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Congress of the United States

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January 24, 2010

MEMORANDUM

TO: Members of the Committee on Oversight and Government Reform

FROM: Majority Staff, Committee on Oversight and Government Reform

SUBJECT: Full Committee Hearing entitled, "The Federal Bailout of AIG."

On Wednesday, January 27, 2010, at 10:00 a.m., in room 2154 of the Rayburn House Office Building, the Committee on Oversight and Government Reform will hold a hearing entitled, "The Federal Bailout of AIG."

The hearing will examine the Federal response to the collapse of AIG, including: (1) the decision to compensate AIG's credit default swap counterparties at 100 cents on the dollar following AIG's near-bankruptcy; and (2) the Federal Reserve's alleged attempt to keep secret the names of the counterparties and the amounts they were paid.

Background

At the beginning of 2008, AIG was the world's largest insurance company, with 116,000 employees, 74 million clients, operations in 130 countries, and more than $1 trillion in assets.[1] Moreover, it was the most profitable property and casualty insurance company in the world. However, beginning in 1998, AIG's Financial Products subsidiary (AIGFP) expanded beyond traditional insurance products, selling nearly $500 billion worth of credit default swaps. These credit default swaps would be a major cause of AIG's downfall.

What is a Credit Default Swap?

A credit default swap (CDS) is an insurance-like contract that AIGFP sold to counterparty buyers such as financial institutions and other large investors. Under a CDS, AIG would receive a series of payments from the counterparties in return for AIG

[1] AIG, *Annual Report* (2007); AIG, Form 10-Q (Mar. 31, 2008).

agreeing to make a payment to the counterparties if a particular adverse credit event occurred with respect to an underlying security (for example, if the credit rating on a security was downgraded or the security went into default). CDSs are often used to hedge against a loss in value of asset-backed securities, including mortgage-backed securities. AIGFP sold CDSs that offered loss protection on assets such as multi-sector collateralized debt obligations (CDOs). CDOs are financial instruments that entitle the buyer to some portion of cash flows from a portfolio of assets, which may include bundles of bonds, loans, mortgage-backed securities, or even other CDOs. A multi-sector CDO is a CDO backed by a combination of corporate bonds, loans, mortgages, or asset-backed securities.

Under the terms of AIG's credit default swap contracts, the counterparties purchasing the CDSs paid AIG regular, insurance-like premiums and were entitled to require AIG to post collateral when certain adverse events occurred relating to the underlying CDOs, including a decline in the market value of the CDOs or a downgrading of the credit rating of the CDOs. AIG's credit default swap contracts also commonly provided that, in the event AIG's credit rating was downgraded, AIG would be required to post cash collateral to insure payment.

AIG's Collapse

Beginning in the summer of 2007 and continuing through 2008, AIG's financial condition deteriorated, causing a decline in market confidence and triggering downgrades in AIG's credit rating. At the same time, the market value of the CDOs protected by AIGFP's credit default swaps declined, caused in part by a dramatic rise in mortgage defaults. As a result, AIG was required to post collateral under the terms of its CDSs. By late August 2008, however, AIG did not have nearly enough liquidity to post the required collateral and was on the verge of defaulting on its obligations to its counterparties.

AIG sought to raise capital from private sources, but it's rapidly deteriorating financial condition, combined with severe problems at other major financial institutions and the ultimate failure of Lehman Brothers, were prohibitive. On September 15, 2008, the day Lehman Brothers failed, the three largest credit rating agencies – Standard & Poor's, Moody's, and Fitch – downgraded AIG. At this point, AIG could not continue to exist on its own.

The Federal Bailout of AIG

On September 16, 2008, deciding that an AIG bankruptcy would pose serious systemic risk to the economy, the Treasury Department and the Federal Reserve Board authorized the Federal Reserve Bank of New York (New York Fed or FRBNY) to loan AIG $85 billion to prevent the company from filing for bankruptcy.[2] In return, the New York Fed received a 79.9 percent ownership stake in AIG. In addition, according to the Wall Street Journal, Treasury Secretary Henry Paulson required AIG's CEO, Robert

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[2] The loan was made under the authority of Section 13(3) of the Federal Reserve Act.

Willumstad, to step down. He was replaced by Edward Liddy, the former CEO of Allstate.[3]

AIG Counterparty Payments

Even after the New York Fed provided AIG with financing, AIG continued to need billions of dollars each week to meet collateral calls and make payments to its CDS counterparties. By November 5, 2008, AIG had already run through about $61 billion of the initial $85 billion. By then it had become clear that the initial $85 billion had not solved the AIG liquidity crisis and that additional measures were necessary.

On November 10, 2008, the New York Fed created Maiden Lane III, a limited liability corporation, to purchase the CDOs underlying the CDSs from counterparties of AIG to allow cancellation of the CDS contracts. The Federal Reserve Board authorized the New York Fed to provide up to $30 billion to pay the AIG counterparties.

The CDS counterparties were effectively paid at par, *i.e.*, 100 percent of the face value of the underlying subprime-linked securities. Many observers, including Members of Congress and former AIG CEO Hank Greenberg, questioned the amount of these counterparty payments. Critics argue that the federal government should have been more aggressive in attempting to negotiate concessions from the counterparties.

Public Disclosure of the AIG Counterparty Payments

Under Securities and Exchange Commission (SEC) rules, AIG was obligated to file an 8K report disclosing the counterparty payments under Maiden Lane III.[4] AIG filed 8K reports on Dec. 2nd and Dec. 24th, 2008.

In its 8K reports, AIG disclosed the collective amount paid to the counterparties under Maiden Lane III and the fact that the counterparties were being compensated at par. However, the 8Ks did not disclose the identities of the counterparties, the amount paid to each counterparty, or information identifying the individual securities in the Maiden Lane III portfolio. On Dec. 30th, 2008, the SEC wrote to AIG, requesting that AIG either disclose this information or explain why such disclosure was unnecessary.

In reply, AIG, with New York Fed approval, supplied the requested information to the SEC, along with a confidential treatment request (CTR) seeking to have the information treated as confidential on the grounds that it constituted sensitive commercial information.

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[3] *U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, Wall Street Journal (Sept. 16, 2008).

[4] Under SEC rules, a Form 8K is required when companies announce "major events that shareholders should know about." *SEC website*: http://www.sec.gov/answers/form8k.htm

On March 5th, 2009, Federal Reserve Board Vice Chairman Donald Kohn testified before the Senate Banking Committee. In response to a question from Chairman Dodd, Mr. Kohn refused to disclose the names of the counterparties, stating that, "giving the names would undermine the stability of the company [AIG] and could have serious knock-on effects to the rest of the financial markets and the government's effort to stabilize them."

Ten days later, on March 15th, in response to growing public and congressional criticism, AIG announced the identities of the counterparties and the amounts paid to each.[5]

A table showing the payments to AIG credit default swap counterparties is appended to this memorandum.

SIGTARP Audit of AIG Counterparties

Twenty-seven Members of Congress asked the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) to review the basis for these counterparty payments, whether they were in the best interest of the taxpayers, and whether they needed to be made at 100 percent of par value.

In a report issued on November 17, 2009, the SIGTARP found, among other things, that:

- The original terms of Federal assistance to AIG inadequately addressed AIG's long term liquidity concerns, thus requiring further government support.

- The New York Fed's negotiating strategy to pursue concessions from counterparties offered little opportunity for success;

- The New York Fed's assistance to AIG effectively transferred billions of dollars of cash from the Federal Government to AIG's counterparties, even though senior policy makers contend that assistance to AIG's counterparties was not a relevant consideration in fashioning the assistance to AIG.

- While the New York Fed may eventually be made whole on its loan to Maiden Lane III, it is difficult to assess the true costs of the AIG rescue until there is more clarity as to AIG's ability to repay all of its government loans.[6]

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[5] On March 17th, AIG filed an amended CTR with the SEC, disclosing the names of the counterparties and the aggregate amounts that each counterparty received, but still redacting information related to the individual securities that were purchased by Maiden Lane III.
[6] Special Inspector General for the Troubled Asset Relief Program (SIGTARP), "Factors Affecting Efforts to Limit Payments to AIG Counterparties" (Nov. 17, 2009).

Alleged Conflict of Interest

In January 2008, Stephen Friedman was appointed Chairman of the Board of Directors of the New York Fed. Mr. Friedman is a former Chairman of Goldman Sachs and since April 2005 has been a member of the Goldman Sachs Board of Directors. He has owned a substantial amount of Goldman Sachs stock since Goldman went public in 1999.

When Mr. Friedman became Chairman of the New York Fed, Goldman Sachs was not subject to New York Fed supervision. However, on September 21, 2008, during the height of the Wall Street meltdown, Goldman Sachs converted to a bank holding company and thus became subject to New York Fed supervision. As both a shareholder of Goldman Sachs and a Class C director of the New York Fed, Mr. Friedman was then in violation of Federal Reserve rules which prohibit Class C directors from owning stock in companies subject to Federal Reserve review. In October 2008, the New York Fed requested a waiver from the Federal Reserve Board of Governors in Washington to allow Mr. Friedman to continue serving as chairman of the New York Fed Board of Directors.

While the waiver request was still pending, in December 2008 Mr. Friedman purchased an additional 37,300 shares in Goldman Sachs. A month later, in January 2009, the Federal Reserve Board granted the requested waiver. In early May, Mr. Friedman's ownership interest in Goldman and his December stock purchase were widely reported in the news.[7] On May 7, 2009, he resigned from the New York Fed Board of Directors, citing a perception of a conflict of interest.

Witnesses

Panel 1

The Honorable Timothy F. Geithner
Secretary
U.S. Department of the Treasury

Panel II

The Honorable Henry M. Paulson Jr.
Former Secretary
U.S. Department of the Treasury

Panel III

Neil M. Barofsky
Special Inspector General for the Troubled Asset Relief Program

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[7] "New York Fed Chairman's Ties to Goldman Raise Questions," Wall Street Journal (May 4, 2009).

Thomas C. Baxter
General Counsel
Federal Reserve Bank of New York

Elias Habayeb
Former CFO, AIG Financial Services Division

Stephen Friedman
Former Chairman, Federal Reserve Bank of New York

Should you have any questions, please contact John Arlington or Chris Staszak of the Committee Staff at 5-5051.

Maiden Lane III

Counterparty Briefers

November 5, 2008

BLACKROCK SOLUTIONS

Societe Generale Negotiations

Negotiating Position: Societe Generale (Soc Gen) views the substantial expected recoveries on CDOs and the funding benefit from collateral posting as providing great negotiating leverage

- Soc Gen believes expected recoveries will exceed collateral shortfalls under the CDS. BlackRock cash flow projections support this view
  - Cash flow projections discounted at bond coupon in the base case indicate that Soc Gen's portfolio is of higher quality than other counterparties (based on projected value of 89% for Soc Gen vs. 86% for all counterparties)
- The funding benefit Soc Gen receives from AIG on collateral posted is the spread between LIBOR and Fed funds (Soc Gen receives LIBOR and pays AIG Fed funds)

Concessions: Soc Gen has been unwilling to sell reference CDOs to AIG below par

- Soc Gen would be resistant to deep concessions, i.e., anything greater than a few points, because it believes economic value from collateral and expected recoveries on CDOs are worth more than par in some cases
- Soc Gen expressed willingness to unwind lowest-quality trades at an effective price of ~90 but only if it retains the reference CDOs (i.e., for a CDO priced at 30%, Soc Gen keeps 70% collateral, receives 20% more in cash from AIG, keeps the bond and the upside, and rips up CDS with AIG). This arrangement would not be acceptable under the contemplated structure of Maiden Lane III.

Access to the Assets: We believe that Soc Gen owns most of the reference assets in its portfolio (~$14bn of $16.4bn)

- ~$2bn worth of reference assets may have been sold to Goldman Sachs
- We have heard second-hand from a trader that Soc Gen has pledged much of the portfolio to the Fed discount window for future liquidity

Other Factors

- Soc Gen and AIG are currently in dispute over existing events of default and credit events under transactions for 2 deals, totaling ~$650M of notional exposure

Societe Generale Portfolio Overview

Societe Generale is the largest counterparty

- $16.4 billion, representing 25% of total counterparty exposure

$1.4 billion in additional collateral has been requested, but not posted as of 10/24

- Societe Generale has received collateral independent amounts from a number of bonds that have been downgraded
- BlackRock's projected values are in line with values implied by collateral posted, but higher than collateral requested, i.e., BlackRock expects the portfolio to perform better than values implied by requested collateral

In the base case, Societe Generale's portfolio has similar expected losses to the overall portfolio, but in stress cases, Societe Generale's portfolio deteriorates more rapidly than the overall portfolio

Societe Generale's portfolio is heavily concentrated in subprime RMBS and in earlier vintages

- 52% of the portfolio is comprised of residential subprime securities, compared to only 36% for all counterparties
- 28% of the portfolio is concentrated in the 2004 vintage, compared to just 18% for all counterparties

There are fewer high quality assets in Societe Generale's portfolio on a relative basis, but the bottom of the credit spectrum resembles the overall portfolio

- Only 21% of Societe Generale's portfolio is rated AAA (vs. 36% overall)
- But below Investment Grade is identical between Societe Generale and the total portfolio (18%)

Goldman Sachs Negotiations

Negotiating Position: Goldman Sachs is the least risk averse counterparty, i.e., the only counterparty willing to tear up CDS with AIG at agreed-upon prices and retain CDO exposure

- Goldman approached AIG in August to discuss tearing up the CDS contracts
- BlackRock has advised AIG on tearing up 9 CDS in the Goldman portfolio with a $3bn notional
  - These transactions were selected because they were distressed positions likely to experience credit events and convert to cash positions in the next few years (converting to cash positions reduces any basis between the CDO and CDS values)
  - The bid-offer spread between AIG and Goldman on these CDS tear-ups is ~$300 million
- Goldman has expressed a willingness to negotiate tear-ups on additional trades (including 7 synthetic Abacus transactions)

Concessions: Goldman would likely accept a small concession but may look to its funders to absorb the loss (or a portion of the loss)

- Goldman's exposure to AIG is limited to the difference between collateral requested (what they are likely posting to swap counterparties) and collateral received at any given time from AIG. While hedging this AIG counterparty risk is expensive, the cost would translate into no more than 2 points on the whole portfolio
- Goldman's swap counterparties are exposed to Goldman Sachs rather than AIG counterparty risk, and are therefore less likely to be receptive to deep concessions

Access to the Assets: Goldman has said that it does not hold the cash CDOs, but has back-to-back swaps on most of the positions

Other Factors

- Because Goldman prices have been consistently lower than third-party prices, Goldman and AIG have negotiated a collateral posting protocol in which Goldman's prices are given a 12% positive haircut for collateral posting. Goldman's requested collateral amount, therefore, is generally 12% higher than the agreed collateral posting at any given time

Goldman Sachs Portfolio Overview

Goldman Sachs is the second largest counterparty

- $14.5 billion, representing 22% of total counterparty exposure

$1.3 billion in additional collateral has been requested, but not posted as of 10/24

- Goldman's collateral request does not reflect any haircut to Goldman prices per the protocol established with AIG, so at least a 12% gap attributable to the haircut will remain as long as the haircut protocol is effective
- BlackRock's projected values are higher than collateral requested, i.e., BlackRock expects the portfolio to perform better than values implied by requested collateral

The portfolio is projected to experience higher tranche principal losses than the overall portfolio in all cases (e.g., 15% higher than the total portfolio in the base case)

Despite a significant concentration in prime/agency RMBS, the overall quality of the portfolio is impaired by a large exposure to Alt-A RMBS

- 29% of the Goldman portfolio is prime/agency securities concentrated in a few high-quality CDOs, compared to only 17% for the total portfolio
- However, another 266 of the portfolio is comprised of Alt-A RMBS (vs. 17% of the total)
- Additionally, 55% of Goldman's portfolio is concentrated in 2005 vintage assets (compared to 38% total)

By rating, Goldman's portfolio is barbelled

- 38% of assets rated AAA (compared to 36%), but 25% are below Investment Grade (compared 18%)

BlackRock Solutions®

Deutsche Bank Negotiations

Negotiating Position: Since AIG owns the funded portions of the reference CDOs, terminating Deutsche Bank's financing facility will involve little negotiation

- Deutsche is financing AIG's position in 2a7 deals, including Project Max (which comprises the vast majority of Deutsche's portfolio with AIG)
- AIG believes that there are no early termination penalties for ending the funding facility
- If it were not terminated, Deutsche Bank's financing would roll off 3 to 6 years in a staggered fashion (and AIG would fund the reference CDOs piecemeal over that period)

Concessions: Thus far, Deutsche has not been approached to unwind the facility because of the liquidity benefit that Deutsche has provided to AIG

- Because Deutsche's funding commitment to AIG consumes a large amount of firm capital, we believe Deutsche would be amenable to some concession on the sales
- Deutsche's financing facility has allowed AIG to delay completely funding the Project Max trade and other 2a7 deals (although AIG has posted ~$2.8bn collateral to Deutsche)
- AIG would be the party to sell the reference CDOs into any structure, after providing to Deutsche the full notional balance (minus any collateral already posted) that Deutsche has funded

Access to the Assets: Based on anecdotal information, we believe that Deutsche is holding the reference CDOs

Deutsche Bank Portfolio Overview

Deutsche Bank is the third largest counterparty

- $7.6 billion, representing 11% of total counterparty exposure
- Almost all of the exposure is comprised of the Project Max CDO, with is backed by AAA CMBS / CRE

$0.1 billion in additional collateral has been requested, but not posted as of 10/24

- Although Project Max is not expected to experience any principal losses, collateral posting is driven by CMBX spreads
- The difference between BlackRock's model price in the base case and extreme stress case reflect a higher discount rate applied to the base case cashflows associated vs. discounting at LIBOR for the extreme stress case

Deutsche's portfolio has virtually no forecast tranche principal losses in all cases

Merrill Lynch Negotiations

Negotiating Position: Merrill Lynch feels that its inexpensive financing and collateral received from AIG limits any incentive to unwind trades at less than par

- Merrill has indicated that in some cases it has locked in inexpensive, long-term financing for the CDOs for which it has purchased protection from AIG. In other cases, Merrill's financing is short-term
- In discussions regarding sale of the reference CDOs, Merrill was not willing to extend financing under any terms to AIG

Concessions: Merrill has been unwilling to sell reference CDOs to AIG below par

- Like Societe Generale, Merrill will likely be resistant to deep concessions because they are satisfied with the current arrangement, but may be receptive to a small concession
- Merrill was not interested in tearing up any CDS with AIG and keeping the reference CDOs

Access to the Assets: Based on discussions with traders, Merrill owns many of the reference CDOs and finances them with third-party banks and conduits

Merrill Lynch Portfolio Overview

Merrill Lynch is the fourth largest counterparty

- $6.4 billion, representing 10% of total counterparty exposure

There have been no additional collateral requests since 10/24

- Merrill requests collateral in line with its own marks (rather than third-party marks) on the positions
- BlackRock's projects the portfolio to perform worse than values implied by collateral requested

Merrill's portfolio is projected to experience higher tranche principal losses than the total portfolio under every scenario

The portfolio is heavily overweight subprime and inner CDOs

- 47% of the portfolio is concentrated in subprime RMBS (compared to 36% overall)
- 20% of the portfolio is comprised of inner CDOs (compared to 10% for the entire portfolio)
- 90% is concentrated in the 2004-2006 vintages (compared to 80% overall)

Only 19% of the portfolio is rated AAA (compared to 36%), while 25% is below Investment Grade (compared to 18% total)

Calyon Negotiations

Negotiating Position: Calyon is highly dependent on AIG collateral posting because of the lower quality of collateral backing its portfolio, and has been aggressive with collateral requests

- Because of independent amounts (IAs) of collateral due to bond downgrades, Calyon's portfolio is well-collateralized by AIG
- Calyon has not been receptive to tearing up the CDS with AIG and retaining the credit risk of its CDO positions

Concessions: Calyon will likely be receptive to a small concession because its portfolio is comprised of CDOs backed by lower quality collateral, but would resist deep concessions because of its overcollateralized position (and because in some cases collateral posting already approaches par)

Access to the Assets: Based on anecdotal information, we believe Calyon owns the reference CDOs

Other Factors:

- For one transaction in the Calyon portfolio (Davis Square V), the bond's downgrade has resulted in AIG's posting of par (bond price = 25 and independent amount upon downgrade = 25, reducing the value to 0)
- AIG has disputed Calyon's collateral request for other transactions in the portfolio (those with marks from Goldman Sachs, since AIG does not give full credit to Goldman's marks for collateral posting purposes). In turn, Calyon will not send the Davis Square V cash CDO to AIG despite the fact that AIG has posted par

Calyon Portfolio Overview

Calyon is the fifth largest counterparty

- $4.3 billion, representing 7% of total counterparty exposure

$0.3 billion in additional collateral has been requested since 10/24

- Calyon is expected to request more collateral due to independent amounts as bonds have been downgraded
- BlackRock's projected values are significantly higher than Calyon's collateral requests, i.e., BlackRock expects the portfolio to perform better than values implied by collateral requests

Calyon's portfolio is forecast to experience higher tranche principal losses in all scenarios, and exhibits disproportionally worse performance in extreme stress scenarios

The portfolio is heavily overweight subprime and slightly overweight Alt-A

- 56% is subprime (compared to 36% overall)
- 19% is Alt-A, slightly higher than the total portfolio (17%)
- 53% of the portfolio is concentrated in the 2005 vintage (vs. 38% overall)

Only 22% of the portfolio is rated AAA (compared to 36%), and 16% is below Investment Grade (compared to 18% total)

UBS Negotiations

Negotiating Position: UBS has expressed strong interest in providing seller repo-financing to facilitate AIG's purchase of the CDOs in the UBS portfolio

- Although talks are now on hold, the preliminary term sheet contemplated that the difference between par and the collateral posted would be submitted by AIG to UBS in the form of highly rated CLO collateral, held by UBS with a 10% haircut for AAA-rated positions, and a 35% haircut for positions rated AA, A and BBB
- Much of the focus for the repo transaction centers on Triaxx, a CDO that is nearly half of the UBS portfolio ($1.9bn out of $4.2bn), backed by 92% AAA RMBS collateral (53% prime / agency), and is not projected to experience losses in the BlackRock stress case, and little loss in the extreme stress case (value of 95 in the extreme stress case when cash flows are discounted at the bond coupon)

Concessions: Because a significant portion of the UBS portfolio (Triaxx) is very high quality with little expectation of losses, UBS is likely to resist any deep concession

Access to the Assets: Based on negotiations with UBS, we believe that UBS has repo'ed parts of the portfolio (Triaxx and Ischus), but has access to the reference CDOs

UBS Portfolio Overview

UBS is the sixth largest counterparty

- $4.2 billion, representing 6% of total counterparty exposure

$0.6 billion in additional collateral has been requested since 10/24

- BlackRock expects the portfolio to perform slightly worse than values implied by collateral requested to date

UBS's portfolio is projected to perform in line with the overall portfolio in each scenario

The portfolio is heavily overweight prime/agency and Alt-A RMBS, with a concentration in 2005 and 2006 vintages

- 30% in each Alt-A and prime/agency (compared to 17% each for the overall portfolio)
- The portfolio is overweight 2006 (35% vs. 23% overall) and underweight 2004 (12% vs. 18% overall)

While 15% of the portfolio is rated AAA (compared to 36%), 21% is below Investment Grade (compared to 18% total)

- AAA assets are found in the Triaxx CDO, while the other CDOs in the portfolio are of significantly lower quality

ML III:
Alternative Structure Options
for Example Counterparty

October 22, 2008

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Contents

I. **Overview of CDO Collateral and Modeling Assumptions**

- Stratifications of the underlying collateral
- Comparison of counterparty and AIG marks versus BLK
- Benchmark of BlackRock loss assumptions on ABX

II. **Define the Solution Set**

III. **Focus on "Mezz Swap" Option**

- Structuring choices
- Stress scenario overviews and "breaking the loan"

Goals for this meeting:

- Clarify BLK analytics/areas for further elaboration
- Confirm set of viable structures
- Create full book for principles immediately afterwards

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Cumulative Loss Estimates by Vintage

Mortgage Model - Base and Stressed Case

Base Case	*Stressed Case*
HPA Projection:	**HPA Projection:**
20% peak to trough U.S. home price decline	45% peak to trough U.S. home price decline
40% peak to trough California home price decline	65% peak to trough California home price decline
Cumulative loss estimates	**Cumulative loss estimates**
Subprime 2004-1: 5%	Subprime 2004-1: 6%
Subprime 2004-2: 6%	Subprime 2004-2: 8%
Subprime 2005-1: 9%	Subprime 2005-1: 11%
Subprime 2005-2: 13%	Subprime 2005-2: 16%
ABX.06.1: 18%	ABX.06.1: 23%
ABX.06.2: 25%	ABX.06.2: 32%
ABX.07.1: 31%	ABX.07.1: 41%
ABX.07.2: 35%	ABX.07.2: 49%

Comparable Loss Estimates

Industry Benchmarks

CumLoss%	BARC	Citi	JPM	UBS
Dealer Assumption	Mkt Imp	-30 HPA	-15% HPA	HPA Method
ABX.HE 06-1	21.3	20.0	17.9	14.3
ABX.HE 06-2	21.6	27.9	25.6	22.7
ABX.HE 07-1	33.7	34.8	32.6	32.8
ABX.HE 07-2	44.9	40.3	37.7	41.8

The stress case is 1.5x the default rate in the base case; extreme stress is 3x base (not on page)

We created four hypothetical indices (2004-1, 2004-2, 2005-1, 2005-2) to mirror later ABX series

- Deal issued within 6 months prior to launch date (e.g., 2004-1 index uses deals issued in the second half of 2003)
- No more than four deals with the same originator
- Rated by Moody's and S&P (the AAA tranche is referenced in the index)

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Marks

Tranche Name	CUSIP	ML Exposure	ML Price	Collateral Posting Requested	AIG Price	IRR used to discount CFs	Cashflows Discounted for IRR (% of Current Face) Base	Stress	Extreme Stress
ANPT 2006-1A A1	612130AA7	79,934,156	14.7	76,139,575	14.8	20	8	15	11
INDES 6A A1	45377TAA4	277,572,357	34.7	195,108,158	41.8	20	34	27	21
NEPTN 2005-2A A	64069RAA2	155,346,315	44.7	131,906,318	34.4	20	25	18	15
DUKEF 2005-8A A1S	26440VAA2	630,930,062	46.2	351,627,214	43.2	20	35	28	19
GLCR 2005-3A A1	37638XAA7	245,509,946	65.5	98,647,869	53.2	20	36	32	29
NEPTN 2004-1A A1A	640639AA2	101,950,809	46.7	56,375,710	49.3	20	35	27	13
BNLI 2006-1A A1A	085558AA2	498,377,915	27.5	439,136,431	38.4	15	42	39	33
BNLI 2006-1A A1B	085558AC8	560,000,000	62.4	171,331,575	38.4	15	49	43	41
STRAG 2004-2A A	86256PAA0	94,150,454	99.0	941,595	75.2	20	50	43	41
CASF 2004-1A A1	147276AA7	179,744,230	67.8	57,819,432	64.5	15	55	51	46
FTSHR 2005-1A A1	348657AA4	655,615,050	48.6	369,445,939	51.8	15	42	37	34
FTSHR 2005-1A A1	348657AA4	84,053,212	48.6	47,364,864	51.8	15	42	37	34
JPTF 2005-3A A1	46205YAA5	739,037,254	52.0	354,433,660	51.9	15	48	43	42
INDES 5A A1	45340PAA0	56,906,577	64.4	24,800,069	58.8	20	49	45	36
MRCY 2004-1A A1VB	58934RAA7	177,090,112	66.5	58,623,523	67.5	15	52	46	39
LAKES 2004-1A A1	51210VAA8	641,598,970	73.1	172,930,864	82.9	15	62	58	56
KLROS 2005-1A A1	49853TAA2	352,415,509	64.5	125,541,830	63.7	15	55	51	49
STRVL 2004-1A A1	863236AA8	440,250,893	66.1	149,051,959	78.0	15	59	56	53
SCF 4A A1	80743TAA2	55,222,162	99.0	658,221	95.0	20	74	71	62
SCF 5A A1	84129VAA9	113,613,478	97.3	3,036,130	95.0	20	61	58	52
SHALE 2005-2A S	KEE0QSPR5	340,837,407	40.4	221,951,743	44.6	20	20	19	13
TCRO 2005-1A A	891038AA4	855,775,755	47.6	455,475,530	49.6	NA	NA	NA	NA
Total		**7,154,940,565**	**53.6**	**3,542,418,159**	**54.8**	**17**	**45**	**40**	**37**

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FRBNY-TOWNS-R1-195976

BLK Cash Flow Projections

	Cashflows Discounted at Bond Coupon (% of Current Face)			Collateral Principal Losses			CDS Credit Event Date		
Tranche Name	Base	Stress	Extreme Stress	Base	Stress	Extreme Stress	Base	Stress	Extreme Stress
VNPT 2006-1A A1	57	24	14	83	86	87	7/6/10	4/7/11	7/6/09
INDE6 6A A1	72	48	28	65	76	82	8/5/11	11/5/10	11/5/09
NEPTN 2005-2A A1	65	40	24	74	81	86	8/8/11	3/8/10	8/7/09
DUKEF 2005-8A A1S	75	51	26	63	76	84	1/7/13	7/7/11	7/7/10
GLCF 2005-3A A1	75	59	46	55	62	72	2/4/14	8/4/11	8/4/10
NEPTN 2004-1A A1LA	83	57	30	53	70	82	9/10/15	12/13/11	6/10/10
BNLI 2006-1A A1A	75	62	49	43	63	65	6/5/18	12/5/13	7/5/12
BNLI 2006-1A A1B	91	84	84	43	60	65	7/5/18	7/7/14	11/5/03
STRAG 2004-2A A1	9?	78	54	30	56	71	2/10/20	3/9/17	8/8/12
CASF 2004-1A A1	89	81	67	27	37	51	6/3/25	3/3/20	3/3/17
FTSHR 2005-1A A1	83	69	52	23	39	59	5/5/28	3/5/13	8/6/12
FTSHR 2005-1A A1	83	69	52	23	39	59	5/5/28	3/5/13	8/6/12
JPTR 2005-2A A1	93	80	65	21	35	46	5/5/24	5/5/21	8/5/12
INDE5 5A A1	94	82	68	72	74	78	5/5/04	2/5/21	6/6/11
MPCL 2004-1A A1VB	92	81	65	17	34	53	6/8/34	6/8/28	12/8/13
LAKES 2004-1A A1	99	93	87	14	24	36	7/3/34	1/2/32	10/4/21
KLRCS 2005-1A A1	96	85	68	4	19	44	1/8/35	7/6/28	7/6/12
STRVL 2004-1A A1	100	93	80	10	21	34	None	11/3/32	11/3/21
SCF 4A A1	100	100	79	40	48	62	None	None	10/7/19
SCF 5A A1	100	99	75	33	48	61	None	11/7/31	8/8/16
WHALE 2005-2A 3	57	35	22	61	75	84	None	9/20/39	3/20/14
TORO 2005-1A A	NA	NA	NA	NA	NA	NA	NA	NA	NA
Total	**85**	**71**	**56**	**35**	**49**	**60**			

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Sector Breakdown

Tranche Name	CUSIP	Exposure	Resi - Subprime	Inner CDOs	Resi - Alt-A	Other Resi (Prime/Agency)	CMBS	ABS (Student Loans, Auto, Credit Cards)	Other
MNPT 2006-1A A1	612180AA7	79,931,156	33%	10%	3%	4%	2%	0%	0%
INCE6 6A A1	45377TAA4	277,572,357	72%	10%	9%	6%	2%	2%	0%
NEPTN 2005-2A A1	64069RAA2	155,346,315	67%	8%	11%	12%	1%	0%	1%
DUKEF 2005-8A A1S	25440VAA2	630,920,062	56%	3%	29%	11%	1%	0%	0%
GLCR 2005-3A A1	37638KAA7	242,502,240	50%	2%	22%	13%	8%	2%	0%
NEPTN 2004 1A A1LA	640699AA2	101,950,809	61%	10%	15%	8%	6%	0%	0%
ENLI 2006-1A A1A	035558AA2	498,377,919	35%	33%	20%	12%	0%	0%	0%
ENLI 2006-1A A1B	035553AC8	360,000,000	35%	33%	20%	12%	0%	0%	0%
STRAS 2004-2A A1	85258PAA0	94,153,454	55%	20%	11%	6%	2%	5%	1%
CASF 2004-1A A1	147276AA7	179,744,230	31%	36%	13%	19%	0%	0%	0%
FTSHR 2005-1A A1	348667AA4	655,615,050	38%	25%	20%	17%	0%	0%	0%
FTSHR 2005 1A A1	348667AA4	84,053,212	38%	25%	20%	17%	0%	0%	0%
JPTR 2005-2A A1	49205YAA5	739,037,254	49%	20%	16%	13%	0%	0%	2%
INCE5 5A A1	45343PAA3	56,906,577	62%	1%	12%	8%	8%	7%	1%
MKLT 2004-1A A1VB	59936RAN1	177,050,112	44%	21%	9%	26%	0%	0%	0%
LAKES 2004-1A A1	51210VAA8	641,998,970	33%	35%	6%	25%	0%	0%	0%
ILROQ 2005 1A A1	462587AA2	350,419,505	58%	12%	9%	16%	0%	0%	5%
STRVL 2004-1A A1	863286AA8	440,250,893	41%	19%	21%	18%	0%	0%	0%
SCF 4A A1	83743TAA2	65,822,112	38%	9%	7%	15%	14%	8%	7%
SCF 5A A1	84129VAA9	113,613,478	42%	9%	6%	11%	19%	13%	0%
WHALE 2005-2A 5	96332SFH5	343,817,407	63%	4%	9%	4%	0%	0%	1%
TORO 2005-1A A	891088AA4	855,779,755	47%	25%	9%	19%	0%	0%	0%
Total		**7,154,910,565**	**48%**	**20%**	**15%**	**15%**	**1%**	**1%**	**1%**

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Ratings Breakdown

Tranche Name	CUSIP	Exposure	Aaa	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Below Baa3	NR
MNPT 2006-1A A1	61218DAA7	79,534,156	1%	0%	0%	0%	0%	0%	0%	6%	1%	4%	82%	6%
INDE5 6A A1	45377TAA4	277,572,357	0%	0%	1%	0%	1%	1%	0%	13%	14%	10%	58%	1%
NEPTN 2005-2A A1	64069RAA2	155,345,315	0%	1%	1%	1%	0%	2%	3%	10%	6%	6%	59%	3%
DUKEF 2005 8A A1S	26440VAA2	630,930,062	2%	1%	8%	1%	0%	5%	2%	7%	14%	7%	49%	3%
GLCR 2005-3A A1	37638XAA7	249,509,940	15%	1%	3%	0%	4%	8%	5%	3%	9%	3%	44%	3%
NEPTN 2004-1A A1LA	640699AA2	101,950,809	0%	1%	2%	4%	4%	10%	1%	5%	21%	5%	37%	1%
BNLI 2006-1A A1A	085558AA2	496,377,919	22%	7%	10%	8%	6%	4%	1%	4%	3%	1%	34%	1%
BNLI 2006-1A A1B	085558AC8	300,000,000	22%	7%	10%	8%	6%	4%	1%	4%	3%	1%	34%	1%
STRAG 2004-2A A1	86358PAA1	94,157,454	0%	1%	1%	0%	0%	8%	3%	10%	17%	14%	41%	1%
CASF 2004-1A A1	147276AA7	179,744,230	23%	13%	11%	5%	5%	9%	8%	2%	2%	1%	21%	0%
FTSHR 2005-1A A1	348667AA4	655,615,050	25%	8%	7%	5%	5%	11%	6%	5%	6%	2%	17%	1%
FTSHR 2005 1A A1	348667AA4	84,053,212	25%	8%	7%	5%	5%	11%	6%	5%	6%	2%	17%	1%
JPTF 2005-2A A1	48305YAA5	729,197,254	15%	17%	18%	4%	3%	8%	7%	4%	6%	3%	17%	0%
INDE5 5A A1	45343PAA3	56,906,577	4%	0%	0%	1%	1%	3%	1%	4%	11%	14%	58%	3%
MAC 2004-1A A1V3	58936RAN5	177,090,112	7%	19%	28%	10%	1%	6%	14%	4%	1%	2%	9%	0%
LAKES 2004-1A A1	51210VAA8	641,223,970	37%	5%	12%	8%	4%	7%	5%	2%	5%	1%	5%	1%
KIROS 2005-1A A1	49855?AA2	359,414,505	18%	27%	16%	9%	3%	6%	3%	3%	4%	1%	10%	0%
STRVL 2004-1A A1	863286AA8	440,250,893	35%	5%	23%	4%	2%	9%	2%	5%	4%	6%	6%	0%
SCF 4A A1	83748TAA2	61,822,112	1%	0%	1%	1%	4%	1%	11%	10%	24%	5%	33%	2%
SCF 5A A1	84129VAA9	110,513,478	0%	1%	2%	1%	1%	14%	4%	13%	30%	5%	25%	1%
KHALE 2005-2A S	1EEJ5SFP8	342,897,407	0%	6%	4%	1%	0%	7%	4%	6%	8%	10%	57%	1%
TORO 2005-1A A	891088AA4	855,779,755	31%	0%	17%	1%	7%	8%	1%	4%	10%	1%	19%	0%
Total		**7,154,940,565**	**18%**	**6%**	**12%**	**4%**	**3%**	**7%**	**4%**	**5%**	**8%**	**4%**	**27%**	**1%**

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Vintage Breakdown

Tranche Name	CUSIP	Exposure	2001	2002	2003	2004	2005	2006	2007	2008	Other
ANPT 2005-1A A1	612180AA7	74,931,756	0%	0%	0%	4%	86%	6%	1%	1%	0%
INDE6 6A A1	45377TAA4	277,572,357	0%	0%	0%	33%	43%	19%	0%	0%	0%
NEFTN 2005-2A A1	64069FAA2	155,346,315	1%	0%	2%	29%	59%	2%	5%	2%	1%
DUKEF 2005-8A A1S	26440VAA2	630,930,062	0%	0%	2%	51%	27%	11%	8%	0%	1%
CLCR 2005-3A A1	37638XAA7	249,509,940	1%	0%	0%	52%	44%	2%	2%	0%	0%
NEFTN 2004-1A A1LA	64069SAA2	101,950,809	2%	0%	3%	44%	7%	20%	22%	3%	0%
BNLI 2006-1A A1A	085558AA2	438,377,919	0%	0%	0%	0%	86%	14%	0%	0%	0%
BNLI 2006-1A A1B	085558AC8	360,000,000	0%	0%	0%	0%	86%	14%	0%	0%	0%
STFAG 2004-2A A1	86256FAA0	84,150,454	0%	0%	4%	47%	11%	38%	0%	0%	0%
CASF 2004-1A A1	147276AA7	179,744,230	2%	2%	20%	37%	25%	11%	0%	0%	1%
FTSHR 2005-1A A1	348667AA4	650,615,050	0%	1%	4%	39%	44%	8%	3%	0%	1%
FTSHR 2005 1A A1	348667AA4	84,053,212	0%	1%	4%	39%	44%	8%	3%	0%	1%
JPTR 2005-2A A1	48205YAA5	729,027,254	1%	0%	[illegible]	61%	33%	3%	0%	0%	0%
INDE5 5A A1	45343FAA3	56,906,577	0%	2%	15%	12%	12%	57%	3%	0%	1%
MRCY 2004-1A A1V3	58836FAH7	177,050,112	3%	0%	8%	54%	25%	5%	0%	2%	1%
LAKES 2004-1A A1	51210VAA8	641,998,970	1%	2%	15%	42%	0%	31%	0%	7%	2%
KLFOS 2005-1A A1	498587AA2	353,419,505	1%	0%	3%	41%	53%	0%	1%	0%	0%
STRVL 2004-1A A1	863286AA8	440,250,893	1%	1%	10%	57%	20%	6%	0%	5%	0%
SCF 4A A1	83743TAA2	65,022,112	0%	6%	54%	4%	33%	1%	2%	0%	1%
SCF 5A A1	84129VAA9	113,613,478	2%	0%	10%	49%	30%	0%	2%	6%	0%
KHALL 2005-2A A	[illegible]	343,857,467	0%	0%	0%	59%	30%	8%	3%	0%	0%
TORO 2005-1A A	891088AA4	865,779,755	1%	0%	3%	25%	68%	3%	0%	0%	0%
Total		**7,154,940,565**	**1%**	**1%**	**5%**	**30%**	**42%**	**10%**	**2%**	**1%**	**1%**

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DRAFT - FOR DISCUSSION PURPOSES

Gating Issue: Counterparty Willingness to Deal

Problem: Liquidity drain from mark to market collateral requirements

Objective: Eliminate liquidity drain

Counterparties' incentives to deal appear to depend on whether they have a net hedged or naked position

Observed responses from GS and ML so far track this hypothesis

Key point: for many deals, the counterparties have very little incentive to tear up near current market value, let alone intrinsic value

Incentives for Various Counterparties

		Incentive to	
Counterparty Status	Example	Novate to funded SPV	Tear up at market value
Has reference bond	Merrill Lynch	Yes - eliminates residual risk	No - creates risk
Lacks reference bond but has mirror hedge	Goldman Sachs	Yes - eliminates residual risk	No - creates risk
Naked synthetic short	Goldman Sachs	Yes	Unclear

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PM's/Credit R/S totals kept real time. Quant Research Analysts kept updated quarterly only.
Fixed Quant R/S analysts = RMAG - TSG -Research (credit) -Equity Quant

No Technology in this Quant. Research figure

Pie cht here is all fixed, not just tax-exempt, as it was requested we make foot to numbers in previous slide
Table shows US, tax exempt, fixed income - Portfolios are # of assignments, not clients.

Talking points:

1. **While our asset base and number of clients has grown, we have managed this growth carefully over the years**. As you can see, we have built a substantial team that is dedicated to managing fixed income portfolios. This team includes: 31 portfolio managers, 21 credit research analysts, and over 100 quantitative analysts. It is important to note that when you hire BlackRock, you get not only ________(PM in the meeting), but the full resources of the entire team!

2. **We are often asked about the advantages and disadvantages of size**. Over the past few years, size has become increasingly important as the market has changed. Wall Street (broker dealers) used to be the primary source of liquidity for the fixed income markets, but ever since Long-Term Capital's demise, they have backed away from this role due to both consolidations and a reluctance to take risks. In this environment, larger managers can use their size to demand better service, including larger allocations on new issue corporates, better liquidity across sectors when selling bonds, more access to traders, and faster access to research professionals. Size also enables us to continue to invest in our team, adding both experienced professionals and junior professionals in both portfolio management and research.

(Note: Below I have printed Andy's complete remarks as they were particularly good and may be especially useful in a Q&A setting where you have already exhausted the basics stated above.)

3. **Your mandate would be very important to us.** We manage $____ assets for __________[public] [corporate] pension clients, and ____% of our institutional clients have assets of similar size to the mandate you are contemplating. We are proud of the client relationships that we have developed, and have found it particularly rewarding that much of our growth every year has come from our existing clients.

(Note: It is very important to CUSTOMIZE your book on this point to show that you care about them and have given it a little thought. The similar size comment is an especially useful point to make for the $100mm and under mandates.)

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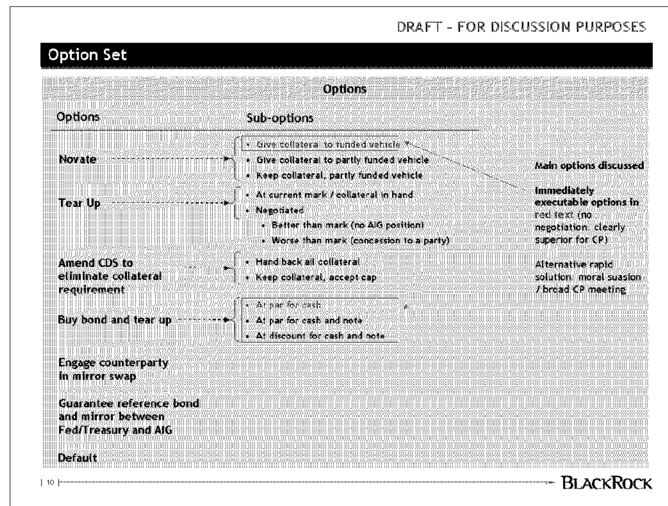

PM's/Credit R/S totals kept real time. Quant Research Analysts kept updated quarterly only.
Fixed Quant R/S analysts = RMAG - TSG -Research (credit) -Equity Quant

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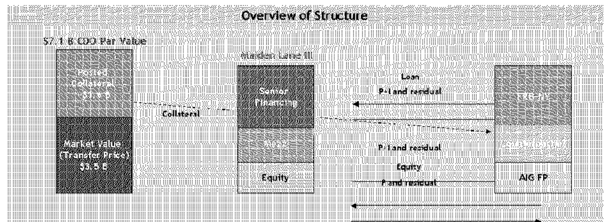
Focus on Mezz Swap Option



	1. Transfer price?	2. Size of senior, mezz, equity tranches?	3. Terms of tranches?	4. Triggers to protect senior note	5. Additional Options
Options	• At current marks • Lower	• Larger equity or mezz tranche	• Coupons • PIKs or not	• Full turbo to debt vs upfront cashflows to mezz, equity • E.g. OC, MV, mark to model tests, LTV	• Over-collateralization (i.e. AIG contributes unencumbered FP assets as reserve

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Stress Cases and Breaking the Loan

BlackRock's models use collateral characteristics and assumptions such as HPA to determine base case cash flow projections

Stress scenarios are designed as a shock to the base case default, severity and prepayment rates

Stress Cases: Shocks to Outputs Relative to Base

	Base	Stress	Extreme Stress
Default Rates	100%	150%	300%
Severity	100%	100%	100%
Prepayment	100%	100%	100%

"Break the Loan" Scenario

An "on top" adjustment was performed to provide a rough approximation of the "break the bond" scenario

- Objective: find a circumstance under which principal on the Senior Debt is paid back, but no return above LIBOR

Extreme Stress cash flows were haircut in order to determine the level of cushion

Taking 55% of the principal projected under this scenario breaks the bond

- 56% does not break the bond

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Meg McConnell/NY/FRS
10/22/2008 11:05 PM

To Timothy Geithner/NY/FRS@FRS
cc Michael Silva/NY/FRS@FRS
bcc
Subject Call tonight with Board staff

I sat in on the AIG call with Board staff at 7:30 (originally scheduled for 7 but moved to 7:30 so that Jester could spend a half an hour telling Sarah that there will be no capital and that we need to make "something else" work).
Before and after that call, the team explained to me a bit more about ML 2 and 3, and 3 in particular. Some things that I noted:

1. The new ML 3--in which they tear up the CDS and purchase the underlying CDOs--seems pretty good from a financial stability perspective (if it can be done), better than the original one they'd proposed bc it seems to remove considerably more uncertainty for the firms and arguably for the system. Some outstanding issues around this are:
- The discrepancy bw what our advisors are saying these CDO's are worth and where the firms have them marked.
- The degree to which we'd want to push the firms that would sell CDOs to the structure to put up a mezz tranche that would either (or both?) cushion our exposure or reduce the size of the equity required from AIG in the structure.
- To what extent do AIG's CDS counterparties actually hold the underlying CDO's on their books? My impression is that for a bunch of the European banks the answer might be yes, but for others it's not clear, and may lean a little more toward no. I think this could matter for actually being able to get this done, but I'm not sure.

2. Leaving aside Treasury's unfortunate (untenable?) stance on this, Board staff still doesn't seem to be attacking this in a "here's what we need to do and why" kind of way. I know they've been much more supportive very recently, but given what's at stake and the speed with which a bunch of decisions need to be made to avoid a bad rating outcome, they seem not quite as focused on helping us sort out the thorny bits as they could be. Some of the things that I noted on this from the call:

- On ML2 and ML3, the staff noted that the lawyers were still not quite "there" on 2, let alone on 3. Not clear what they are waiting for on these things, but it seems like they should say yes or no fast because we're running out of time to devise new structures
- Getting the right balance of extending the term and lowering the rate on the facility. Here there was a view that lowering the rate would be too "provocative", so extending term would be better. The point was made that we need both, but I wasn't clear whether they fully appreciated this.
- Neither Treasury nor us can provide guarantees. Treasury bc of scoring and us for the usual reasons. So the presumption was that keepwells are off the table.
- Neither Treasury nor us can put capital in. I guess Tom is calling Scott to talk through the subordination issue, though Sarah stressed that leverage ratio constraints meant that some form of equity and not debt was required.

Overall, what seemed to be missing in the way Board staff talked with our team about these issues was an appreciation of the fact that without making some combination of all or at least most of these things happen within a very short period of time, the firm will be downgraded and we'll be forced to do way more on all those fronts. And that maybe even if we did way more on all these fronts, a downgrade would lead to a default and we'd undo all that's been done from a financial stability perspective over the last two weeks, and we'd lose the public's trust at a really bad time to lose it. I hope they see the potential for that scenario to be just as "provocative" to Congress as one in which we take the rate down from this crazily high one that was forced on us (meaning FRBNY) by people that have since punted on all the hard things that came about as a result of the decision to lend that all of us knowingly made together that weekend.

Again, my sense is that Board staff is listening to our guys and is generally supportive of their effort, but they seem to be operating under the assumption that we have way more wiggle room on this than I understand us to have. Anyway, I think you know all this, but I wanted to pass along my impressions in advance of the calls tomorrow.

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HOUSE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

STATEMENT OF NEIL BAROFSKY

SPECIAL INSPECTOR GENERAL
FOR THE TROUBLED ASSET RELIEF PROGRAM

BEFORE THE
HOUSE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

January 27, 2010

Chairman Towns, Ranking Member Issa, and Members of the Committee, I am honored to appear before you today to discuss SIGTARP's audit examining the factors affecting efforts to limit payments to American International Group ("AIG") counterparties that was released back in November,[1] as well as to discuss several troubling issues that have come to light since the audit was released that relate to whether the Government has been fully transparent with the American people with respect to the AIG transactions.

Before I begin, I would like to thank the Committee for both its strong support and its leadership on this issue. SIGTARP's audit was commenced as the result of a letter request made by Congressman Cummings and 26 other Members of Congress, including several members of this Committee, and the tenacity and leadership demonstrated by the Chairman, Ranking Member and many other members of this Committee has been crucial in continuing the drive for transparency and accountability on the AIG bailout in general and the counterparty payments in particular.

FACTUAL BACKGROUND

In September 2008, AIG was on the brink of collapse, unable to access credit in the private markets and bleeding cash. On September 16, 2008, the Federal Reserve Bank of New York ("FRBNY"), pursuant to the authorization of the Board of Governors of the Federal Reserve System ("Federal Reserve Board," and, collectively with FRBNY, "Federal Reserve") provided AIG with an $85 billion loan. On November 10, 2008, the Federal Reserve and the Department of the Treasury ("Treasury") announced the restructuring of the Government's financial support to AIG. As part of this restructuring, the Federal Reserve Board authorized FRBNY to lend up to $30 billion to Maiden Lane III, a newly formed limited liability company. Pursuant to this authorization, FRBNY lent $24.3 billion to Maiden Lane III, which, in

[1] A copy of the audit is appended hereto for the Committee's reference.

combination with a $5 billion equity investment from AIG, was used to fund the purchase of assets from counterparties of American International Group Financial Products ("AIGFP") having a fair market value of about $27.1 billion. In exchange for that payment and being permitted to retain $35 billion in collateral payments that had been previously made by AIG (including billions in collateral payments made possible by the FRBNY loan), the counterparties agreed to terminate their credit default swap contracts—insurance-like contracts intended to protect the underlying assets—with AIGFP. Because the counterparties were both paid the fair market value of the assets underlying the credit default swap contracts and permitted to keep the collateral that had previously been posted, the counterparties were effectively paid the par value of the underlying assets.

In light of this factual context, and consistent with the issues raised by Congressman Cummings and others, SIGTARP's audit addressed (1) the decision-making processes leading up to the creation of Maiden Lane III, (2) why AIG's counterparties were paid effectively at par value, and (3) AIG's current exposure to credit default swaps outside Maiden Lane III.

SIGTARP'S AUDIT FINDINGS

SIGTARP's audit, which was issued on November 17, 2009, found that, when first confronted with the liquidity crisis at AIG, the Federal Reserve Board and FRBNY, who were then contending with the demise of Lehman Brothers, turned to the private sector to arrange and provide funding to stave off AIG's collapse. Confident that a private sector solution would be forthcoming, FRBNY did not develop a contingency plan, and, when private financing fell through, FRBNY was left with little time to decide whether to rescue AIG and, if so, on what terms. Having witnessed the dramatic economic consequences of Lehman Brothers' bankruptcy just hours before, senior officials at the Federal Reserve and Treasury determined that an AIG

bankruptcy would have far greater systemic impact on the global financial system than Lehman's bankruptcy and decided to step in to prevent that result.

Not preparing an alternative to private financing, however, left FRBNY with little opportunity to fashion appropriate terms for the support, and, believing it had no time to do otherwise, it essentially adopted the term sheet that had been the subject of the aborted private financing discussions (an effective interest rate in excess of 11 percent and an approximate 80 percent ownership interest in AIG), albeit in return for $85 billion in FRBNY financing rather than the $75 billion that had been contemplated for the private deal. In other words, the decision to acquire a controlling interest in one of the world's most complex and most troubled corporations was done with almost no independent consideration of the terms of the transaction or the impact that those terms might have on the future of AIG.

The impact of those terms, however, soon became apparent to FRBNY. In a matter of days, FRBNY officials recognized that, although the $85 billion credit line permitted AIG to meet billions of dollars of collateral calls and thus avoid an immediate bankruptcy, its terms were unworkable. Among other things, the interest rate imposed upon AIG was so onerous that, if unaddressed, the burden of servicing the FRBNY financing greatly increased the likelihood that there would be further credit rating downgrades for AIG, a result that FRBNY officials believed would have "devastating" implications for AIG. For this and other reasons, modification of the original terms thus became inevitable. One example of such modification was Treasury's $40 billion investment in AIG in November 2008 through the Troubled Asset Relief Program ("TARP") — which was used to pay down the FRBNY loan in part. Another was termination of a portion of AIG's credit default swap obligations made possible through the creation of Maiden Lane III.

A significant cause of AIG's liquidity problems stemmed from its obligations to post collateral (cash payments that equaled the drop in value of the underlying securities) in connection with AIGFP's credit default swap contracts. To avoid the necessity for AIG to continue to post collateral and to reduce the danger of further rating agency downgrades, by early November 2008, FRBNY decided to create Maiden Lane III, a special purpose vehicle, to retire a portion of AIG's credit default swap portfolio by purchasing the underlying CDOs from the swap counterparties, which eased pressure on FRBNY's credit line and transferred the issues with these contracts off of AIG's balance sheet and on the Federal Reserve's.

When considering the amount of payment for the underlying CDOs for the Maiden Lane III transaction, FRBNY decided to attempt to seek concessions, or "haircuts," from the counterparties. FRBNY contacted by telephone eight of AIG's largest counterparties over a two-day period and attempted to obtain such concessions from the counterparties. Although one counterparty, UBS, was willing to make a modest 2 percent concession if the other counterparties did so, FRBNY's attempts to obtain concessions from the others were completely unsuccessful, and FRBNY decided to pay the counterparties the full market value of the CDOs, which, when combined with the already posted collateral, meant that the counterparties were effectively paid full face (or par) value of the credit default swaps, an amount far above their market value at the time.

On November 7th, 2008, FRBNY employees involved with the negotiations reported to then-FRBNY President Geithner on the efforts to convince AIG counterparties to accept haircuts on their claims against AIG in return for unwinding the CDS contracts. Noting both the willingness of UBS to negotiate a small haircut and the generally negative reactions from the other counterparties, these FRBNY officials recommended that FRBNY cease negotiations and

proceed with paying the counterparties the market value of their underlying CDOs and permitting them to keep the collateral already posted, effectively paying them par for securities that collectively had a market value, based on the amount of the collateral payments, of approximately 48 cents on the dollar. According to these FRBNY executives, then-President Geithner "acquiesced" to the executive's proposal. When asked by SIGTARP if the executives felt they had received their "marching orders" from then-FRBNY President Geithner to pay the counterparties par, one FRBNY official responded "yes, absolutely."

The decision to pay effective par value was then brought before the Board of Directors of the FRBNY and the Board of Governors of the Federal Reserve. Each body gave its approval. According to the General Counsel for FRBNY, officials from Treasury were not involved in the negotiations of concessions with AIG's credit default swap counterparties. The Chief Compliance Officer for Treasury's Office of Financial Stability at the time also told SIGTARP that Treasury was not involved with the Maiden Lane III transaction and, when asked about who at Treasury SIGTARP should speak with regarding the transactions, he responded that Secretary Geithner was the appropriate official.

In pursuing the counterparty negotiations, FRBNY made several policy decisions that severely limited its ability to obtain concessions. FRBNY officials told SIGTARP that: FRBNY determined that it would not treat the counterparties differently, and, in particular, would not treat domestic banks differently from foreign banks — a decision with particular import in light of what FRBNY officials recounted was the reaction of the French bank regulator which, according to FRBNY, refused to allow two French bank counterparties to make concessions; FRBNY refused to use its considerable leverage as the regulator of several of these institutions to compel haircuts because FRBNY was acting on behalf of AIG (as opposed to in its role as a

regulator); FRBNY was uncomfortable interfering with the sanctity of the counterparties' contractual rights with AIG, which entitled them to full par value; FRBNY felt ethically restrained from threatening an AIG bankruptcy because it had no actual plans to carry out such a threat; and FRBNY was concerned about the reaction of the credit rating agencies should imposed haircuts be viewed as FRBNY backing away from fully supporting AIG. Although these were certainly valid concerns, these policy decisions came with a cost — they led directly to a negotiating strategy with the counterparties that even then-FRBNY President Geithner acknowledged had little likelihood of success.

FRBNY's decision to treat all counterparties equally (which FRBNY officials described as a "core value" of their organization), for example, gave each of the major counterparties effective veto power over the possibility of a concession from any other party. This approach left FRBNY with few options, even after one of the counterparties indicated a willingness to negotiate concessions. It also arguably did not account for significant differences among the counterparties, including that some of them had received very substantial benefits from FRBNY and other Government agencies through various other bailout programs (including billions of dollars of taxpayer funds through TARP), a benefit not available to some of the other counterparties (including the French banks). It further did not account for the benefits the counterparties received from FRBNY's initial bailout of AIG, without which they would have likely suffered far reduced payments as well as the indirect consequences of a potential systemic collapse. It also did not recognize that each bank's portfolio of assets were different and had different market values, meaning that certain counterparties (such as Goldman Sachs, the market value of whose securities, based on the collateral payments made by AIG, was approximately 40

cents on the dollar) arguably received a greater benefit than others (such as UBS, whose securities had a comparable market value of approximately 71 cents on the dollar).

Similarly, the refusal of FRBNY and the Federal Reserve to use their considerable leverage as the primary regulators for several of the counterparties, including the emphasis that their participation in the negotiations was purely "voluntary," made the possibility of obtaining concessions from those counterparties extremely remote. While there can be no doubt that a regulators' inherent leverage over a regulated entity must be used appropriately, and could in certain circumstances be abused, in other instances in this financial crisis regulators (including the Federal Reserve) have used overtly coercive language to convince financial institutions to take or forego certain actions. As SIGTARP reported in its audit of the initial Capital Purchase Program investments, for example, Treasury and the Federal Reserve fully used their leverage as regulators, just weeks before the negotiations with AIG's counterparties, to persuade nine of the largest financial institutions (including some of AIG's counterparties) to accept $125 billion of TARP funding. In stark contrast to those negotiations, in the case of the AIG counterparty payments, Mr. Geithner and Mr. Bernanke did not participate; nor did the CEO's of the counterparties; and the counterparties were not gathered together and told that they should, together, voluntarily concede to concessions because of the importance of this issue to the United States government. Instead, the negotiations were generally conducted through a series of telephone calls from executives at FRBNY to executives at the counterparties. Ultimately, in the CPP negotiations, there was no need for the Federal Reserve to impose the CPP investments on the participants using its regulatory authority because it obtained voluntary agreements based on an aggressive negotiating strategy. It is impossible to determine now, given the policy choices

made by the FRBNY, whether a similarly proactive strategy with the AIG counterparties would have resulted in taxpayer savings.

Moreover, subsequent to the issuance of the audit report, SIGTARP was informed that the French regulator was in fact open to further negotiations with the Federal Reserve to discuss the possibility of such concessions. While they viewed the transactions proposed by the Federal Reserve as being violative of French law, the regulators informed SIGTARP that they believed that an exception was possible and that they were willing to further discuss potential concessions. The French regulators noted that such negotiations would have been unprecedented, would have likely required universal agreement among counterparties to make concessions, and would have had to be conducted in a transparent manner and at a high level, but that continued negotiations were possible. While the French regulators would not clarify to SIGTARP what specific statements were made to the Federal Reserve during the actual negotiations, they did inform SIGTARP that they did not "slam the door" to such continued discussions.

Questions have been raised as to whether the Federal Reserve intentionally structured the AIG counterparty payments to benefit AIG's counterparties — in other words that the AIG assistance was in effect a "backdoor bailout" of AIG's counterparties. Then-FRBNY President Geithner and FRBNY's general counsel deny that this was a relevant consideration for the AIG transactions. Irrespective of their stated intent, however, there is no question that the *effect* of FRBNY's decisions — indeed, the very *design* of the federal assistance to AIG — was that tens of billions of dollars of Government money was funneled inexorably and directly to AIG's counterparties. Although the primary intent of the initial $85 billion loan to AIG may well have been to prevent the adverse systemic consequences of an AIG failure on the financial system and

the economy as a whole, in carrying out that intent, it was fully contemplated that such funding would be used by AIG to make tens of billions of dollars of collateral payments to the AIG counterparties. The intent in creating Maiden Lane III may similarly have been the improvement of AIG's liquidity position to avoid further rating agency downgrades, but the direct effect was further payments of nearly $30 billion to AIG counterparties, albeit in return for assets of the same market value. Stated another way, by providing AIG with the capital to make these payments, Federal Reserve officials provided AIG's counterparties with tens of billions of dollars they likely would have not otherwise received had AIG gone into bankruptcy.

Any assessment of the costs of these decisions to the Government and the taxpayer necessarily must look beyond FRBNY's loan to Maiden Lane III to also take into account both the funds that FRBNY previously loaned to AIG and the subsequent TARP investments. All of these infusions to AIG are linked inextricably: more than half the total amounts paid to counterparties in connection with the credit default swap portfolio retired through Maiden Lane III did not come about through the Maiden Lane III CDO purchases, but rather from AIG's earlier collateral postings that were made possible in part by the original FRBNY loan, which was, in turn, paid down with TARP funds. Because of this linkage, the ultimate costs to the Government and the taxpayer cannot be measured in isolation. Stated another way, irrespective of whether FRBNY is made whole on its loan to Maiden Lane III, we will only be able to determine the ultimate value or cost to the taxpayer after the likelihood of AIG repaying all of its assistance can be more readily determined.

The remarkable narrative surrounding the AIG loans and the creation of Maiden Lane III set forth in SIGTARP's audit gives rise to two additional lessons learned. First, AIG stands as a stark example of the tremendous influence of credit rating agencies upon financial institutions

and upon Government decision making in response to financial crises. In the lead-up to the crisis, the systemic over-rating of mortgage-backed securities by rating agencies was reflected in the similarly over-rated CDOs that underlied AIGFP's credit default swaps. Once the financial crisis had come to a head, the credit rating agencies' downgrades of AIG itself and of the underlying securities played a significant role in AIG's liquidity crisis as those downgrades and the related market declines in the securities required AIG to post billions of dollars in collateral. The threat of further rating agency downgrades due to the onerous terms of the initial FRBNY financing, among other things, led to further Government intervention, including the TARP investment in AIG and the necessity to do something with the swap portfolio, *i.e.*, Maiden Lane III. And the concern about the reaction of the credit rating agencies played a role in FRBNY's decision not to pursue a more aggressive negotiating policy to seek concessions from counterparties. All of these profound effects were based upon the judgments of a small number of private entities that operate, as described in SIGTARP's October 2009 Quarterly Report to Congress, on an inherently conflicted business model and that are subject to minimal regulation. Without drawing any conclusions about the particular actions taken by the rating agencies in the case of AIG, this report further demonstrates the dramatic influence of these entities on our financial system.

Second, the now familiar argument from Government officials about the dire consequences of basic transparency, as advocated by the Federal Reserve in connection with Maiden Lane III, once again simply does not withstand scrutiny. Federal Reserve officials initially refused to disclose the identities of the counterparties or the details of the payments, warning that disclosure of the names would undermine AIG's stability, the privacy and business interests of the counterparties, and the stability of the markets. After public and Congressional

pressure, AIG disclosed the identities. Notwithstanding the Federal Reserve's warnings, the sky did not fall; there is no indication that AIG's disclosure undermined the stability of AIG or the market or damaged legitimate interests of the counterparties. The lesson that should be learned — one that has been made apparent time after time in the Government's response to the financial crisis — is that the default position, whenever Government funds are deployed in a crisis to support markets or institutions, should be that the public is entitled to know what is being done with Government funds. While SIGTARP acknowledges that there might be circumstances in which the public's right to know what its Government is doing should be circumscribed, those instances should be very few and very far between.

ONGOING TRANSPARENCY ISSUES

Since the release of the audit, three broad issues have come to light that call into question whether the Government has been and is being as transparent as possible with the American people.

The first relates to public statements recently made by Treasury about the AIG transactions. For example, on January 7, 2010, in response to press inquiries regarding the role of Secretary Geithner in the decisions concerning AIG, a Treasury spokesperson stated the following via email to reporters:

> In the transaction at the heart of this dispute (Maiden Lane III's purchase of CDO's), the FRBNY made a loan of $25 billion which is on track to be paid back in full with interest *so that taxpayers will be made whole*. Somehow that fact that the government's loan is "above water" gets lost in all the consternation despite its mention on page 2 of the SIG-TARP report and weekly updates on the FRBNY's web site. (Emphasis added.)

This statement simply does not advance the cause of transparency. As noted in the audit, it is clear that all of the infusions to AIG are linked: more than half the total amounts paid to counterparties in connection with the swap portfolio retired through Maiden Lane III did not

come about through the Maiden Lane III purchases, but rather from AIG's earlier collateral postings that were made possible in part by the original $85 billion FRBNY loan; that loan, in turn, was paid down with $40 billion of TARP funds. Treasury's own TARP financial statement estimates that Treasury will *not* be made whole, but is rather projected to lose more than $30 billion on its AIG investments. Again, the various AIG infusions are directly linked: (a) the counterparties terminated their credit default swap agreements with AIG after they were *both* paid the fair market value of the underlying assets through Maiden Lane III and permitted to keep the collateral payments made by AIG; (b) many of those collateral payments were only made possible by the FRBNY loan; and (c) that loan was paid back in part by the initial $40 billion TARP investment. Narrowly asserting that taxpayers will be "made whole" on Maiden Lane III — just one part of the AIG counterparty transactions — without mentioning the huge losses Treasury expects to suffer on other, inextricably linked parts of *the very same* transactions is simply unacceptable; the American people deserve better.

The second issue relates to a series of documents that have recently been disclosed — as the direct result of the tenacity of the members of this Committee — about the Maiden Lane III transactions. As has been widely reported, these newly disclosed documents, among other things, relate to discussions about the public disclosure by AIG of the Maiden Lane III transactions in filings with the Securities and Exchange Commission. In light of these documents, we have initiated an investigation into whether there was any misconduct relating to the disclosure or lack thereof concerning the Maiden Lane III transactions.

Third, additional documents and facts have come to light that have caused SIGTARP to initiate an investigation to review the extent of the Federal Reserve's cooperation with SIGTARP during the course of the audit. For example, in connection with the recent document productions

to this Committee, documents have come to light that were not provided to the SIGTARP audit team during the course of the audit. FRBNY's outside counsel has told SIGTARP that FRBNY will cooperate fully with SIGTARP's investigation.

With respect to these investigations, it is SIGTARP's policy not to comment publicly on non-public, ongoing criminal or civil investigations, and thus we cannot comment further at this time, other than to note that these assertions do not at this time constitute a factual finding by SIGTARP. At the conclusion of the investigations, however, we anticipate that the details of our findings will be reported to Congress, as appropriate, either through formal court filings or in the form of Investigative Reports.

Chairman Towns, Ranking Member Issa and Members of the Committee, I want to thank you again for this opportunity to appear before you, and I would be pleased to respond to any questions that you may have.

If you are aware of fraud, waste, abuse, mismanagement or misrepresentations affiliated with the troubled asset relief program, please contact the SIGTARP Hotline.

Via Online: WWW.SIGTARP.GOV
Via Toll Free Phone: 877-SIG-2009
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Statement by

Thomas C. Baxter, Jr.

Executive Vice President and General Counsel, Federal Reserve Bank of New York

before the

Committee on Government Oversight and Reform

United States House of Representatives

regarding

Factors Affecting Efforts to Limit Payments to AIG Counterparties

January 27, 2010

Good morning, Chairman Towns, Ranking Member Issa, and other members of the Committee. Thank you for inviting me to testify today. As the General Counsel of the Federal Reserve Bank of New York, I welcome the opportunity to talk about the Federal Reserve's work to stabilize AIG, and more specifically the Federal Reserve's restructuring of certain problematic AIG contracts in November of 2008, at a critical point in what is aptly characterized as the worst financial crisis since the Great Depression. I will also speak about the role played by the Federal Reserve Bank of New York (the "New York Fed") in securities disclosures made by AIG over the following months. The actions of the New York Fed and the Board of Governors of the Federal Reserve System (the "Board of Governors") in stabilizing AIG were undertaken to avoid the potentially catastrophic consequences that would have resulted from an AIG bankruptcy.

Stabilizing AIG

I. Background

As is now well known, AIG's liquidity crisis emerged at nearly the same time that the securities firm Lehman Brothers collapsed, one week after the GSEs Fannie Mae and Freddie Mac were placed in conservatorship, and amidst ongoing acute stress in U.S. and global financial markets. It was against this backdrop, and in recognition of the financial stability threat posed by the abrupt and disorderly failure of an even larger and more complex firm than the one that had failed a day earlier, that the Board of Governors, with the full support of the Treasury Department, decided to intervene to prevent the bankruptcy of AIG on September 16, 2008.

AIG was a $1 trillion company when it alerted the Treasury and the Federal Reserve that it was encountering severe liquidity problems. It remains one of the largest insurance and financial services companies in the world. AIG conducts insurance and finance operations in more than 140 countries and has more than 76 million individual and corporate customers globally. In the United States, AIG has approximately 30 million customers, including commercial, institutional and individual customers. It is also a major provider of protection to municipalities, pension funds, and other public and private entities through guaranteed investment contracts and products that protect participants in 401(k) retirement plans.

In terms of net premiums underwritten, AIG is both the largest life and health insurer, and the second largest property and casualty insurer in the United States. It has written more than 81 million life insurance policies worldwide, with a face value of $1.9 trillion. The company insures approximately 180,000 small businesses, non-profit organizations, and other corporate entities. Estimates are that close to one-third of the United States population, or 106 million people, are employed by entities that are protected by insurance coverage issued by AIG. AIG is the largest issuer of fixed annuities in the United States. It is also one of the largest providers of retirement services to non-profit healthcare groups, schools and universities. More than six million people hold retirement plans or accounts with AIG.

AIG had also been a major participant in derivatives markets through its Financial Products business unit ("AIG FP"), an unregulated subsidiary. AIG FP had engaged in financial transactions with a broad range of customers, which include many major

national and international financial institutions, as well as U.S. pension plans, stable value funds, and municipalities.

An AIG bankruptcy under the economic conditions existing in the fall of 2008 would have had catastrophic consequences for our financial system and our economy. Money market mutual funds to which so many Americans entrust their savings were major holders of the roughly $20 billion of commercial paper issued by AIG. Losses to these funds would have had potentially devastating effects on confidence and would have accelerated the run on financial institutions of all kinds. By way of comparison, money market mutual funds and other investors held approximately $5 billion of commercial paper issued by Lehman Brothers. Lehman's collapse triggered a run on money market funds after the Reserve Primary Fund "broke the buck" due to losses on Lehman commercial paper.

Global commercial banks and investment banks would have suffered losses on loans and lines of credit to AIG and on derivatives contracts and other transactions with AIG FP. This could have led to the outright collapse of the financial system. At a minimum, it would have caused even greater constraints on the availability of credit to homeowners and businesses.

In the event of an AIG failure, many of AIG's insurance subsidiaries likely would have been seized by their state and foreign regulators, leaving U.S. policyholders facing considerable uncertainty about their rights and claims. State and local government entities that had lent in excess of $10 billion to AIG would have been exposed to losses in an already difficult and deteriorating municipal budget environment.

AIG also had approximately $38 billion of what are called stable value wrap contracts. These contracts allow trustees and investment managers of defined contribution plans to manage the asset-liability mismatch arising from withdrawals. Workers whose 401(k) plans had purchased these contracts from AIG to insure against the risk that their stable value funds would decline in value could have seen that insurance disappear in the event of an AIG bankruptcy. Pension plans would have been forced to write down their assets from book to market value, resulting in significant losses in participants' portfolios.

Ultimately, AIG, the world's largest insurance company, received extraordinary assistance because of the impact its failure would have had all across America. As Federal Reserve Vice Chairman Donald Kohn has testified, "because of the dependence of modern economies on the flow of credit, serious financial instability imposes disproportionately large costs on the broader economy. The rationale for public investment in the financial industry is not, therefore, any special regard for managers, workers, or investors in that industry over others, but rather the need to prevent a further deterioration in financial conditions that would destroy jobs and incomes in all industries and regions."

II. AIG Credit Facilities

On September 16, 2008 the Board of Governors authorized the New York Fed to lend up to $85 billion to AIG through a secured revolving credit facility ("Fed Facility"). The Fed Facility was (and remains) secured by a pledge of a substantial portion of AIG's assets, including ownership interests in the company's domestic and foreign insurance subsidiaries. As additional compensation for this Facility, AIG issued, to a trust for the

benefit of the Treasury, preferred stock convertible into approximately 78 percent of AIG's outstanding common stock.

The policy decision to authorize a loan to AIG was a difficult one, because addressing the systemic crisis facing the United States required the Federal Reserve to assist a private company at the center of the risks that led to the crisis. Nonetheless, the potentially far-reaching consequences of an AIG bankruptcy compelled policymakers to take affirmative action. The failure of AIG in the fall of 2008 would have imposed significant financial losses on many individuals, households and businesses, shattered confidence in already fragile financial markets, and greatly increased fear and uncertainty about the viability of our financial institutions. Last month, Chairman Bernanke observed that the Federal Reserve did not lend support to AIG for the Fed's own benefit, "because it obviously has hurt the Federal Reserve in the public's view. We did it because we felt that there was no other way to avoid what [many] have called the risk of a catastrophic collapse of the financial system."

The initial emergency $85 billion Fed Facility was successful in stabilizing AIG in the short term, but the company's financial condition and capital structure remained vulnerable to further deterioration in market conditions. AIG's pressing liquidity needs were resulting in rapid and sizeable draws on the Fed Facility, prompting concern that AIG's needs might well exceed the facility's capacity. The prospect of further downgrades of AIG's credit rating by rating agencies intensified the liquidity concerns AIG faced, because such downgrades would have immediately triggered billions of dollars of additional liquidity demands related to AIG FP's business. Absent further government action, a ratings downgrade was all but inevitable.

In early October of 2008, the Board of Governors approved an additional secured credit facility that permitted the New York Fed to lend AIG up to $37.8 billion in order to address liquidity needs related to the securities lending program of certain AIG domestic insurance subsidiaries. Additionally, toward the end of October 2008, four AIG affiliates began participating in the Federal Reserve's Commercial Paper Funding Facility ("CPFF") on the same terms and conditions as other participants.

Notwithstanding AIG's access to these additional Federal Reserve credit facilities, AIG continued to face serious liquidity pressures. Some of these pressures arose out of AIG's losses on residential mortgage backed securities ("RMBS") it had invested in as part of its securities lending program. In November 2008, the Board of Governors authorized the New York Fed to take a second step to alleviate these pressures by funding Maiden Lane II, which purchased RMBS at market value and allowed AIG to unwind its securities lending transactions. With this transaction, the original $37.8 billion facility to fund AIG's repayment of its securities lending transactions was fully repaid and terminated.

A substantial additional cause of AIG's liquidity pressure was its exposure to credit default swaps, or CDSs, one of many derivative products AIG FP offered. A CDS is essentially an unregulated insurance policy that protects the holder of a security from default. AIG FP, the CDS seller, agreed to protect its counterparties, the CDS buyers, from losses incurred on certain securities owned by the counterparties. In return, the counterparties paid AIG FP periodic premiums.

Under the terms of these particular CDS contracts, counterparties had the right to require AIG FP to post cash collateral as a result of adverse events relating either to the

underlying securities, which in this case were multi-sector collateralized debt obligations ("CDOs"), or to AIG's credit condition, such as a ratings downgrade. The posted collateral secured each counterparty in the event AIG FP was not able to perform on the contract as contemplated. AIG FP's performance on these contracts was also guaranteed by its parent, AIG, making it impossible to isolate AIG FP's problems from AIG or its insurance subsidiaries. As AIG's financial condition deteriorated in 2008, and as the CDOs declined in value as the nation fell deeper into crisis, AIG FP was forced to post more and more collateral to the counterparties, a cash outflow that in turn caused AIG's liquidity and credit condition to deteriorate further. It was a vicious cycle.

As explained in the report by the Office of the Special Inspector General for the Troubled Asset Relief Program, or SIGTARP, entitled "Factors Affecting Efforts to Limit Payments to AIG Counterparties" (SIGTARP-10-003), the Federal Reserve considered a number of options in an effort to address the liquidity drain created by AIG's CDS exposure. One critical constraint applied to any option chosen: it had to be arranged by the earnings announcement on November 10th, when AIG was facing an imminent credit ratings downgrade in connection with its announcement of a $25 billion loss for the third quarter.

The first proposed option would have allowed the counterparties to keep their multi-sector CDOs and the protection provided by the credit default swaps. The counterparties would have agreed to forego additional collateral calls in exchange for a New York Fed guarantee of AIG's performance under the credit default swaps. Under this proposal, the New York Fed would not own the underlying CDOs, but the New York Fed – through the guarantee – would eliminate the downside risk to the counterparties of

a further decline in the CDOs' market value. Not only did this structure have unappealing economics – taxpayer funds would have been exposed to the downside risk with no opportunity to participate in the upside – it also was not viable because the Federal Reserve lacked legal authority to issue the proposed guarantee under this structure.

The second proposed option would have involved persuading AIG's counterparties to take back some of the risk relating to the CDOs from AIG by canceling their credit default swaps and selling the underlying CDOs to an SPV. The SPV would be funded by the counterparties, the New York Fed, and AIG, with the counterparties' interests subordinated to those of the New York Fed. The New York Fed was concerned that the counterparties would not be motivated to cancel the swaps if they were left with un-hedged CDO risk associated with their part of the financing. This option was also deemed impractical because the complex negotiations required for each counterparty could not be completed quickly enough to satisfy AIG's liquidity needs, i.e., before November 10th.

The third option became Maiden Lane III.

III. Maiden Lane III

In the months leading up to early November 2008, AIG had been actively engaged in efforts to negotiate tear-ups of its CDS contracts with its counterparties. AIG was completely unsuccessful. The need for the tear-ups was real; AIG was effectively hemorrhaging cash. Throughout October, while the New York Fed worked to identify various restructuring options, AIG continued to negotiate with its counterparties. The New York Fed ultimately agreed to participate in these counterparty negotiations,

extremely mindful of the exigency of obtaining final agreement with at least the eight largest counterparties by Monday, November 10th, when earnings were to be released by AIG.

The earnings release would show a third quarter loss of approximately $25 billion. The ratings agencies had advised AIG that, absent a parallel announcement of solutions to its liquidity problems, a ratings downgrade was certain following the earnings announcement. With that further downgrade, additional collateral calls, and possibly terminations, would be triggered. As of November 6, 2008, AIG had drawn down approximately $61 billion of the $85 billion Fed Facility, leaving $24 billion of liquidity for operations and further collateral calls. Continuing to borrow from the Fed Facility, however, was not a solution to AIG's problems. First, additional borrowing from the Federal Reserve would significantly add to AIG's overall debt burden, which was a very negative factor in the eyes of the rating agencies. Second, it was doubtful that the remaining $24 billion in the line of credit would cover the anticipated collateral calls under the CDS contracts and AIG's other liquidity needs.

In the limited time available, agreement had to be obtained from at least the eight largest counterparties, who together represented the bulk of AIG's CDS exposure. A ratings downgrade on November 10th would have created a possibly fatal downward spiral for AIG. Unless the Federal Reserve was prepared to pump substantially more funds into AIG by increasing the $85 billion credit line, the only option would have been to reverse course and allow AIG to file for bankruptcy. This abrupt reversal of course would not only have triggered all of the adverse consequences for the U.S. and global economies that prompted the initial intervention, it would also have undermined the

public's trust in the U.S. government's commitment to the broader range of extraordinary financial stability initiatives underway during that very fragile period. With bankruptcy not an option, it was necessary to find a solution that stemmed the liquidity drain arising from the continuing collateral calls on the CDS contracts, stabilized AIG, and protected the taxpayer interests. The Maiden Lane III transaction was that solution.

In this context, the Board of Governors authorized the New York Fed to lend Maiden Lane III up to $30 billion, and to secure that loan with the multi-sector CDOs that were insured by the AIG CDS contracts. Pursuant to this authorization, the New York Fed lent $24.3 billion to Maiden Lane III that it used, in combination with a $5 billion equity investment from AIG, to purchase CDOs from 16 of AIG's counterparties. At the time, the CDOs had a fair market value of about $29.6 billion and a par value of approximately $62 billion. In exchange for agreeing to terminate AIG's CDS contracts and turning over the underlying CDOs to Maiden Lane III, the counterparties would also be allowed to retain approximately $35 billion in collateral previously posted by AIG. The result was that counterparties essentially received "par," with Maiden Lane III obtaining the CDOs and AIG obtaining the tear-up of the CDSs.

AIG's $5 billion equity investment in Maiden Lane III was subordinated to the Fed's $24.3 billion secured loan, and the Fed also obtained two-thirds of the upside in Maiden Lane III – securing both downside protection and upside participation for the U.S. taxpayer. Moreover, because Maiden Lane III can hold the underlying CDOs to maturity, it is largely immune from trading prices and liquidity needs, and is therefore in a better position to maximize the value of the CDO portfolio.

The Federal Reserve executed a transaction that involved an asset purchase and the termination of AIG's CDS contracts. By terminating the CDS contracts, the Federal Reserve stopped the collateral calls and the resulting liquidity drain on AIG. By stopping this liquidity drain, the Federal Reserve avoided AIG's downgrade and downward spiral and the resulting threat to the U.S. economy.

IV. Negotiating Concessions from AIG's Counterparties

The Federal Reserve has been criticized by some for not using its regulatory power to force the counterparties to accept less money for the CDOs. The critics overlook a number of key factors.

First, there was little time, and substantial execution risk and attendant harm of not getting the deal done by the deadline of November 10th. As noted above, AIG had attempted for some time to negotiate tear-ups of its CDS contracts with its counterparties under terms more favorable than Maiden Lane III. It did not succeed. When the Federal Reserve reached out to AIG's counterparties, we believed, based on AIG's own experience, that our probability of success of getting them timely to agree to concessions was slim. Even in a best-case scenario, we did not expect that the counterparties would offer anything more than a modest discount to par. In our judgment, taking additional time to press further for a discount was not justified in light of the overwhelming risk and catastrophic consequences of failing to complete the transaction by November 10. Today, it might be tempting to suggest that a transaction that was in the best interests of the taxpayers could have been improved had the New York Fed pressed harder for concessions. But it is much more likely that continuing to push the counterparties toward concessions would not have gotten us to final agreements on November 10th. The

consequences to AIG and our economy of failing to reach an agreement made obtaining concessions a lower priority than executing the transactions.

Second, the Federal Reserve had little or no bargaining power given the circumstances. This restructuring negotiation was taking place in November of 2008, less than two months after the decision to rescue AIG from insolvency and the infusion of tens of billions of dollars. The Federal Reserve had already acted to rescue AIG, and the counterparties fully expected that we would stand by that decision, especially because the economic situation had gotten worse, not better. So, the typical threat in such negotiations – we will stand down and watch AIG file for bankruptcy – would have been an idle threat had we made it. In addition, the counterparties were unwilling to offer concessions because their contractual rights were already well-protected. The value of the CDOs they held, combined with the $35 billion of collateral they had previously obtained from AIG was, in most cases, equal to or in excess of par value. Thus, if AIG defaulted, and even filed for bankruptcy protection, the counterparties would have kept both the collateral and the underlying CDOs (and would have been made whole if they had sold the CDOs for fair value).

Finally, even if we had had bargaining power, the rating agencies, as discussed above, were closely examining AIG for signs that it would not be able to address its financial situation. If they saw the Federal Reserve take any action that seemed to suggest a lack of full support, in particular a bankruptcy threat, it might well have led to an immediate downgrade and the irreversible destruction of AIG, with the attendant consequences on the financial stability of our economy.

Some have said that, in the absence of other bargaining power, the Federal Reserve should have used its regulatory power – threatening an adverse use of that power, or suggesting some kind of a benefit flowing from it – to make regulated counterparties give up or compromise their contractual rights. We see that as an abuse of regulatory power. The idea that the Federal Reserve would threaten a financial institution with supervisory action when no grounds for such action exist, or give a financial institution special treatment simply to gain an advantage in a commercial transaction is, in our view, an abuse of our authority. Such conduct by the Federal Reserve might have generated bargaining power over the counterparties, but it is simply inconsistent with the rule of law.

It also would have resulted in unfair treatment of supervised firms. Institutions regulated by the Federal Reserve would have been required to make concessions, while those not subject to the Federal Reserve's supervisory authority would not. As a result, domestic banking organizations regulated by the Federal Reserve would have received less for their property than would foreign banks. This would violate the principle of equality of treatment, a fundamental value of the Federal Reserve.

By getting the eight largest counterparties and AIG to execute term sheets by November 10th, and another eight to do the same shortly thereafter, the Federal Reserve accomplished its overarching goal of avoiding the failure of AIG. As a subsidiary objective, the taxpayers have a well-structured vehicle with downside protection and upside potential, which owns a securities portfolio worth billions more than the loan balance. Moreover, it bears mention that more than $6 billion of the loan has already been repaid.

The situation faced by AIG and the Federal Reserve in the fall of 2008 with respect to the CDS contracts pointedly demonstrates the urgent need for adoption of new resolution procedures for systemically important nonbank financial firms. Had such a tool been available at that time, it could have been used to put AIG into conservatorship or receivership. Not only would this option have allowed AIG to be unwound in an orderly way, protecting policyholders, customers, and taxpayers, but it would have provided a clear and effective mechanism for imposing appropriate haircuts on creditors and counterparties.

AIG's Securities Disclosures

On November 25, 2008, Maiden Lane III began purchasing the underlying CDOs from AIG FP's counterparties. Under SEC rules, because AIG had entered into a "Material Definitive Agreement," it was required to file a Form 8-K with the SEC within four business days. On November 24th, a lawyer for AIG sent a draft version of the 8-K to lawyers for the New York Fed to review, asking for their comments. This made sense: Maiden Lane III was created, funded, and majority-owned by the New York Fed, and AIG wanted to ensure that its public filings would be accurate.

It is commonplace for a publicly traded company to share draft securities filings with another company where the subject matter involves a material transaction affecting both companies. Both the reporting company and the second company – whether the second company is publicly traded or not – want to ensure that the public filing is accurate. What is described here is the kind of thing that routinely happens in major transactions.

Although AIG was consulting regularly with the New York Fed, it is important to note that AIG fully understood that it was wholly responsible for the content of its SEC filings. Indeed, lawyers for both sides were very aware of their respective roles. Lawyers for the New York Fed, both at the Bank and through its outside law firm of Davis Polk & Wardwell LLP, made suggestions about content and timing. AIG and its outside counsel at Sullivan & Cromwell LLP and Weil Gotshal & Manges LLP, accepted the edits that they felt improved the accuracy of the descriptions of the transactions, and declined those edits that they felt did not.

The first 8-K was filed by AIG on December 2, 2008, after Maiden Lane III purchased the first group of CDOs. On December 18 and 22, 2008, Maiden Lane III purchased a second group of CDOs. Also, an agreement struck in November in conjunction with the original transaction, known as the Shortfall Agreement between Maiden Lane III and AIG FP, was amended as of December 18th. These events required the filing of a second 8-K on December 24, 2008. As with the initial public disclosure three weeks earlier, there were many e-mails among all the lawyers before the filing on the 24th. Once again, the New York Fed lawyers had two goals: (1) to help AIG make this filing accurate and consistent with the first; and (2) to protect, where appropriate, the substantial taxpayer funds at stake in Maiden Lane III. And once again, after receiving the New York Fed's suggestions, AIG, aided by its two outside law firms, made the disclosures that they deemed to be legally required and otherwise appropriate.

With that factual backdrop in place, I would now like to turn to the assertions that the New York Fed somehow pressured AIG into "covering up" parts of the transactions

in its securities disclosures. There have been four separate allegations, and I would like to address each one in turn.

I. Disclosure of Par Value Payments to CDS Counterparties

First, let me address the assertion that the New York Fed pressured AIG to remove a line in the second 8-K filed on December 24th stating that "the AIG FP counterparties received 100 percent of the par value of the Multi-Sector CDOs sold." The New York Fed believed that disclosure of the actual arithmetic showing that the counterparties received essentially par value was more accurate and would make the new 8-K consistent with AIG's prior 8-K announcing Maiden Lane III. The draft 8-K listed the par value ($16 billion) as well as the amount paid to the counterparties ($6.7 billion), and the amount of collateral previously paid to the counterparties that AIG was surrendering ($9.2 billion). Adding up the last two numbers (which total $15.9 billion) shows that the counterparties were receiving essentially par (which was listed as $16 billion). Because the sum tendered to the counterparties was slightly less than par, the proposed sentence about it being 100 percent of par value (and which was not in the prior 8-K) was not completely accurate, and it was therefore suggested that it be removed.

This was done to be accurate, not to cover up the fact that the counterparties were essentially receiving par. The New York Fed lawyers were motivated by concern for accuracy and precision in the content of these Form 8-Ks. In fact, the clearest evidence that there was no cover up was that it was widely understood in the market and reported in the press at the time that the counterparties were receiving very close to par value. For example, an analyst report published by Credit Suisse on December 2, 2008 – the same day as the initial 8-K filing addressing the first settlements with the counterparties –

opens with the following sentence: "This evening AIG terminated $46.1b of its $71.6b of targeted multi-sector CDO exposure, at par." Similarly, a Fox-Pitt-Kelton report dated the next day, December 3, 2008, contains the following statement: "Along with surrendering $25.9 billion of collateral that had been previously posted by AIG with the counterparties, the purchase of the $46.1 billion of par value essentially made the counterparties whole." On November 12, 2008, a month earlier and shortly after the initial announcement of the Maiden Lane III facility, an article in The Wall Street Journal stated: "The banks that participate will be compensated for the securities' full, or par, value in exchange for allowing AIG to unwind the credit default swaps it wrote." On December 25, 2008, the day after the second 8-K was filed, an article in The Washington Post further reported that, "The fund, called Maiden Lane III, paid about $6.7 billion to the investors for the securities in the latest purchases. The counterparties were also able to keep more than $9 billion that AIG had posted in collateral, reimbursing them at face value for the assets." The fact that the disclosure included all of the actual numbers, and that analysts and the media understood them immediately, belie any assertions of a cover up.

II. Disclosure of Transactions Involving Synthetic CDOs

The second assertion relates to the New York Fed's suggestion to delete that portion of AIG's draft press release accompanying the December 24th 8-K that implied that the New York Fed would enter into additional transactions with AIG concerning the termination of a portfolio of CDS relating to synthetic CDOs. This edit was proposed because there was in fact no commitment at the time for either the Federal Reserve or Maiden Lane III to acquire the synthetic CDOs that backed this portfolio of CDSs.

Indeed, neither the Federal Reserve nor Maiden Lane III has acquired any synthetic CDOs from any counterparty of AIG FP. Thus, rather than seeking to conceal information, the New York Fed comment was made in an effort to help ensure the accuracy of the disclosures so as to avoid any suggestion that the New York Fed had made a commitment that was not made at the time (and in fact was never made). The comment also ensured that there would be no incorrect expectation created in the public markets that such additional Federal Reserve assistance to AIG would be forthcoming.

III. Disclosure of the CDS Counterparties

Third, some have suggested that in November 2008, AIG had planned to disclose the identities of the CDS counterparties and that the New York Fed pressured or compelled AIG not to. This is not true. In December 2008, circumstances were very different than today. Markets were much more fragile, and AIG was concerned at the time that its counterparties, and potentially other AIG customers, would stop doing business with AIG if they believed that the government would cause the disclosure of what is ordinarily confidential customer information, including, in some cases, customer identities. If counterparties and customers began moving away from AIG, the company feared that it would be subject to a loss of business and possible additional downgrades from the rating agencies. This would have had the effect of harming the taxpayers' investment in AIG by reducing the public's interest in doing business with AIG.

For this reason, the New York Fed actively supported AIG's application to the SEC to have the names of its counterparties remain confidential. In March 2009, in response to requests by Congress that the identities of the CDS counterparties be made public, and after taking account of its decision to wind down the AIG FP derivatives

business, AIG changed its view and decided to reveal the counterparty names. The Federal Reserve agreed with this decision. Indeed, the counterparty names were disclosed nearly one year ago.

IV. Disclosure of Information Identifying Specific CDOs in the Portfolio

Finally, there have been allegations that the New York Fed inappropriately pressured AIG not to disclose certain commercially sensitive information, including CUSIPs and tranches, that would have identified the individual securities in the Maiden Lane III portfolio. To be sure, the New York Fed actively supported the idea of keeping this information confidential, but once again, only to maximize the value of the Maiden Lane III portfolio for the benefit of the taxpayer.

The portfolio of securities held by Maiden Lane III represents substantial value to the American taxpayer. At the end of the third quarter of 2009, the fair market value of the securities was several billion dollars more than the outstanding balance on the loan. The New York Fed also owns two-thirds of any eventual upside. The New York Fed's investment staff, with the concurrence of its outside advisors, was (and is) strongly of the view that if information identifying these individual securities in the portfolio and the individual prices paid by Maiden Lane III were to become available to traders in such securities, those traders would be able to use that information to their advantage. This, in turn, would undercut the ability of Maiden Lane III to sell those assets for their highest value, to the detriment of taxpayers. Furthermore, as AIG stated in its application to the SEC for confidential treatment, this data does not provide any additional information that would be material to investors in AIG. After lengthy and detailed dialogue, on May 22, 2009, the SEC concluded that this commercially sensitive information need not be

disclosed. To be clear, it is only this sensitive security-by-security information that has received confidential treatment and has not been included in AIG's 8-K filings.

The Federal Reserve System shares this committee's goals of transparency and accountability. That is why the Federal Reserve provides weekly public reports on the *aggregate* performance of the Maiden Lane III assets – information that is highly relevant to taxpayers' evaluation of the success of this program, but that does not undercut the ultimate taxpayer recovery that is such an important objective. Also, on a monthly basis, the Federal Reserve publishes a transparency report called "Credit and Liquidity Programs and the Balance Sheet" that provides still more information and analysis regarding Maiden Lane III and the Federal Reserve's other lending programs. This represents a middle ground where our performance as stewards of taxpayer funds can be analyzed and evaluated, but without potentially compromising the taxpayers' prospective return on their investment.

Thank you again for giving me the opportunity to appear before you today. I look forward to answering your questions.

United States House of Representatives
Committee on Oversight and Government Reform

"Factors Affecting Efforts to Limit Payments to AIG Counterparties"
Prepared Testimony of Stephen Friedman
January 27, 2010

Mr. Chairman, Ranking Member Issa, and Members of the Committee,

I am here today because of my great respect for Congress and the essential role that it plays in the United States Government. It was my recent privilege to serve my country in the Executive Branch as Assistant to the President for Economic Policy and Director of the National Economic Council from 2002 to 2004, and as Chairman of the President's Foreign Intelligence Advisory Board from 2006 to 2009, and I developed a renewed appreciation of our Constitutional system of checks and balances.

Despite my recognition of the importance of the Committee's inquiry, I cannot provide the Committee with any insight into the principal subject of today's hearing—the transaction that paid AIG's credit default swap counterparties at par.

The questions raised about these transactions reflect understandable confusion about the role that a Reserve Bank's Chairman and Board of Directors play in a Reserve Bank's operations. Consistent with the structure created by the Federal Reserve Act, the Board of Directors of the New York Federal Reserve Bank has no role in the regulation, supervision, or oversight of banks, bank holding companies, or other financial institutions. Such responsibilities are instead carried out by the officers of the New York Federal Reserve Bank acting at the direction of the Board of Governors of the Federal Reserve System here in Washington.

A Reserve Bank's Board of Directors in many respects is more akin to an "Advisory Board" than it is to the Board of Directors of a corporation. Reserve Bank Directors "make recommendations on monetary policy," including approving the recommended discount rate subject to Board of Governors approval, and are responsible for approving the Bank's budget, reviewing the Bank's internal controls and policies and procedures, and overseeing personnel matters, including assisting in the selection of the Bank President and other senior Bank officers. But the Board of Directors of a Reserve Bank has no authority over, and is walled-off from, regulatory and supervisory policies and actions involving banks, bank holding companies, and other financial institutions.

Accordingly, as I explained to Committee staff, whether as Chairman of the New York Federal Reserve Board or otherwise, I was not involved in the initial decision to bail out AIG, the decision to repay the AIG counterparties at par, or the decision not to publicly disclose those counterparties' names. I did not ratify those decisions; and I do not know who made those decisions.

Not only was I not involved in the Reserve Bank's decisions regarding the supervision and management of AIG, but my actual knowledge of those decisions is extraordinarily limited. I did receive summary briefings from senior Reserve Bank officers regarding both the initial September 16, 2008 rescue of AIG and the November 10, 2008 transaction to repay AIG's counterparties at par, although in both instances the briefing occurred after the transactions already had been negotiated. In the case of the November 10 transaction, I have been advised that on the evening of November 9, 2008, Charles Wait—the Chair of the Bank's Audit Committee—and I received a telephonic summary briefing from Bank officials about the transaction. At that point the deal had been signed up and was to be announced by the Board of Governors the next morning. As to the decision not to disclose the names of AIG's counterparties, I do not recall receiving any briefings on that subject.

*   *   *

The Committee also has inquired about my purchases of Goldman Sachs stock on December 17, 2008 and January 22, 2009, subsequent to the decision to repay AIG's counterparties at par on November 10, 2008.

As is shown in the attached chronology, at the time of my purchases, it was widely known and reported – through various public statements by Goldman Sachs officials, in numerous contemporaneous newspaper articles, in multiple investment analysts' reports, and in the November 10 Federal Reserve Board and AIG press releases making clear that AIG's counterparties had been repaid in full – that Goldman Sachs was a counterparty to AIG and had been repaid at par on November 10. Indeed, the December 17, 2008 purchase occurred the day after Goldman Sachs' quarterly earnings release and an earnings call statement by its CFO that its exposure to AIG "has been immaterial" and "is still immaterial."

Consistent with company policy to ensure that statutory "insiders" do not trade in Goldman Sachs securities while in possession of any undisclosed material information, I consulted with and received the approval of the Goldman Sachs General Counsel's office prior to executing the December 17 and January 22 trades, as being within a "window" during which Goldman Sachs Directors were permitted to trade. These purchases promptly were publicly disclosed in filings with the Securities and Exchange Commission.

In addition, my purchases, in the words of the General Counsel of the New York Reserve Bank, "did not violate any Federal Reserve statute, rule or policy." When I was appointed in January 2008 to the New York Reserve Board of Directors as Chairman and as a Class C Director, the New York Reserve Bank and the Board of the Governors of the Federal Reserve System were aware that I was a Director of Goldman Sachs, that I held a significant amount of Goldman Sachs stock, and that I was scheduled annually to receive additional Goldman Sachs restricted stock by virtue of my service as a Goldman Sachs Director. When Goldman Sachs became a bank holding company on September 21, 2008, I became technically ineligible to serve as Class C Director because Class C

Directors cannot own bank holding company stock (Class A and Class B Directors can own bank holding company stock) and because Class C Directors cannot serve as officers or directors of banks (Class A Directors can serve as officers and directors of banks). At that point, the Board of Governors either could request my resignation as a Class C Director, or, as subsequently occurred, could "waive" the eligibility requirements with respect to my ownership of Goldman Sachs stock and service on the Goldman Sachs Board.

At the time of my selection and appointment as Reserve Board Chairman, I had been forewarned that I would be expected to spend considerable time leading the search for Mr. Geithner's replacement as President of the New York Reserve Bank in the event he accepted another position. I therefore was not surprised that, a month before the November 2008 election and at a time of great stress in the financial markets, the New York Reserve Bank requested such a waiver, following consultation with the Board of Governors staff. I thereafter continued to serve as Board Chairman and a Director, with the understanding that I was permitted to do so by Federal Reserve policies and precedents until the expected waiver was granted.

Immediately upon Mr. Geithner's selection by President-elect Obama as Secretary of the Treasury-Designate on November 24, 2008, the New York Reserve Bank Board, under my leadership, commenced a thorough and expedited search process for his replacement, in close coordination with the Board of Governors, which concluded in late January 2009. In early December, I inquired about the status of the Bank's waiver request, and, as has been publicly reported, I was informed by the General Counsel of the New York Reserve Bank that I should consider the eligibility requirements to be in abeyance while the request for a waiver was pending. The waiver was issued on January 21, 2009, without any conditions upon my increasing my ownership of Goldman Sachs stock.

I am advised that the Board of Governors three months ago published a new policy regarding the eligibility, qualifications, and rotation of Reserve Bank Directors, which expressly addresses the situation I faced and now provides a 60-day period for resolving (whether through waiver, divestiture, or resignation) a situation where a Director becomes ineligible to serve because of a change in the status of a financial institution. I note that if this policy had been in place in September 2008, it would have abbreviated the delay that occurred in the processing of the Reserve Bank's waiver request on my behalf.

When I was appointed by the President of the United States as Director of the National Economic Council in 2002, I divested all of my ownership interests in individual companies and entities, including my Goldman Sachs holdings, to avoid any possibility of a potential conflict of interest. I approached my appointment as Director and Board Chairman of the New York Federal Reserve Bank with the same public service mindset. By statutory design, the Reserve Bank Board is comprised of Members with intentionally diverse financial interests and affiliations that theoretically would present potential conflicts of interest, if the Board of Directors had any authority over or role in individual

supervisory matters – matters like the New York Reserve Bank's rescue of AIG. But the Board does not have such authority and it did not play such a role.

I stand ready to answer any questions that the Committee may have.

Attachment – Chronology of Selected Events and Disclosures

Chronology of Selected Events and Disclosures

Attachment to the Prepared Testimony of Stephen Friedman
January 27, 2010

Jan. 1, 2008	Mr. Friedman appointed Chairman and "Class C Director" of New York Fed by the Board of Governors of the Federal Reserve; at the time of his appointment, the Board of Governors is made aware of Mr. Friedman's financial interests in Goldman Sachs (including expected annual awards of restricted stock) and his position as Director of The Goldman Sachs Group.
Sept. 16, 2008	The Federal Reserve Board (through the New York Fed) pledges $85 billion to AIG. FRB Press Release, *Federal Reserve Board, with full support of the Treasury Department, authorizes the Federal Reserve Bank of New York to lend up to $85 billion to the American International Group (AIG)*, Sept. 16, 2008, *available at* http://www.federalreserve.gov/newsevents/press/other/20080916a.htm.
Sept. 16, 2008	In response to a question about Goldman Sachs' exposure to AIG, Goldman Sachs CFO David A. Viniar tells investors: "The way we do business with financial institutions is by having appropriate daily margin terms. … That is how we manage our risk. In addition to the margin terms, we augment our risk management with appropriate hedging strategies. … [W]hatever the outcome at AIG, I would expect the direct impact of our credit exposure to both of them to be immaterial to our results." Goldman Sachs Q3 2008 Earnings Call.
Sept. 16, 2008	A Bank of America equity research report notes: "While both LEH & AIG are large, important counterparties to GS, mgmt expects the direct impact of outcomes at both firms to be immaterial to results given hedging strategies and the firm's commitment to avoiding large concentrated positions." Michael Hecht, *The Goldman Sachs Group, Inc.: You Can Run But You Can't Hide; No Immunity from Cyclical Challenges*, Bank of America Equity Research (Sept. 16, 2008).
Sept. 17, 2008	Sandler O'Neill & Partners reports that "A point of management emphasis was on the firm's desire to avoid large concentrated exposures. To this effect, management successfully mitigated its risk to LEH and AIG. While both important counterparties, conservative daily margin terms reduced the risk of doing business with these institutions as well as other counterparties. With that said, management expects that the direct impact of GS's credit exposure to these firms will be 'immaterial' to results." *Goldman Sachs Group, Inc.: 3Q08 Earnings Review*, Sandler O'Neill & Partners, L.P. (Sept. 17, 2008).
Sept. 17, 2008	William Blair reports: "Lehman Holdings (LEH $0.30) and AIG (AIG $3.75) are certainly both important counterparties to Goldman Sachs; although Goldman has worked hard to avoid large direct exposures to any single counterparty by managing margin terms and hedging strategies. Management commented that Goldman Sachs' 'direct' impact to the unwinding of both Lehman and AIG would not be material. The Fed-led bailout of AIG certainly reduces any potential strain from any credit exposure to the company or exposure to others that may have outsized exposures to AIG." Mark Lane and Katherine McCauley, *The Goldman Sachs Group, Inc.: Highlights of Fiscal Third-Quarter Results; No Surprises in The Face of Subdued Expectations in Very Challenging Environment*, William Blair & Company, L.L.C. (Sept. 17, 2008).
Sept. 21, 2008	Board of Governors of the Federal Reserve approves applications of The Goldman Sachs Group, Inc. and Goldman Sachs Bank USA Holdings LLC to convert to bank holding companies. Goldman Sachs Press Release, *Goldman Sachs To Become The Fourth Largest Bank Holding Company*, Sept. 21, 2008, *available at* http://www2.goldmansachs.com/our-firm/press/press-releases/archived/2008/bank-holding-co.html.
Sept. 23, 2008	Berkshire Hathaway agrees to purchase $5 billion in Goldman's preferred stock, and also received warrants to buy another $5 billion in Goldman's common stock, exercisable for a five-year term. Susanne Craig, Matthew Karnitschnig and Aaron Lucchetti, *Buffett to Invest $5 Billion in Goldman*, WALL STREET JOURNAL, Sept. 24, 2008.

Chronology of Selected Events and Disclosures

Date	Event
Sept. 24, 2008	Goldman Sachs announces a public offering of $5 billion in common shares. Goldman Sachs Press Release, *Goldman Sachs Prices $5 Billion Public Offering of Common Equity*, Sept. 24, 2008.
Sept. 28, 2008	The NY Times reports that "Goldman Sachs was a member of A.I.G.'s derivatives club … It was a customer of A.I.G.'s credit insurance and also acted as an intermediary for trades between A.I.G. and its other clients." The article further reports that Goldman Sachs had $20 billion of transactions with AIG, and also includes statements from several Goldman Sachs executives that its exposure to AIG was "immaterial" because of hedges. Gretchen Morgenson, *Behind Insurer's Crisis, Blind Eye to a Web of Risk*, NY Times, Sept. 28, 2008.
Sept. 28, 2008	Reuters reports that Goldman was AIG's "largest trading partner" and had $20 billion of transactions with AIG, but disputes Goldman's level of exposure. Lucas van Praag, a Goldman Sachs spokesman, is quoted in the article, noting that: "we have said many times on the record that our exposure to AIG was, and is, not material … For the avoidance of doubt, our exposure to AIG is offset by collateral and hedges and is not material to Goldman Sachs in any way." *Goldman Sachs faults NY Times story on AIG risk*, Reuters, Sept. 28, 2008.
Sept. 29, 2008	Goldman Sachs completes its public offering, which is oversubscribed. Total proceeds are $5.75 billion. Goldman Sachs 2008 Fourth Quarter Earnings Report, *available at* http://www2.goldmansachs.com/our-firm/press/press-releases/archived/2008/pdfs/2008-q4-earnings.pdf; *See also Goldman Sachs raises $5b with public stock offering*, AP, Sept. 25, 2008.
Oct. 6, 2008	New York Fed (via letter from Timothy Geithner) seeks waiver of Fed rules against board members owning stock or being a director of bank holding companies; letter specifies that Mr. Friedman is a Director of and holds financial interests in The Goldman Sachs Group.
Oct. 8, 2008	The Federal Reserve Board (through the New York Fed) pledges an additional $37.8 billion to AIG. FRB Press Release, *Board authorizes Federal Reserve Bank of New York to borrow securities from certain regulated U.S. insurance subsidiaries of AIG*, Oct 8, 2008, *available at* http://www.federalreserve.gov/newsevents/press/other/20081008a.htm.
Oct. 31, 2008	The Wall Street Journal reports that AIG has posted "about $50 billion in collateral to its trading partners" and that these payments "have continued to balloon after the bailout." The story notes that "Goldman Sachs Group Inc., for instance, has pried from AIG $8 billion to $9 billion, covering virtually all its exposure to AIG -- most of it before the U.S. stepped in." The Journal reported further that Goldman had become concerned about exposure to AIG in 2007 and had hedged its exposure: AIG's trading partners were worried. Goldman Sachs held swaps from AIG that insured about $20 billion of securities. In August 2007, Goldman demanded $1.5 billion in collateral, arguing that the assets backing the securities were falling in value. AIG argued that the demand was excessive, and the two firms eventually agreed that AIG would post $450 million to Goldman, this person says. Late last October, Goldman asked for even more collateral, $3 billion. Again, AIG disagreed, and it ultimately posted $1.5 billion. Goldman hedged its exposure by making a bearish bet on AIG, buying credit-default swaps on AIG's own debt, according to one person knowledgeable about this move. Carrick Mollenkamp, Serena Ng, Liam Pleven and Randall Smith, *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, Wall Street Journal, Oct. 31, 2008 at A1.

Chronology of Selected Events and Disclosures

Nov. 9, 2008	Mr. Friedman, as Board Chairman, together with the Audit Committee Chairman, receives a courtesy telephonic briefing from NY Fed officers the evening of November 9, after the transaction has been structured ,signed, and approved by the Board of Governors of the Federal Reserve System. The transaction is scheduled to be announced the following morning.
Nov. 10, 2008	The Federal Reserve Board and the Treasury announce the restructuring of AIG's debt and the decision to repay AIG's counterparties at par. FRB Press Release, *Federal Reserve Board and Treasury Department announce restructuring of financial support to AIG*, Nov. 10, 2008*, available at* http://www.federalreserve.gov/newsevents/press/other/20081110a.htm.
Nov. 10, 2008	AIG issues press release that RMBS counterparties would be "repaid in full." AIG Press Release, U.S. Treasury, Federal Reserve And AIG Establish Comprehensive Solution For AIG, Nov. 10, 2008, *available at* http://media.corporate-ir.net/media_files/irol/76/76115/releases/111008.pdf.
Nov. 12, 2008	Wall Street Journal reports: "The banks that have sought and received collateral from AIG include Goldman Sachs Group Inc., Merrill Lynch & Co., UBS AG, Deutsche Bank AG and others." It also notes that these banks "will be compensated for the securities' full, or par, value in exchange for allowing AIG to unwind the credit-default swaps it wrote." Serena Ng and Liam Pleven, *New AIG Rescue Is Bank Blessing – Buyers of Insurer's Default Swaps Would Recover Most of Their Money*, WALL STREET JOURNAL, Nov. 12, 2008 at C1.
Nov. 14, 2008	ProPublica reports that "Under the government's latest deal, the Fed has helped AIG pay its obligations to those counterparties. The identity of those banks remains officially under wraps, but the Wall Street Journal has named a number of them: Goldman Sachs, Merrill Lynch, UBS, Deutsche Bank, Barclays, Credit Agricole, Royal Bank of Scotland, CIBC and Bank of Montreal." The article reports that billions of dollars in collateral payments were made by AIG to Goldman Sachs dating back to 2007. Paul Kiel*, AIG's Spiral Downward: A Timeline*, PROPUBLICA, Nov. 14, 2008.
NOV. 17, 2008	Reuters reports that of the 21 analysts covering Goldman Sachs, eight rated it a "buy" and only one analyst recommended selling the stock. Anurag Kotoky, *More analysts see bleak fourth quarter at Goldman, M. Stanley,* REUTERS, NOV. 17, 2008.
Nov. 20, 2008	Regularly Scheduled meeting of the Board of Directors of the NY Fed takes place. The Board minutes do not reflect any discussion of the AIG transaction.
Nov. 24, 2008	President-Elect Obama announces New York Fed President Timothy Geithner to be Treasury Secretary. Press Release, *Geithner, Summers among key economic team members announced today*, Nov. 24, 2008 *available at* http://change.gov/newsroom/entry/geithner_summers_among_key_economic_team_members_announced_today/.
Nov. 25, 2008	Sterne Agee analyst Ada Lee gives Goldman Sachs a "buy" rating, saying the banks' shares were undervalued. Lee notes that Goldman's current stock price "reflects an unrealistically high probability of failure in light of the fresh capital raised from deep pockets and government funding programs." *Analyst rates Goldman, Morgan Stanley a 'buy*,' AP, Nov. 25, 2008.
Early Dec. 2008	Mr. Friedman asks about the status of the waiver and he is informed by New York Fed general counsel Tom Baxter that Fed rules as a matter of practice should be considered in abeyance while waiver decision is pending.
Dec. 10, 2008	Audit Committee of the NY Fed discusses the assets received from the bailout of AIG. Mr. Friedman did not attend the meeting.

Chronology of Selected Events and Disclosures

Dec. 16, 2008	Goldman Sachs releases its 2008 Fourth Quarter Earnings Report, *available at* http://www2.goldmansachs.com/our-firm/press/press-releases/archived/2008/pdfs/2008-q4-earnings.pdf. The report includes detailed information about the Firm's revenue, expenses, and capital.
Dec. 16, 2008	During Goldman Sachs' Q4 2008 Earnings Call, Meredith Whitney of Oppenheimer & Co. notes that Goldman Sachs' "stated exposure to AIG has been immaterial," but asked whether the Federal Reserve's purchase of AIG securities had impacted Goldman Sachs' exposure. Goldman Sachs CFO David Viniar explained: "Our exposure has been immaterial. It is still immaterial. So there's been no change."
Dec. 16, 2008	Michael Wong, an equity analyst at Morningstar says: "We believe that Goldman Sachs is currently undervalued." *Goldman Sachs' Public Progress Report*, PBS, Dec. 16, 2008.
Dec. 17, 2008	Stephen Friedman purchases 37,300 shares of Goldman Sachs stock. Mr. Friedman also receives an award of 3,906 shares by virtue of his position as a Goldman Sachs director. The shares will convert to common stock following Mr. Friedman's retirement from the Goldman Sachs board. Stephen Friedman, Statement of Changes in Beneficial Ownership (Form 4) (Dec. 19, 2009).
Jan. 21, 2009	Federal Reserve Board Vice Chairman Donald Kohn grants Mr. Friedman a 1-year waiver allowing him to own stock in and be a Director of The Goldman Sachs Group.
Jan. 21, 2009	Mr. Friedman is reappointed Chairman and "Class C Director" of New York Fed by the Board of Governors of the Federal Reserve.
Jan. 22, 2009	Stephen Friedman purchases 15,300 shares of Goldman Sachs stock. Stephen Friedman, Statement of Changes in Beneficial Ownership (Form 4) (Jan. 26, 2009).
Jan. 27, 2009	Barron's reports Friedman's stock purchases. Teresa Rivas, *Goldman Director Makes $1 Million Buy*, BARRON'S, Jan. 27, 2009.
Jan. 27, 2009	Public announcement made that Mr. Friedman is reappointed Chairman and "Class C Director" of New York Fed by the Board of Governors of the Federal Reserve.
Jan. 29, 2009	Formal announcement made that William Dudley will replace Timothy Geithner as President of New York Fed.

TESTIMONY OF ELIAS HABAYEB

BEFORE THE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 27, 2010

MR. CHAIRMAN, RANKING MEMBER ISSA, MEMBERS OF THE COMMITTEE. THANK YOU FOR THE INVITATION TO APPEAR BEFORE YOU TODAY.

FROM SEPTEMBER 2005 UNTIL MAY OF LAST YEAR, I WAS SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER OF THE FINANCIAL SERVICES DIVISION OF AMERICAN INTERNATIONAL GROUP, INC. AIG'S SUBSIDIARIES WITHIN THE FINANCIAL SERVICES DIVISION ENGAGE IN A DIVERSE RANGE OF ACTIVITIES INCLUDING AIRCRAFT AND EQUIPMENT LEASING, CAPITAL MARKETS, CONSUMER FINANCE AND INSURANCE PREMIUM FINANCE. THESE SUBSIDIARIES INCLUDE AIG FINANCIAL PRODUCTS CORP. ("FP"). AS HAS BEEN WIDELY REPORTED, FP IS THE UNIT THAT WROTE THE CREDIT DEFAULT SWAPS (THE "SWAPS") PROTECTING MULTI-SECTOR COLLATERALIZED DEBT OBLIGATIONS (THE "BONDS") THAT HAD EXPOSURE TO THE U.S. SUBPRIME MORTGAGE MARKET AND THAT CONTRIBUTED GREATLY TO AIG'S LIQUIDITY CRISIS IN SEPTEMBER 2008.

BY WAY OF BACKGROUND, I AM A LICENSED CPA AND I PRACTICED WITH DELOITTE & TOUCHE LLP, BECOMING A PARTNER IN 2003, BEFORE I WAS RECRUITED TO AIG IN 2005. I LEFT EMPLOYMENT WITH AIG IN MAY 2009 ON EXCELLENT TERMS, AND CONTINUE TO PROVIDE ADVISORY SERVICES TO THE COMPANY WHILE I PLAN THE NEXT PHASE OF MY CAREER.

MY POSITION WHILE I WAS EMPLOYED BY AIG GAVE ME SOME INSIGHT INTO THE CREATION OF WHAT IS COMMONLY REFERRED TO AS "MAIDEN LANE III". MAIDEN LANE III LLC IS A FINANCING VEHICLE CREATED BY THE NEW YORK FEDERAL RESERVE BANK ("NY FED") THAT HELPED FACILITATE THE UNWINDING OF A SIGNIFICANT PORTION OF FP'S SWAPS BY PURCHASING THE UNDERLYING BONDS FROM FP'S SWAP COUNTERPARTIES. AT THE SAME TIME, THE RELATED SWAPS WERE TERMINATED.

I ALSO WAS INVOLVED IN AIG'S EARLY AND UNSUCCESSFUL EFFORTS TO REDUCE FP'S RISK EXPOSURE, INCLUDING BY TERMINATING FP'S SWAPS. ULTIMATELY, THE NEW YORK FED TOOK CONTROL OF THE NEGOTIATIONS WITH FP'S COUNTERPARTIES TO THE SWAPS. THE NEW YORK FED COMPLETED THAT PROCESS THROUGH MAIDEN LANE III. AFTER THE TRANSACTIONS WERE COMPLETED, I, ALONG WITH OTHERS, REVIEWED AIG'S FILINGS WITH THE SECURITIES AND EXCHANGE COMMISSION TO HELP ENSURE THAT THEY ACCURATELY DESCRIBED THESE TRANSACTIONS.

I UNDERSTAND THAT THE COMMITTEE IS INTERESTED IN LEARNING MORE ABOUT THE MAIDEN LANE III TRANSACTIONS. THESE TRANSACTIONS WERE CRITICAL TO AIG IN ORDER TO MATERIALLY REDUCE THE RISK OF SUBSTANTIAL COLLATERAL POSTINGS TO COUNTERPARTIES THAT FP WAS REQUIRED TO MAKE UNDER THE SWAPS AND ALSO TO REDUCE THE EROSION TO AIG'S CAPITAL FROM MOUNTING MARK-TO-MARKET LOSSES ON THE SWAPS.

I PAUSE FOR A MOMENT TO RECOUNT SOME CONTEXT BECAUSE I BELIEVE IT SHEDS LIGHT ON WHY MAIDEN LANE III WAS NECESSARY.

FIRST, IT IS IMPORTANT TO UNDERSTAND THE NATURE OF AIG'S EXPOSURE TO THE SWAPS BECAUSE AIG GUARANTEED FP'S DEBT OBLIGATIONS SINCE FP'S INCEPTION IN 1987.

SINCE 1998, FP WROTE SWAPS THAT PROVIDED CREDIT PROTECTION ON MULTI-SECTOR COLLATERALIZED DEBT OBLIGATIONS (REFERRED TO HERE AS THE BONDS). AS OF SEPTEMBER 30, 2008, THE TOTAL NOTIONAL VALUE OF THE BONDS WAS APPROXIMATELY $72 BILLION.

FP'S COUNTERPARTIES TO THESE SWAPS WERE MOSTLY LARGE US AND INTERNATIONAL FINANCIAL INSTITUTIONS. THE COUNTERPARTIES PURCHASING THE SWAPS PAID FP PERIODIC PREMIUMS IN EXCHANGE FOR FP ASSUMING THE RISK THAT THE COUNTERPARTIES HAD OF NON-PAYMENT OR

LOSS RESULTING FROM CERTAIN "CREDIT EVENTS" (*E.G.*, FAILURE TO PAY, BANKRUPTCY, ACCELERATION, RESTRUCTURING) WITH RESPECT TO THE UNDERLYING BONDS.

FP WAS ALSO REQUIRED UNDER CERTAIN CIRCUMSTANCES TO POST COLLATERAL TO THE COUNTERPARTIES – SECURING FP'S ABILITY TO PERFORM IN THE EVENT OF A DEFAULT OR OTHER CREDIT EVENT TRIGGERING A PAYMENT OBLIGATION ON THE SWAP.

GENERALLY, THE AMOUNT OF COLLATERAL REQUIRED TO BE POSTED BY FP UNDER THE SWAPS WAS DETERMINED BY A FORMULA THAT TOOK INTO ACCOUNT AIG'S CREDIT RATINGS, THE UNDERLYING BOND'S CREDIT RATINGS, AND THE MARKET VALUE OF THE UNDERLYING BOND. TO SIMPLIFY, IF THE VALUE OF THE BONDS COVERED BY THE SWAP, THE UNDERLYING BOND'S CREDIT RATING, OR AIG'S CREDIT RATING DROPPED, FP HAD TO POST COLLATERAL "FOR THE PROTECTION" OF ITS COUNTERPARTY.

DURING THE SUB-PRIME MORTGAGE CRISIS, THE BONDS UNDERLYING FP'S SWAPS BEGAN TO DECREASE IN VALUE. AS A RESULT, BEGINNING IN LATE 2007 THROUGH 2008, FP REPORTED BILLIONS OF DOLLARS OF MARK-TO-MARKET LOSSES ON THE SWAPS UNDER THE FAIR VALUE ACCOUNTING RULES. (AS CFO OF THE FINANCIAL SERVICES DIVISION, I WAS INVOLVED IN ACCOUNTING FOR THE SWAPS, EVEN THOUGH I WAS NOT INVOLVED IN WRITING THE SWAPS –

INDEED, THE MAJORITY OF THE SWAPS WERE ON FP'S BOOKS BEFORE I JOINED AIG.) THESE VALUATION LOSSES COULD (AND INITIALLY WERE EXPECTED TO) REVERSE IF THE FAIR VALUE OF THE SWAPS RECOVERED AND FP STILL HELD THE SWAPS.

FP ALSO POSTED BILLIONS OF DOLLARS IN COLLATERAL TO ITS COUNTERPARTIES UNDER THE SWAPS AS A RESULT OF THE DECLINING MARKET VALUE OF THE BONDS AND DECLINES IN AIG AND THE BONDS' CREDIT RATINGS.

IN LIGHT OF THESE MOUNTING LOSSES, BEGINNING IN THE SUMMER OF 2008, BEFORE THE FEDERAL RESCUE, I WAS ACTIVELY INVOLVED, ALONG WITH OTHERS AT AIG AND ITS ADVISORS, IN EXPLORING POSSIBILITIES TO REDUCE THE LIQUIDITY AND MARK-TO-MARKET RISKS POSED BY FP'S SWAPS.

HOWEVER, AIG LACKED THE FINANCIAL RESOURCES TO COME UP WITH A LARGE SCALE SOLUTION INVOLVING A $72 BILLION BOOK OF SWAPS. EVEN THOUGH AIG HAD MANY ASSETS, MOST WERE ASSETS HELD BY ITS INSURANCE COMPANY SUBSIDIARIES, AND STATE INSURANCE REGULATIONS SEVERELY LIMITED AIG'S ABILITY TO ACCESS THEM. BECAUSE AIG IS NOT A BANK, IT DID NOT HAVE ACCESS TO FUNDING THROUGH THE FEDERAL RESERVE IN THE NORMAL COURSE. INSTEAD, AIG HAD TO RELY ON THE CAPITAL MARKETS. BUT AIG WAS UNABLE TO OBTAIN ADDITIONAL LIQUIDITY FROM THE CAPITAL MARKETS.

ADDITIONALLY, OUR EFFORTS TO STEM THE TIDE OF COLLATERAL CALLS AND REDUCE FP'S RISK EXPOSURE BY NEGOTIATING WITH COUNTERPARTIES DURING THIS PERIOD WERE UNSUCCESSFUL. UNFORTUNATELY, WE HAD LITTLE NEGOTIATING LEVERAGE WITH FP'S COUNTERPARTIES TO EXTRACT DISCOUNTS. THE CONTRACTUAL COLLATERAL POSTING PROVISIONS IN THE SWAPS WERE A SOURCE OF CHEAP CASH FOR THEM. IT WAS ALSO MY UNDERSTANDING THAT EVEN IF FP OR AIG FILED FOR BANKRUPTCY, THE COUNTERPARTIES WOULD KEEP THE COLLATERAL FP HAD POSTED TO DATE, THEY WOULD KEEP THE UNDERLYING BONDS (AND ANY FUTURE UPSIDE), AND THEY COULD MAKE A CLAIM AGAINST FP FOR DEFAULTING ON THE SWAPS.

BY AUGUST 31, 2008, FP HAD POSTED $19 BILLION IN COLLATERAL TO FP'S SWAP COUNTERPARTIES. AND BY THE BEGINNING OF SEPTEMBER 2008, FP'S COLLATERAL PAYMENT OBLIGATIONS (AS WELL AS CASH REQUIREMENTS IN CERTAIN OF AIG'S OTHER BUSINESS SEGMENTS) WERE PLACING INCREASING STRESS ON AIG'S LIQUIDITY. ON SEPTEMBER 15, 2008, THE RATING AGENCIES DOWNGRADED AIG'S CREDIT RATING, TRIGGERING AN ONSLAUGHT OF NEW COLLATERAL CALLS.

EVEN AFTER THE FEDERAL RESCUE ON SEPTEMBER 16, 2008, AIG STILL NEEDED TO DO SOMETHING TO REDUCE ITS EXPOSURE TO THE MARK-TO-MARKET LOSSES AND COLLATERAL CALLS ON FP'S SWAPS. THE FEDERAL

RESCUE DID NOT STOP THESE LOSSES OR PAYMENT OBLIGATIONS. INDEED, FP POSTED APPROXIMATELY $12.5 BILLION IN THE MONTH OF SEPTEMBER ALONE. AND AS THE LOSSES AND PAYMENTS CONTINUED, AIG FACED YET ANOTHER RATINGS DOWNGRADE THAT COULD HAVE FURTHER STRAINED AIG'S LIQUIDITY BY TRIGGERING YET MORE COLLATERAL CALLS OR PERMITTING COUNTERPARTIES TO TERMINATE SWAPS AT PRICES FAVORABLE TO THEM.

IN OUR ONGOING DISCUSSIONS WITH COUNTERPARTIES DURING THIS PERIOD, THE COUNTERPARTIES WERE UNWILLING TO ACCEPT LESS THAN PAR VALUE. SOME COUNTERPARTIES WERE WILLING TO TERMINATE THE SWAPS, BUT ONLY IF AIG PURCHASED THE UNDERLYING BONDS FROM THEM – SOMETHING AIG COULD NOT DO WITHOUT THE NY FED'S HELP.

ON SEPTEMBER 30, 2008, I, OTHERS AT AIG, AS WELL AS AIG'S FINANCIAL ADVISORS AND LEGAL COUNSEL, PRESENTED TO THE NY FED AND ITS FINANCIAL ADVISORS, SEVERAL OPTIONS FOR ADDRESSING THE LIQUIDITY AND MARK-TO-MARKET LOSSES. THE OPTIONS AVAILABLE TO AIG WITHOUT NY FED SUPPORT WERE LIMITED GIVEN AIG'S LACK OF FINANCIAL RESOURCES AND ACCESS TO THE CAPITAL MARKET. BUT A LARGE SOLUTION WAS CRITICAL TO REDUCING THE LIKELIHOOD OF A FURTHER DOWNGRADE OF AIG'S RATING.

ONE OF THE OPTIONS PRESENTED WAS FOR FP AND THE NY FED TO CREATE A SPECIAL PURPOSE VEHICLE FUNDED LARGELY BY THE NY FED AND

FP'S EXISTING COLLATERAL POSTINGS THAT WOULD PAY TO ACQUIRE THE UNDERLYING BONDS AND TERMINATE THE RELATED SWAPS. (THIS OPTION WAS VERY SIMILAR TO MAIDEN LANE III.) THIS OPTION WOULD REDUCE FP'S EXPOSURE TO MARK TO MARKET LOSSES AND COLLATERAL CALLS BUT WOULD NECESSITATE A LARGE UPFRONT FUNDING REQUIREMENT.

UNDER THE FINAL MAIDEN LANE III STRUCTURE, THE NY FED WOULD LEND UP TO $30 BILLION AND AIG WOULD PROVIDE $5 BILLION IN EQUITY FUNDING TO MAIDEN LANE III AND MAIDEN LANE III WOULD BUY THE BONDS UNDERLYING THE SWAPS FROM FP'S COUNTERPARTIES. MAIDEN LANE III WOULD COLLECT CASH FLOWS FROM THE BONDS AND PAY A DISTRIBUTION TO AIG FOR ITS EQUITY INTEREST ONCE THE PRINCIPAL AND INTEREST OWING TO THE NY FED ON ITS LOAN HAD BEEN PAID DOWN IN FULL. UPON PAYMENT IN FULL OF THE NY FED'S LOAN AND AIG'S EQUITY INTEREST, ALL REMAINING AMOUNTS RECEIVED BY THE ENTITY WOULD BE PAID 67 PERCENT TO THE NY FED AND 33 PERCENT TO AIG.

THIS ARRANGEMENT ALLOWED BOTH THE NY FED AND AIG TO RETAIN THE UPSIDE FROM THE BONDS – FUTURE CASH FLOWS.

ON OCTOBER 31, 2008, I WAS TOLD THAT THE NY FED AND ITS FINANCIAL AND LEGAL ADVISORS TOOK OVER NEGOTIATIONS WITH THE COUNTERPARTIES AND ALL EFFORTS WERE NOW FOCUSED ON IMPLEMENTING THE MAIDEN LANE

III SOLUTION. I PERIODICALLY RECEIVED UPDATES ABOUT THE NY FED'S PROGRESS IN THESE NEGOTIATIONS.

UNDER THE FINAL TERMS NEGOTIATED BY THE NY FED, MAIDEN LANE III (THE FINANCING ENTITY CREATED BY THE NY FED), BOUGHT THE UNDERLYING BONDS AT THEIR THEN MARKET VALUE – NOT AT PAR. SEPARATELY, FP AGREED TO TERMINATE THE SWAPS FOR AN AMOUNT EQUAL TO THE DIFFERENCE OF THE BONDS' NOTIONAL (PAR) VALUE AND ITS MARKET VALUE. THE COLLATERAL THAT FP HAD POSTED TO DATE WAS USED TO PAY THE COST OF TERMINATING THE SWAPS. SO, THE COUNTERPARTIES ENDED UP WITH PAR.

AS AIG DISCLOSED IN AN SEC FILING ON DECEMBER 2, 2008, MAIDEN LANE III PURCHASED APPROXIMATELY $46.1 BILLION NOTIONAL AMOUNT OF BONDS UNDERLYING FP'S SWAPS AND TERMINATED THE ASSOCIATED SWAPS ON NOVEMBER 25, 2008. THE AGGREGATE COST OF THE PURCHASES AND TERMINATIONS WAS FUNDED THROUGH APPROXIMATELY $15.1 BILLION OF BORROWINGS UNDER THE NY FED LOAN TO MAIDEN LANE III, AIG'S $5 BILLION EQUITY FUNDING AND THE SURRENDER OF APPROXIMATELY $25.9 BILLION OF COLLATERAL PREVIOUSLY POSTED BY FP TO THE SWAP COUNTERPARTIES.

ON DECEMBER 18 AND 22, 2008, MAIDEN LANE III ACQUIRED $16 BILLION IN PAR AMOUNT OF ADDITIONAL BONDS. AS DISCLOSED IN AN SEC FILING ON DECEMBER 24, 2008, THIS PURCHASE WAS FUNDED WITH A NET PAYMENT TO

COUNTERPARTIES OF APPROXIMATELY $6.7 BILLION. ADDITIONALLY, FP SURRENDERED APPROXIMATELY $9.2 BILLION IN COLLATERAL PREVIOUSLY POSTED TO FP'S SWAP COUNTERPARTIES TO TERMINATE THE SWAPS. IN CONNECTION WITH THE TERMINATION OF THE SWAPS, FP GOT BACK $2.5 BILLION IN EXCESS COLLATERAL IT HAD PREVIOUSLY POSTED UNDER THE SWAPS.

IN SUM, MAIDEN LANE III PURCHASED APPROXIMATELY $62 BILLION IN NOTIONAL AMOUNT OF BONDS UNDERLYING FP'S SWAPS FOR A MARKET VALUE OF $29 BILLION. FP PAID THE COUNTERPARTIES IN PREVIOUSLY POSTED COLLATERAL, $33 BILLION, TO TEAR UP THE SWAPS.

I UNDERSTAND THE COMMITTEE IS ALSO INTERESTED IN AIG'S DISCLOSURES ABOUT MAIDEN LANE III. AFTER THE MAIDEN LANE III TRANSACTIONS WERE COMPLETED, I, ALONG WITH OTHERS, REVIEWED AIG'S FILINGS WITH THE SEC TO HELP ENSURE THEIR ACCURACY BECAUSE OF MY FAMILIARITY WITH THE TERMS OF THE MAIDEN LANE III TRANSACTIONS. I DID NOT DECIDE WHAT EXHIBITS OR SCHEDULES WERE DISCLOSED. AIG HAD OUTSIDE LEGAL COUNSEL WHO GUIDED THE COMPANY THROUGH THAT PROCESS.

TO CONCLUDE, MAIDEN LANE III WAS CRITICAL IN HELPING AIG TO ELIMINATE MOST OF ITS CONTINUED EXPOSURE TO THE SIGNIFICANT MARK-TO-

MARKET LOSSES AND COLLATERAL CALLS ON THE SWAPS THAT WERE DRAINING AIG'S LIQUIDITY.

I AM HAPPY TO ANSWER ANY QUESTIONS THE MEMBERS OF THE COMMITTEE MAY HAVE. THANK YOU.