**From:** dennis ryan/ny/frs;nsf;dennis.ryan@ny.frb.org;smtp
**Sent:** Wed Sep 17 2008 20:37:59 EDT
**To:** alejandro latorre/ny/frs@frs;anthony cirillo/ny/frs@frs;arthur angulo/ny/frs@frs;barbara yelcich/ny/frs@frs;caroline frawley/ny/frs@frs;christopher calabia/ny/frs@frs;christopher hunter/ny/frs@frs;clinton lively/ny/frs@frs;daniel muccia/ny/frs@frs;deborah lohnau/ny/frs@frs;denise goodstein/ny/frs@frs;dianne dobbeck/ny/frs@frs;homer hill/ny/frs@frs;james hodgetts/ny/frs@frs;jan voigts/ny/frs@frs;jeanmarie davis/ny/frs@frs;jill yellock/ny/frs@frs;jim mahoney/ny/frs@frs;john reynolds/ny/frs@frs;john ricketti/ny/frs@frs;john ruocco/ny/frs@frs;jonathan polk/ny/frs@frs;margaret brush/ny/frs@frs;mark scapp/ny/frs@frs;paul whynott/ny/frs@frs;robert galletta/ny/frs@frs;roger graham/ny/frs@frs;sandra galvan/ny/frs@frs;sarah adelson/ny/frs@frs;sarah dahlgren/ny/frs@frs;steven j manzari/ny/frs@frs;wendy ng/ny/frs@frs;william brodows/ny/frs@frs;zahra el-mekkawy/ny/frs@frs;
**CC:** john ricketti/ny/frs@frs;
**Subject:** SG's $5.3 billion collateral call (update) and potential DW concern based on collateral.

Hello,

I have provided Bill Hallacy and Rich Kunen with some updates today on the AIG collateral call. Below is some additional information.

If you have any questions I can be reached at:
SG - 212 278 7835
BB - 914 783 5155

AIG $5.3 billion collateral call status:

Following up on the $5.3 billion AIG collateral call made by SG yesterday - as of this afternoon, SG received approximately $358 million (yesterday). According to the CAO, AIG did not deliver on the collateral because AIG stated that the collateral notice was not received in time. I was informed that AIG would be delivering another $1.2 billion (approximately) today. The $1.2 billion that AIG is willing to post was calculated by AIG using the matrix pricing (by reference obligation and counterparty rating) schedule in the CSA. SG is still considering the next steps

According to the CAO, AIG is honoring the contractual amount in the CSA based on the matrix. The CAO stated that SG now has the right to classify it a "bona fide dispute". However, in doing so it would trigger certain requirements in the ISDA/CSA. These include:
One day after classifying it as a dispute SG and AIG will have to agree on an independent bona fide party to calculate the value of the collateral call based on the transactions under the agreement.
If this is not agreed, each party needs to seek their own independent bona fide parties to perform portfolio calculations (I do not know if AIG must approve SG's and if SG must approve AIG's).
If after the two independent calculation parties have provided valuations and AIG/SG can not negotiate a resolution the mater is escalated to litigation.

CDS CDO Background information:

SG has approximately $16 billion of exposure in the form credit protection purchased on CDOs and other ABS securities. Approximately, $10.8 billion of this exposure is the result of calls exercised on CDS to cover exposure of CDOs supported due to liquidity puts on super senior CDOs.

Two weeks ago, SG negotiated an agreement with AIG. In the agreement, AIG would post $2 billion of additional collateral (bringing AIG's total collateral posting to $4.3 billion). SG agreed not to seek additional collateral unless AIG was downgraded or there were downgrades in the collateral. The credit rating downgrade lowered the CSA unsecured threshold to zero and allowed SG to call for additional collateral. The collateral call value was determined by using market quotes for values of the 28 pieces of underlying CDO. Based on the valuations provided by the street, SG asked for $5.3 billion of additional collateral. The total collateral requested equals $9.6 billion ($4.3B held plus $5.3B called), implying an average mark of approximately 40 cents on the dollar.

The total collateral posted is significantly different than SG's internal stress test results. SG's stress results report projected losses of approximately $1 billion. This stressed exposure differs significantly from the exposure used to calculate the collateral call value of $9.6 billion. The exposures calculated by the stress tests are calculated by using a held to maturity methodology. Basically, SG applies a stressed LGD for non RMBS collateral and a separate stress methodology for RMBS collateral. The RMBS stress methodology makes assumptions based of prepayment, real estate appreciation, default rates, recovery rates, etc,. These methodologies are applied to each piece of collateral in the structure and the losses are summed. Any aggregate loss above the attachment point are considered the stress loss. The $1 billion stress loss is the total of the 28 CDO structures.

Potential Discount Window issue:
An important note is that $8.8 billion of the reference assets (AAA CDOs) are posted as collateral at the discount window. I requested and received the independent quotes used to mark the CDOs. Based on these marks, approximately $8 billion of this collateral is valued at less that 50 cents on the dollar. If my memory is correct, the value of these assets provided to the window was very high (at or near par). I will be in contact with Bill Walsh to discuss the issue.