



BOARD OF GOVERNORS  
OF THE  
**FEDERAL RESERVE SYSTEM**  
WASHINGTON, D. C. 20551

BEN S. BERNANKE  
CHAIRMAN

January 27, 2010

The Honorable Darrell Issa  
Ranking Member  
Committee on Oversight and Government Reform  
House of Representatives  
Washington, D.C. 20515

Dear Congressman:

This is in response to your letter of January 22, 2010, asking questions about the role of the Federal Reserve in the transactions involving the American International Group, Inc. (AIG), the Federal Reserve, and certain counterparties of credit default swaps written by AIG on multi-sector collateralized debt obligations (CDOs).

In September 2008, the Federal Reserve extended emergency credit to AIG to prevent the imminent disorderly failure of the company, an event that would likely have led to a significant intensification of an already severe financial crisis and a further worsening of global economic conditions. We have provided significant information to Congress and the public on our actions with respect to AIG. Thomas Baxter, Executive Vice President and General Counsel of the Federal Reserve Bank of New York, will testify on this matter before your Committee today.

Because of the public interest, to afford the public the most complete possible understanding of our decisions and actions in this matter, and to provide a comprehensive response to questions that have been raised by members of Congress, I have welcomed a full review by the Government Accountability Office of all aspects of our involvement in the extension of credit to AIG.

Responses to your specific questions about these transactions are enclosed.

Sincerely,

A handwritten signature in black ink, appearing to be "B. Bernanke", written in a cursive style.

Enclosure

**Responses to questions from Ranking Member Issa dated January 22, 2010, concerning certain counterparties of credit default swaps written by AIG on multi-sector collateralized debt obligations**

Following the Federal Reserve's initial secured loan, the ongoing stress in the financial markets continued to place substantial pressure on AIG. The CDS protection that AIG had written on multi-sector CDOs was a significant source of AIG's capital and liquidity strains during 2008. These contracts require AIG to provide its counterparties collateral as the market value of the underlying CDOs, AIG credit rating, or the credit rating on the reference assets declined. As of November 5, 2008, AIG had posted or agreed to post approximately \$37 billion in collateral against these exposures, and these exposures contributed significantly to the \$24.5 billion in losses that AIG reported for the third quarter of 2008.

As a part of the restructuring of the government's assistance to AIG by the Treasury and the Federal Reserve in November 2008, Maiden Lane III LLC (ML III) was formed to ease this continued pressure on AIG. ML III purchased from the CDS counterparties multi-sector CDOs with the par value of \$62 billion referenced in the CDS at their current market value (approximately \$29 billion), a substantial discount to par value. The purchase of the CDOs was funded in part by a loan of approximately \$24 billion from the Federal Reserve Bank of New York (FRBNY) to ML III and a \$5 billion equity contribution to ML III by AIG. In addition, the counterparties were allowed to retain approximately \$35 billion in collateral already posted with the counterparties by AIG pursuant to its obligations under the CDS contracts. In return, the counterparties agreed to terminate the CDS, relieving AIG of, among other things, the obligation to post additional collateral pursuant to the CDS.

**1. In deciding on how FRBNY would pay AIG's CDS counterparties in return for tearing up their CDS contracts, did Federal Reserve officials take into consideration the financial health of the counterparties themselves?**

Because of its concerns about the stability of the financial markets during this period, the Federal Reserve was monitoring the financial condition of major banking and investment banking participants in the markets, which included many firms that were not counterparties to AIG's CDS and some that were. However, the overriding motivating factor in structuring the payments to the counterparties was to relieve AIG of the destabilizing drains on its liquidity caused by the requirement to continue to post collateral as required by the CDS contracts. All counterparties were treated the same for payment purposes. Whether the individual counterparties were in relatively sound financial condition or not was not a factor in the decision regarding the amount paid to the counterparties or whether concessions should be sought from them.

**2. Did you ever personally discuss the payment of AIG's counterparties with employees or representatives of AIG's counterparties?**

I was not directly involved in the negotiations with the counterparties. These negotiations were handled primarily by the staff of the FRBNY on behalf of the Federal Reserve. I participated in and supported the Board's final action to authorize lending to ML III for the purpose of purchasing the CDOs in order to remove an enormous obstacle to AIG's financial stability and thereby help prevent a disorderly failure of AIG during troubled economic times.

**3. Were you ever personally involved in discussions about what AIG should disclose to the public or Congress about the payments to AIG's CDS counterparties?**

I was not directly involved in the discussions with AIG related to this decision. I fully supported AIG's decision to release publicly in March 2009 the identities of the AIG's CDS counterparties that received payments from ML III.

**4. Did you ever recuse yourself from involvement with decisions related to the disclosure of the payments to AIG's CDS counterparties and, if so, when?**

I did not recuse myself from involvement with any decisions related to the disclosure of payments made to AIG's CDS counterparties because I have no financial or other interest that would have made a recusal necessary or appropriate. However, as explained above, I was not involved in discussions with AIG regarding counterparties or the disclosure matters you raise. As I have previously indicated, I supported AIG's decision to make public the identities of the counterparties, and those names were disclosed nearly a year ago. In addition, I was actively involved in Federal Reserve initiatives to expand disclosure of information relating to various Federal Reserve credit facilities, including the *Monthly Report on Credit and Liquidity Programs and the Balance Sheet*, and the weekly H.4.1. release, which include detailed information on the status of the ML III credit facility. These and other publications of the Federal Reserve provide substantial information about all of our credit facilities, including the loans to AIG, ML III, and Maiden Lane II LLC, and the value of collateral supporting those loans.

**5. What alternatives to the course FRBNY ultimately took in paying AIG's CDS counterparties were considered and why were they rejected?**

The alternatives considered by the FRBNY are explained in the testimony of Thomas Baxter, Executive Vice President and General Counsel, FRBNY, before the Committee on Government Oversight and Reform.

As I and other Federal Reserve officials have made clear in congressional testimony and elsewhere, the situation faced by AIG and the Federal Reserve in the fall of 2008 with respect to AIG's CDS contracts pointedly demonstrates the urgent need for adoption of new resolution procedures for systemically important nonbank financial

firms. Such a resolution authority would provide a wider range of tools for addressing the potential disorderly failure of a systemically significant firm, such as receivership or conservatorship powers, than are available to the Federal Reserve, which is limited to lending authority.

**6. Did FRBNY consider assuming or guaranteeing AIG's obligations to its CDS counterparties and, if so, why was this course of action rejected?**

See answer to Question 5 above.

**7. If the Federal Reserve felt it lacked the statutory authority to pursue alternatives to the course FRBNY ultimately took in paying AIG's CDS counterparties, why didn't the Federal Reserve seek additional authority from Congress?**

As I and other Federal Reserve officials have made clear in congressional testimony and elsewhere, the situation faced by AIG and the Federal Reserve in the fall of 2008 with respect to AIG's CDS contracts pointedly demonstrates the urgent need for adoption of new resolution procedures for systemically important nonbank financial firms. Such a resolution authority would provide a wider range of tools for addressing the potential disorderly failure of a systemically significant firm, such as receivership or conservatorship powers, than are available to the Federal Reserve, which is limited to lending authority. Given the extremely compressed time frame in which a solution to the liquidity threat to AIG posed by its CDS had to be found, obtaining additional statutory authority for additional powers was not possible.

**8. How did FRBNY determine the price it paid for the CDOs it purchased through Maiden Lane III ("ML3")?**

As explained in Mr. Baxter's testimony, ML III purchased the multi-sector CDOs underlying AIG's CDS at their current market value (approximately \$29 billion), which represented a significant discount to their par value (\$62 billion). Before agreeing to the transaction, the Federal Reserve consulted independent financial advisors to assess the value of the underlying CDOs and the expectation that the value of the CDOs would be recovered. The advisors believed that the cash flow and returns on the CDOs would be sufficient, even under highly stressed conditions, to fully repay the Federal Reserve's loan to ML III. Under the terms of the agreement negotiated with AIG, the Federal Reserve will also receive two-thirds of any profits received on the CDOs after the Federal Reserve's loan and AIG's subordinated equity position are repaid in full.

**9. Do you believe that FRBNY paid a fair price for the CDOs it purchased through ML3 and, if so, what basis do you support that belief?**

See answer to Question 8 above.

**10. Are you aware of any attempts by Federal Reserve officials, staff or outside counsel to prevent public disclosure of information about the payment of AIG's**

**CDS counterparties by seeking special procedures from the Securities and Exchange Commission ("SEC")?**

I was not involved in discussions with the SEC about any disclosure issues involving AIG. I understand that the Federal Reserve staff and its outside advisors supported AIG's initial application to the SEC to have the names of the CDS counterparties that sold CDOs to ML III remain confidential in public disclosures. I understand that the material sought to be kept confidential was handled under the special procedures created by the SEC for handling certain types of information for which confidential treatment has been requested. Under these procedures, the SEC keeps the confidential information in a separate safe so that the confidential version of the relevant document is not mistakenly treated as the public version. The procedures do not relate to the SEC's decision with regard to whether the information at issue warrants confidentiality under applicable standards.

Three months later AIG changed its view and decided to reveal the counterparty names. The Federal Reserve supported that decision. The counterparty names were disclosed nearly one year ago. I also understand that AIG has continued to ask the SEC to keep confidential certain commercially sensitive information, including CUSIP numbers and tranche names, that would identify the individual CDOs that ML III acquired from the counterparties. The Federal Reserve has supported this request. The FRBNY and its advisors believed that public disclosure of the identifying details concerning individual securities in ML III's portfolio, including to market participants, would undercut the ability of ML III to sell those assets for a maximum return to the detriment of taxpayers. In May 2009, the SEC independently concluded that this commercially sensitive information need not be disclosed. All other material information concerning the ML III transaction has been disclosed in AIG public filings with the SEC.

**11. Are you aware of any attempts by Federal Reserve officials, staff or outside counsel to prevent Congress from obtaining information about the payment of AIG's CDS counterparties?**

The Federal Reserve has made a tremendous amount of information about its actions with respect to AIG available to Congress in testimony, correspondence, and reports as well as to the public on the Federal Reserve website. I strongly support the goal of transparency with respect to the Federal Reserve's actions in connection with the creation of the ML III credit facility and the other actions we have taken regarding AIG. To further this goal, I have welcomed a full review by the Government Accountability Office of all aspects of our involvement in the extension of credit to AIG.

**12. Are you aware of any attempt by Federal Reserve officials, staff or outside counsel to prevent public disclosure, either through the SEC or Congress, of any AIG employee compensation packages?**

See answer to Question 11.