Appendix D—Management Comments from Federal Reserve

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

Federal Reserve Bank of New York
33 Liberty Street
New York, N.Y. 10045-0001

November 15, 2009

Special Inspector General Neil Barofsky
Office of the Inspector General for the
Troubled Asset Relief Program
1801 L Street, N.W.
Washington, D.C. 20220

Dear Mr. Barofsky:

On behalf of the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York (collectively "Federal Reserve"), we write in response to your draft report titled "Factors Affecting Efforts to Limit Payments to AIG Counterparties and Future Exposures" ("Report"). We appreciate the effort that your team has put into learning the complicated set of facts surrounding the Treasury's and Federal Reserve's work to stabilize American International Group ("AIG"). Our comments center primarily on the Conclusions and Lessons Learned section.

I. The Context

As your Report describes, the events that unfolded over the weekend of September 13, 2008, and continued through the week of September 15 were unprecedented. Two very large, systemically important financial institutions, Lehman Brothers and AIG, neither of which were regulated by the Federal Reserve, faced failure within days of each other. During the weekend of September 13, 2008, the Federal Reserve received repeated assurances from the New York State Insurance Department that AIG was managing its situation both through the state insurance regulators and through a private sector consortium of banks who would provide the capital AIG needed. As your report notes, Federal Reserve Bank of New York President Geithner encouraged a private solution to AIG's liquidity needs. However, when Lehman Brothers failed, the willingness of private sector banks to lend to AIG disappeared.

As the Report notes, the Federal Reserve's decision at this point to provide financial assistance was motivated by a broad range of systemic concerns about the effect of a default on AIG's creditors. These creditors include not only AIG's Credit Default Swap ("CDS") counterparties, but also holders of insurance policies and annuities issued by AIG insurance companies, retirement and 401(k) plans that had purchased stable value wraps from AIG, municipalities that held AIG Guaranteed Investment Contracts, and numerous other entities that are important threads in the fabric of the American economy.

The Federal Reserve's intervention in AIG was designed to prevent a system-wide collapse and achieved that end. Importantly, the Federal Reserve's Revolving Credit Facility is fully secured by a pledge of AIG assets, and we anticipate that the loan under that Facility will be fully repaid.

II. The Terms of the Original Loan to AIG Were Appropriate in Light of the Circumstances at the Time

The Report notes that the terms of the original AIG loan were based on a proposed private sector financing arrangement that was not consummated. The Report also suggests that those terms were too severe and were adopted with almost no independent consideration of the impact that those terms might have on the future of AIG.

While the terms of the transaction between the Federal Reserve and AIG were based in part on the economic terms proposed by a private sector consortium, those terms were adopted by the Federal Reserve after consideration of the best way in which to prevent the disorderly collapse of AIG while simultaneously protecting taxpayers' interests. The Federal Reserve judged at the time, and continues to believe, that it would have been inappropriate for the Federal Reserve to extend credit to AIG on terms that were more favorable to AIG than those developed under the circumstances by the private consortium. As the Report recognizes, economic conditions at AIG unrelated to the Federal Reserve's original loan continued to deteriorate and required the injection of capital and the restructuring of the Federal Reserve's credit in November.

III. The Federal Reserve Acted Appropriately in Attempting To Obtain Concessions from AIG Counterparties

As part of the November restructuring of the AIG loan, the Federal Reserve created the Maiden Lane III ("ML III") facility to address the increasing liquidity strains faced by AIG resulting from its obligation to post collateral with counterparties of CDS it had written on multi-sector collateralized debt obligations. As the Report recognizes, in connection with this restructuring to terminate the AIG CDS, the Federal Reserve actively undertook to obtain concessions from the CDS counterparties, but was unable to obtain any such agreements.

We believe that the Federal Reserve acted appropriately in conducting these negotiations and that our negotiating strategy, including the decision to treat all counterparties equally, was not flawed or unreasonably limited. After the U.S. Government had determined that AIG was systemically important and had acted to prevent its disorderly failure, it was natural for all of AIG's creditors, including its counterparties on multi-sector CDS, to expect full payment from the company and to believe that the company would not be in a position to demand concessions from its counterparties on their claims. As noted above, the counterparties included a wide range of creditors, including holders of insurance policies and annuities issued by AIG, retirement and 401(k) plans that had purchased stable value wraps from AIG, municipalities that held AIG Guaranteed Investment Contracts, and numerous other entities.

As the Report correctly acknowledges, the Federal Reserve should be cautious not to misuse its supervisory leverage over a regulated entity. We believe that it would not have been appropriate to use our supervisory authority on behalf of AIG to obtain concessions from domestic counterparties in purely commercial transactions in which some of the foreign counterparties would not grant, or were legally barred from granting, concessions. To do so would have been a misuse of our supervisory authority to further a private purpose in a commercial transaction and would have provided an advantage to foreign counterparties over domestic counterparties. In contrast, supervisory authority is designed and specifically intended to be used to further the safety and soundness of supervised institutions, for example to require supervised institutions to raise capital as protection against current or expected losses.

We agree with the observation in the Report that the ultimate cost or benefit of the CDS transactions with AIG counterparties depends on the repayment of the loan to ML III and the other federal assistance to AIG, and on the value of the assets securing that credit. Based on available data and models, the Federal Reserve anticipates that the loan to ML III will be repaid and U.S. taxpayers will not incur any net loss on the loan. The assets of ML III will either mature or be sold in an orderly fashion and AIG's $5 billion subordinated position is available to absorb the first loss should any ultimately be incurred by ML III. Because the Federal Reserve is entitled to a portion of any residual cash flow generated by the assets, the ML III loan may yield a profit for the taxpayers. As of September 30, 2009, the fair market value of the assets ML III purchased exceeded the balance of ML III's loan by $3.6 billion.

IV. <u>The Federal Reserve Supports the Need for Appropriate Transparency</u>

The Report addresses the value of transparency, which we share. We have taken a number of significant steps with the objective of increasing the information publicly available about the Federal Reserve and its lending programs so that the Congress and the public can more effectively assess our efforts in pursuit of financial stability and monetary policy objectives. Among these steps is regular publication on our website of comprehensive information about ML III and the other Federal Reserve facilities. Altogether, we now provide more information about the operations of the Federal Reserve than ever before, and we continue to explore whether additional information can be provided without jeopardizing the effectiveness of our efforts.

V. <u>Conclusion</u>

In his testimony on AIG before the House Committee on Financial Services on March 24, 2009, our Chairman identified two additional lessons from the AIG experience that should inform the ongoing discussions on regulatory reform in Congress and elsewhere. First, AIG highlights the urgent need for new resolution procedures for systemically important nonbank financial firms. If that tool has been available in September, 2008, it could have been used to put AIG into conservatorship or receivership, unwind it slowly, protect policyholders, and impose haircuts on creditors and counterparties as appropriate. Second, the AIG situation highlights the need for strong, effective consolidated supervision of all systemically important financial firms. AIG built up its concentrated exposure to the subprime mortgage market largely out of the sight of its functional regulators. More effective supervision might have identified and blocked the extraordinarily reckless risk-taking at AIG. These two changes could measurably reduce the likelihood of future episodes of systemic risk like the one presented by AIG.

Sincerely,

	Thomas C. Baxter, Jr. (sga)
General Counsel Board of Governors of the Federal Reserve System	General Counsel Federal Reserve Bank of New York