From: michael nelson/ny/frs;nsf;michael.nelson@ny.frb.org;smtp
Sent: Thu May 20 2010 16:18:14 EDT
To: james p bergin/ny/frs@frs;joyce hansen/ny/frs@frs;
Subject: Fw: COP Notes

to prep you for the murder board on Monday
----- Forwarded by Michael Nelson/NY/FRS on 05/20/2010 04:18 PM -----

From: Stephanie Ruiz/NY/FRS
To: Michael Nelson/NY/FRS@FRS
Date: 05/14/2010 04:44 PM
Subject: Fw: COP Notes

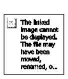
----- Forwarded by Stephanie Ruiz/NY/FRS on 05/14/2010 04:44 PM -----

Shari Leventhal/NY/FRS
05/14/2010 04:43 PM

To
Stephanie Ruiz/NY/FRS@FRS
cc

Subject
Re: COP Notes

Here they are. I sent them to Tom B. already.



From: Stephanie Ruiz/NY/FRS
To: Shari Leventhal/NY/FRS@FRS
Date: 05/14/2010 04:20 PM
Subject: Re: COP Notes

Can you please send me the notes once they are complete? Michael Nelson wanted to see them before his Monday morning meeting.

Shari Leventhal/NY/FRS
05/14/2010 12:01 PM

To
Stephanie Ruiz/NY/FRS@FRS
cc

Subject
Re: COP Notes

I realize that - it's not your fault at all. I kind of like referring to Damon as that COP Guy.

From: Stephanie Ruiz/NY/FRS
To: Shari Leventhal/NY/FRS@FRS
Date: 05/14/2010 11:48 AM
Subject: Re: COP Notes

Okay, thanks. Sorry I didn't know who everybody was and no one announced their names.....

Shari Leventhal/NY/FRS
05/14/2010 11:48 AM

To

Stephanie Ruiz/NY/FRS@FRS
cc

Subject
Re: COP Notes

Not yet. I'm cleaning them up to put in missing names etc...

From: Stephanie Ruiz/NY/FRS
To: Shari Leventhal/NY/FRS@FRS
Date: 05/14/2010 11:10 AM
Subject: Re: COP Notes

Ha, how funny! I just sent them to you. Do you want me to forward them on to anyone else?

Shari Leventhal/NY/FRS
05/14/2010 11:09 AM

To
Stephanie Ruiz/NY/FRS@FRS
cc

Subject
COP Notes

Hi Stephanie,

The Treasury is wondering whether we can send them the notes from Tuesday's COP meeting that they also attended. Please let me know how they are coming.

Thanks,
Shari

COP/AIG Interviews 5/11/10

Tom Baxter, FRBNY

Michael Patrick, FRBNY

Shari Leventhal, FRBNY

Julie Dolan, FRBNY

Michael Alix, FRBNY

Steve Manzari, FRBNY

Sarah Dahlgren, FRBNY

James Hennessy, FRBNY

Jim Mahoney, FRBNY

Jennifer Schuster, FRBNY

Marshall Huebner, DPW

Chairman Warren, COP

Damon Silvers, COP

Richard Neiman, COP

J. Mark McWatters, COP

Paul Atkins, COP

Jim Millstein, Treasury

Carole Florman, Treasury

(And others who did not identify themselves.)

Warren: Hope you (Baxter) and Sarah can testify.

Go through the timing of the decisions made on September 16. When decisions made to give the initial loan. When AIG appeared it was going to crumble.

Damon Silvers: Panel is aware of the pressures of that moment. Understand the policy considerations, in the broadest sense, that you all faced at that moment. What objectives, concerns you had, at policy level.

Baxter: Important to remember the context, September, '08. Already experienced the conservatorship of Fannie and Freddie, second week of September, Lehman weekend, trying to rescue Lehman, then Lehman parent in chapter 11 bankruptcy and lending to us broker dealer, 16th, 1y7th and 18th. I was here throughout Lehman weekend. Spent the night here on the 14th, never went home. Monday evening went home, returned morning September 16th, joined conference call with Geithner, key call with Bernanke, Secretary Paulson, Geithner, other staff. We talked through the policy decision whether or not the Fed should lend to AIG. The developments were rapid and they occurred overnight. Involved the private sector consortium. Monday night into Tuesday decision not to lend to AIG, I wasn't here but I joined at 8 am. Decision to be made was would the Fed step in, early in the morning on September 16th, AIG needed liquidity. Liquidity problem, we thought, not a solvency problem. Focused on whether or not would lend and what the amount would be.

There may have been others on the call.

Warren: Determined there was a liquidity problem, not solvency. Why did the privates pull out?

Baxter: Let me back up. Over the course of Lehman weekend, discussions at the Fed with private sector to rescue Lehman, several people said that the private sector would take care of AIG. We knew there was a liquidity problem at AIG, we knew private sector was working. Private sector was going to take care of AIG. We had the sense as we went into the 15th that that problem was being attended to by the private sector. In the course of a day that all changed, b/c of the Lehman bankruptcy filing. Banks hunkered down and couldn't extend credit to AIG. That's my view. We were the contingency plan on the morning of the 16th. This conference call was for the purpose of analyzing the policy question. Would the Fed lend?

Silvers: liquidity vs. solvency?

Baxter: Demand for cash by AIG, one problem was securities lending, life insurance subsidiary. Cash collateral calls generated by AIGFP because of the contracts it had with the CDS counterparties.

Silvers: AIG had the capacity to repay?

Baxter: AIG was balance sheet solvent, had more assets than liabilities. It had a cash need. Could we meet their cash need by lending fully secured.

Silvers: Private sector couldn't do that?

Baxter: What we had observed over the course of 24 hours, the banks that were prepared to lend over the weekend had changed their position, I think b/c of the Lehman chapter 11 situation.

Silvers: Not AIG specific. Pull back in fear. Understand Goldman was present over Lehman weekend, but Goldman had liquidity worries of its own. What was Goldman's role?

Baxter: Like Long Term Capital Management, I can tell you that part of the decision making over Lehman weekend was to call together major participants in our markets and to get them to contribute to financing a Bear Stearns type of solution to Lehman. The people who were called here Friday, September 12, were reps of major mortgage participants in a consortium that would work out financing to Lehman similar to Bear Stearns case. That worked b/c by Sunday the private sector reps had agreed to provide the financing. We succeeded in that mission. But we couldn't get Barclays to do the guarantee. If you go back and study Bear transaction, guarantee provided by JPMC was a key element. Couldn't get that guarantee done by Barclays because they said they needed a shareholder meeting. But the financing part worked.

Warren: difference in the 2 decisions. If already had the financing lined up for Lehman, but no guarantee, why didn't Fed step in?

Baxter: Fed has no legal authority to do a guarantee to facilitate a merger. In the new act, the guarantee power was added. Statutory power to do a guarantee. We don't have power to do naked guarantee. We did not have the power. It is not clear to me as I sit here today whether the stated reason was in fact the real reason why Barclays couldn't do the guarantee. British government didn't want Barclays to acquire all of Lehman, that is also a possibility. I don't know where truth lies. Why Goldman? Why JPMC? They were both in the room for a different purpose. AIG came up. Statements were made that the private sector was working on it and would take care of it.

Silvers: Who from the private sector was there?

Baxter: We'll try to get you the names.

Silvers: Goldman?

Baxter: Here as one potential source of financing. You bring together the big players who can contribute to the financing package. We did that in 1998.

Huebner: Lehman weekend was different, huge drains after that. Snowball after the Lehman filing. Investment in Goldman was after.

Silvers: Realization they needed something

Baxter: The following weekend both Goldman and Morgan Stanley made decision to become bank holding companies. Occasioned by the circumstances both companies were facing.

Goldman and the others committed to a financing package to a rescue of Lehman, Goldman did not do that individually.

PDCF opened March 17, 2008 after Bear Stearns.

Warren: LTCM- locked up together.

Baxter: LTCM – I was there. Creditors of LTCM were called by McDonough. Dialogue took place what would happen to their exposures to LTCM if LTCM filed for bankruptcy. Would've happened in the Cayman Islands. Had to find out how bankruptcy happened there. As the creditors became aware and learned and saw their self interest would be to provide capital to LTCM. Financial problems occasioned by the Russian crisis. They decided to put in capital and that decision turned out to be very wise. They got interest and made a small profit. Not a single penny of taxpayer money was put into LTCM. In 2008, our role changed. One of the variations, instead of Fed providing the financing, more like LTCM, we would lean on these major institutions to come up with the financing packages. It worked in that we got them to agree.

SIlvers: Agreed over Lehman. What about discussing impact of AIG?

Baxter: don't remember any discussion of specific impact of Lehman on individual firm. Discussion was of impact of Lehman filing for markets generally.

Warren: Lehman would be handled the way that LTCM was. You make the point that it was partially successful. AIG knew it was ongoing at the same time. Private parties had worked out what would happen with AIG. The Fed was not an active participant like it was with LTCM?

Baxter: my best recollection of what happened in that room with the CEOS, the course of several CEOS, all weekend. Several times, AIG came up. Sense was not that AIG would fail, so the feeling was we didn't need to talk about AIG there.

Warren: Doing it separate than the Fed?

Baxter: Yes. There is a term sheet. Private sector AIG had a massive need for liquidity, look at term sheet, 75 billion dollars. Not solvency, liquidity, private sector, see it in term sheet. Financing to AIG. 75 billion. Going to downgrade

Silvers: 75 billion term sheet on the table, suggests two matters were unfolding prior to Lehman bankruptcy?

Huebner: Yes

Dahlgren: Rating agencies clearly telegraphing going to downgrade AIG over the summer. It knew they had pending problems. Potential lines of credit, repos.

Silvers: Expectations among AIG and lenders that the downgrade was coming prior to Lehman's bankruptcy.

Warren: on Tuesday morning, the private lenders say we're not going to do this. Seems like Fed is in the same position with LTCM. You all go down together if you can't put together the facility.

Baxter: We were told by JPMC that they were done. Weren't going to listen anymore. That they were out. It was futile to continue that discussion.

Warren: did someone say to them here's what happens if you don't do this? Everybody goes down?

Huebner: Don't know the answer to that. Different banks had different exposures. It was the creditors who had a huge amt at stake. Morning of September 16^{th}, I was representing JPMorgan.

Silvers: You weren't there. Need to hear from people who were there

Baxter: Policy decision was either the Fed lends or AIG is going to file. AIG would file day after Lehman

Silvers: Policy considerations.

Baxter: Have to make your policy decision in the context. When evaluating, that's in a context. What we already experienced in September. Edge of a full-fledged panic. Alternatives identified in the conf call- we can lend or we can let AIG file similar to Lehman. We understood the AIG Board was available and ready to meet. I don't remember if they were waiting or if they knew we were having our call. They did meet later in the day. They didn't need to ask we knew we were the lender of last resort.

Silvers: Lack of tools and information at the time to judge the exposure?

Baxter: we had a sense of the major creditors when we were meeting that morning. There was a list of the major creditors of AIG. Across the board. Total exposure. The question I was asked – do we have the legal authority? We do under 13(3) and we do, we're going to be fully secured over whatever credit we extended to AIG. They had to come up with collateral. All of those things were discussed in that conf call in the morning. Consequences of a bankruptcy filing are far worse than providing liquidity to AIG so we provided liquidity

Warren: Do you have legal authority to condition your lending? Others take haircuts

Baxter: I'm sure we could condition our lending. Questions about liability. Also Question would be what would the conditions do to the market and AIG. Had we done conditional lending, the conditions would have frustrated the overall objective which would be to carry AIG through its liquidity problem and get out. 13(3) requires we be secure to our satisfaction. Should have more than enough collateral to warrant the exposure.

Manzari: Downgrades had impact on collateral calls. People were running away. People scared of AIG. Not just the downgrade. With everything else going on in the market, people wanted to get their cash back now. Broad shrinking of securities lending market. Greater than AIG. People are going to first cut the lower graded counterparties.

Dahlgren: After September 15th downgraded, still investment grade.

Baxter: AIG had biggest problem in history. We took 79.9 to make darn sure that the US taxpayer was the ultimate beneficiary of this rescue.

Silvers: Downsides of downgrade or insolvency?

Baxter: Downsides were clear. BCCI insolvency. Failed in 1991. Conducted operations in 70 countries including the US. The supervisors took action to protect the... us happened to be first b/c federal reserve team went to the middle east. Every creditor received 100 cents on the dollar. First supervisor who takes action benefits. Translate that to insurance insolvency. State supervisors were acting to protect the policy holders. 130 countries. 400 supervisors around the world. As soon as they felt insecure and felt warning signs, those supervisors would take affirmative action if they were paying attention.

COP guy: What troubled you with lending to AIG?

Baxter: AIG in isolation out of September 2008 it would be a different story, maybe. In that context, that question was easy to answer

Warren: Perceived as a bailout and creating moral hazards. And would it work?

Silvers: what were the moral hazards?

Baxter: In counterparty risk management in an institution of a certain size, if you are over a certain size, you are too big to fail and the government won't let that fail. Don't need to worry about counterparty risk.

Dahlgren: Those who invest or transact won't do the appropriate level of due diligence assuming that the government is standing behind them.

Large amt of due diligence from AIG distributors.

Silvers: How do you mitigate moral hazards?

Baxter: Once we reached the policy decision that is better to lend, still have to meet with the Board of Governors -- need authorization. Under 13(3). Chairman needs to get that done and needs to convince the Board that that needs to happen. We learned that AIG was going to have a cash need and going to have to disburse on the 16th. Combination of cash. Find the credit need. Get the collateral and make the loan, all in the course of that day. Day that other things were going on. Lending 40 million to Lehman's broker dealer. Lots of conflicting demands and lots of things to get done. Had to be sequenced in a certain way.

I don't remember discussion to mitigants to moral hazards. Neither the Fed nor the treasury had authority to hold the shares. When we saw equity on term sheet- problem of legal ownership and the conflict. Maybe strike that and not take equity. But then thought of taxpayer. Create a trust, put shares in trust. For benefit of American people. We had to decide that right away. Will we take this private sector term sheet? Interest rate was not a Fed interest rate. More of a loan shark. If AIG was ready to do this deal at that rate, why should we take less? So we stayed with that rate. One exception- the amount. 75 billion. We did it for 85. I cannot tell you why we went from 75 to 85. Don't know why.

Dahlgren: It was to anticipate problems. Provide a cushion. Not understanding if it was going to work.

Warren: Wouldn't put conditions on lending.... Reason?

Huebner: from a lender liability perspective, would never tell client to put conditions. AIG was investment grade, had huge amt of unencumbered collateral. How does one lend money to AIG, negative pledges, by laws, unbelievably complicated to lend money to AIG. The idea that a lender in court or out of court would say other obligations need to be short paid. I've never seen that

Dahlgren: Remember the context. To mitigate what was happening in the markets. Lack of confidence with how things were going to play out. If we added more mitigants, would say other things to the market. Goal is to stabilize AIG And get the payback to the taxpayer.

We spent all of September, October and November with sudden debt problem.

Silvers: Not going to be an uncontrollable level of default, did that require that all creditors receive 100 cents on the dollar?

Dahlgren: Didn't have a view on that on September 16th.

Baxter: On September 16th we didn't. In theory bankruptcy is still an option. Sell collateral, repay our loan.

Silvers: Trying to signal something?

Baxter: trying to avoid an AIG filing. Stark decision.

Silvers: If commit to endless liquidity, \

Huebner: You are asking for greater genius than exists. The whole system was falling down. AIG filing by tonight. 85 billion thought to be enough to save them. And they were able to give the Fed sufficient collateral. Taxpayers had to be protected. Lehman failed. Worst panic since 1929. Massively bigger than Lehman. 401ks etc. do we make the loan or let them supernova? Wish everyone was sophisticated enough to see counterparties that. . . . Einstein level. Emergency triage. Alternative was a supernova that would drag down the financial system. Past insurance failure- ...

Silvers: Overriding goal that you had was to ensure the continued solvency of this very large institution and to reassure market participants?

Huebner: Doesn't address solvency.

Silvers: Signal that you sent. Avoid systemic meltdown. It was important in order to achieve that, under the great pressure you were under, that all counterparties got paid and would get paid.

Baxter: I'm not sure you're wrong. We were trying to answer a liquidity need we saw in AIG on September 16th. We didn't feel there was a solvency problem at AIG. One of the consequences of that, if you know how the Fed lends, and we lend fully secures. If unsecured lender, might actually scare you. Fed is going to solve all the pre-collateral, and if you are unsecured and there is a bankruptcy you might be less protected. One of the concerns. Unsecured could be more worried. Let AIG file and deal with the collateral consequences or provide liquidity. As we went forward, faced same conundrum. Let AIG file in November? Irresponsible to save in September and then let them fail in November. Shows government can't make a decision, in the course of a crisis, that would be poisonous. Didn't reverse course. Adapted and changed, made minor course changes. At no point did we believe that we should let AIG file.

SIlvers: The decision made on the 16th, critical setting of policy.

Baxter: Once you made that decision, it was much more difficult to reverse course and let AIG file at some pt in time. Not until AIG isn't a systemic concern. And we're not there yet.

Warren: No counterparty risk if dealing with one of the big guys, stand behind them with no penalty to you and no cost. Created 2 policies- we are steady and we created too big to fail.

Huebner: Lehman had failed the day before.

Warren: Can't lose money, they are too big. Let them fail and then government comes in. it's not file or not file. Either bail them out conditionally or unconditionally. It's not binary. Excluding alternatives. There may have been bad alternatives.

Huebner: Dealing with a worldwide insurance company. We thought about these options. Filing just the parent. Thought about different possibilities. At the end of the day, the decision was In this case, the further confusions were surest, safest way to delay the consequences. Talking about GM as the analogy.

Dahlgren: Objectives remained the same. Continue to stabilize AIG. Thing about context and what was going to happen to AIG as a result. 25 billion loss in 2nd quarter. To not impact more broadly.

Cop guy: what kind of impact trying to avoid?

Dahlgren: once government makes the decision, you're not seeing huge improvements in how the markets are functioning either. How AIG is performing and the ratings agencies. Government has made 85 billion dollar loan. Agencies don't downgrade.

So AIG could continue to function. As obligations came in, AIG could function. Trying to make sure AIG meet obligations as they come through.

Key driver was the ratings agencies even absent them. 25 billion loss, nearly 100 billion loss for the year. Markets would have reacted absent action.

SIlvers: How much the policy was driven by a need to keep the ratings agencies happy? Peculiar thing.

Expectation of continued government support.

Huebner: Keeping AIG's business operating and not having people pull out. The buying market. AIG was going to be a survivor. Thought to be biggest and richest company in the world. Keeping the buyers of policies believing that AIG Was going to make it. That was the magic ring. Huge dip with lots of net withdrawals. World has accepted that AIG was not going to fail. Start booking profits.

At noon they said they needed nothing. Called back at 2 and said we were off by 14 billion.

We're disentangling now.

Silvers: Post March. We're bound by White House policy paper.

Baxter: We have a trust here and problem for the trustees. Not a problem for the Fed.

Dahlgren: The risk has been reduced on the impact of a ratings downgrade but not down to 0 which is where we would expect to see it go over the course of the year

Baxter: Problem with FP is the parent guarantee. We might've let them go into bankruptcy but the problem is with the default of the parent guarantee

Warren: If Goldman was truly hedged why cdo go down? Why did the Fed insist on bailout?

Alix: we don't know whether Goldman was hedged or not. Not our perspective or our function. If AIG was downgraded to a certain level, they could terminate. Keeping all the collateral, retaining the cdo, shortfall. If Goldman or any other party, cds counterparties, had back to back hedge, not clear this reduces the damages. Termination value in the event of the termination. Had a list from AIG who their counterparties were but only knew their exposure as to AIG's perspective.

Warren: Conversations with foreign regulators?

Baxter: Tuesday conf call in afternoon between our head of supervision and foreign supervisors to describe Fed was going to provide liquidity to AIG. After decision had been made. To alert them. Senior supervisors group, headed by Bill Rutledge. Both banking and insurance supervisors. FSA (both) they were on the call.

No conversations that preceded that decision.

Neiman: Policy recommendations or statutory changes?

Baxter: Look at the parent guarantee. Implication of that. Trying to do a resolution. Those things make it more difficult. Restructuring of financial companies is depending on short term credit which is dependent on rating. Bringing the whole house apart. Try to extract value from a counterparty to pay less them less than par. Default. You have to ... spend some time . .. and understand their selective default. Like to leave accordance satisfaction rules

Silvers: Moodys would downgrade a company with a government guarantee?

Dahlgren: They said they would.

Silvers: Offer guarantees at less than par. We'll give you 80 cents on what we owe you.

Baxter: A rating is an assessment that the rated debt is going to be paid in cash when due in full. When they see 80 cents, how about 70? Rating agency can downgrade. We live having to use taxpayer money in full in a distressed situation. From the business perspective, the most painful thing I've been involved in.

Dahlgren: We've had discussions all along. No discussion on September 16^{th} of this issue. Discussions with rating agencies.