are ill-suited to be resolved while the system is failing.

The government argued that requiring haircuts might well have resulted in the very harm to the system that the assistance was intended to avoid (for example, by triggering a run, ratings downgrade, or lawsuits). (COP 2010, p.113). Another problem with the COP’s desire to have downstream payments go to “sympathetic” or “deserving” payees, is that, unlike the rules-based bankruptcy code, the government was operating without a resolution regime in rescuing a nonbank like AIG. Notably, the Panel’s report does not provide a rubric for how the Fed or Treasury is to make determinations on which payees are worthy of receiving downstream payments in the middle of a crisis. No doubt, any such attempt to do so would likely be fraught with uncertainty and subject to much scrutiny.

Lastly, is cannot be overlooked that since the crisis was sparked by the meltdown in the housing market, at the same time that the government was funneling billions of dollars to

⁶³ See for a contrast, that in restructuring the auto manufacturers, General Motors and Chrysler, the government often mentioned the need for “shared sacrifice” in its announcements and lambasted creditors who did not agree to haircut their claims. *Obama Administration Auto Restructuring Initiative Chrysler-Fiat Alliance. US Treasury Department Press Release, 4/30/2009* (<https://www.treasury.gov/press-center/press-releases/Pages/tg115.aspx>) and

giant companies like AIG, which were paying their executives million dollar bonuses, millions of Americans were watching their mortgages reset to higher payments, fighting a foreclosure action, being battered by the downturn unable to sell, or watching their home sink under water. ([FHFA website/HARP](#)) [Cordell, Dynan 2009](#) The appearance that Wall Street was rescued from their risky derivatives bets while “taxpayers got stuck with the bill,” is a powerful one that fueled “public anger” and a “popular sense of injustice” at the government, even though, in total, there was no economic loss to the taxpayer from the AIG assistance. ([Greider 2010](#)).

- (3) Dissatisfaction with the mechanics of the rescue and the level of transparency adhered to.

Governance. There were also indicators that some government officials and legislators were not comfortable with the Fed, a semi-autonomous entity, being at the helm of such a massive intervention which was essentially (and out of necessity improvised), although many of its decisions were, from the beginning, made in consultation with the Treasury:

Even so, it is worth noting that the government has no well-defined legal process to wind down a company like AIG in the same way that it winds down banks through the FDIC resolution process or nonfinancial companies through bankruptcy. As a result, the Federal Reserve and Treasury had to repurpose powers that were originally intended for other circumstances, leading to a bailout that was improvised, imperfect, and in many ways deeply unfair. ([COP 2010, p.199](#)).

FRBNY effectively nationalized AIG, yet questions swirled about the ownership and the independence of the trust created to hold the shares on behalf of the Treasury because at the neither the Fed nor the Treasury had the authority to own such shares of a commercial company ([U.S. Court of Federal Claims, June 2015 – pp. 2](#)) ([FRB Minutes 2008 – pp. 4](#), [Geithner 2014 – pp. 196 - 197](#)). But the trust also served to minimize conflicts of interests between the Fed’s potential role as shareholder and creditor.

The “equity kicker” was challenged by a shareholder and found to be an illegal exaction but resulted in no financial damages to the plaintiff as no economic harm was found. ([U.S. Court of Federal Claims 2015 – pp. 65 - 67](#)). The mechanism paid off handsomely for the government in the long run, which both realized repayment of the loans and a significant gain for the taxpayers when the shares were sold. However, the government bodies reviewing the rescue questioned the Fed whether it best achieved its policy goal by acting like a private investor.⁶⁴ (Citation). Additionally, the comparisons with assistance provided

⁶⁴ See for example the COP Report (at page 241, fn 943) 0-00regardign the sale of AIG’s insurance subsidiary (In this scenario, AIG is treating U.S. taxpayers like private-equity investors

to other entities at less stringent terms also proved unfavorable.⁶⁵ ([COP 2010, p.104-05, 151-53](#)).

Transparency. The Fed is subject to less oversight and accountability from Congress or the Administration than Treasury or another agency might have been— “Since the Federal Reserve is not as politically accountable as Treasury, it is likely that the Federal Reserve’s goals are at least somewhat different from those of Treasury.” ([COP 2010, p.140](#)). Also noted by the COP were the differences in the reporting requirements—“While the Federal Reserve has provided a large amount of reporting and information concerning its actions during the crisis” it was not subject to the statutory disclosure and oversight requirements that governed the Treasury. Thus, some information might have been constrained, although this did not seem to be a major concern of the Panel. ([COP 2010, pp.185](#)).

In sum, the AIG rescue demonstrates how complex and challenging the rescue of a nonbank could be under the regulatory system that existed in 2008. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) that was passed in 2010 enacted a new resolution scheme, the Orderly Liquidation Authority (OLA), to address future failing entities such as AIG. Under the OLA, the FDIC would take failing entities through a receivership process similar to what it does for failing banks. ([FDIC Website-OLA](#)). However, availability of the OLA is dependent on the company being designated a Systemically Important Financial Institution (SIFI) by the Financial Stability Oversight Council (FSOC)([FDIC Website-OLA](#)). AIG was so-designated in July 2013, but the FSOC removed its designation in October 2017 after finding that changes that AIG made to reduce its balance sheet and risk profile reduced the “the extent to which AIG’s material financial distress could pose a threat to U.S. financial stability.” ([FSOC 2017](#)).

Today, the government would stand in a position similar to but more constrained than in 2008 with respect to an AIG-type company that began to fail– there would be no resolution authority to address its orderly dissolution other than bankruptcy. However, due to changes in the law enacted by Dodd-Frank, the Fed’s Section 13(3) authority would not be as available to address early liquidity issues. Section 13 was amended by Dodd-Frank so that the Fed’s emergency lending must be done through a “program or facility with broad-based eligibility” that is established with the approval of the Secretary of the Treasury.⁶⁶ ([Fed](#)

funding its growth in hopes of a nice payoff down the line. That’s wrong. The only way to mitigate the moral hazard of saving AIG is to repay U.S. taxpayers sooner, not later. [Emphasis in original]]

⁶⁵ See the COP Report for discussion comparing assistance to AIG with that provided to other companies such as Citicorp, Bank of America, and the auto companies. ([COP 2010, p.151-53](#)).

⁶⁶ “Broad-based eligibility has been defined through rule-making to mean (i) the program was designed to provide liquidity to an identifiable market or sector of the financial system, (ii) the program was not designed to aid one or more specific companies to avoid bankruptcy or other resolution including by removing assets from the balance sheet of the company or companies, and (iii) that at least companies would be eligible to

[Website-Sec13](#)) Either way, it is likely that now as then, whatever actions the government might take will be subject to intense scrutiny and may be judged harshly at every step even if in the final accounting the combined efforts prove successful. Although it may be difficult when addressing a failing company, attention to a longer than immediate time-frame and transparency might help to mitigate negative fallout.

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APPENDIX A-Overview of AIG Combined Assistance

Tool	Date Implemented ⁶⁷	Vehicle	Agency	Amounts Expended \$	Date Terminated	Authority
Lending	Pre-existing	Standing Lines of Credit	Treasury	Not Accessed	N/A	
Rules/Convening Authority	03/XX/2008	Loosening of Capital requirements	Treasury/OFHEO			FHFA
Lending	07/13/2008	Discount Window lending made available	Federal Reserve	Not Utilized		FRA §13(13)
Rules/Moral Sustain	07/30/2008	Developed comprehensive plan for more intense intervention resulting in passage of the Housing and Economic recovery Act (HERA)	Treasury and Federal Reserve	N/A	N/A	N/A
Rules	07/15/2008	Issued an Emergency Order prohibiting naked short selling of GSE stock	Securities and Exchange Commission	N/A		
Other	07-08/2008	Coordinated Financial Review	Federal Reserve, OCC, Morgan Stanley on behalf of Treasury	N/A	08/2008	
Restructuring	09/06/2008	Conservatorships ⁶⁸	FHFA, Federal Reserve	N/A	N/A	HERA §
Capital investment	09/06/2008	Senior Preferred Stock Purchase Agreement (SPSPA)	Treasury	189.5 billion	N/A	HERA §
Restructuring	09/06/2008	Operational constraints in SPSPAs ⁶⁹	Treasury, FHFA	N/A	N/A	HERA §
Capital investment	09/06/2008	Warrant for 79.9% common	Treasury		N/A	HERA §

⁶⁷ Unless otherwise stated, date shown is the date that the vehicle was authorized. The Treasury's standing lines of credit, \$X billion per entity, were implemented prior to the crisis. The Fed's Large Scale Asset Purchase Program (LSAP) began purchasing agency debt the second week of December 2008 and began purchases of agency MBS on January 5, 2009, which continued through March 31, 2010.

⁶⁸ During the early phase of the conservatorship, the FHFA focused the GSEs on stemming credit losses and reducing their retained portfolios. By 2016, the outstanding debt and portfolios of both entities had shrunk to less than their respective 2008 levels, while their outstanding MBS guarantees remained fairly constant. Also changes in 2012, in effect prohibited the entities from retaining earnings and building their capital.

⁶⁹ The 2012 Amendments to the SPSP Agreements substituted a fixed dividend payment for a net sweep of all profits and prohibited the entities from accumulating capital.

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“Guaranteeing”	09/06/2008	SPSPA assured the GSEs’ solvency and thus their ability to pay their obligations– “hardened the implied guarantee”	Treasury	5.3 trillion ⁷⁰	N/A	HERA §
Lending	09/06/2008	Revolving Credit Facility	Treasury	Not Utilized	12/31/2009	HERA § 117
Buying Assets	09/06/2008	Purchases of GSE MBS in open market (LSAP)	Treasury	225 billion	12/31/2009	
Buying Debt	11/25/2008	LSAPP	Federal Reserve	172.1 billion	03/31/2010	FRA §14
Buying Assets	11/25/2008	LSAPP	Federal Reserve	1,250 billion	03/31/2010	FRA §14

⁷⁰ Represents the total amount of GSE debt (\$ 1,657.9 billion) and guarantees on MBS (\$ 4,393.9 billion) outstanding in Sept 2008 [minus amounts held by the US government].