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The Rescue of American International Group Module D: Maiden Lane II[1]

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Yale Program on Financial Stability Case Study
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Abstract

In September 2008, American International Group (AIG) faced increasing difficulty in returning cash collateral to counterparties looking to terminate, rather than roll over, their securities lending agreements, in part because the company had invested the collateral in residential mortgage-backed securities (RMBS), which were becoming illiquid. The Federal Reserve Bank of New York (FRBNY) provided liquidity to the company, including through the Securities Borrowing Facility (SBF), which allowed for the repayment of cash collateral but did not address the falling values of the RMBS. In November 2008, the Federal Reserve Board authorized the creation of Maiden Lane II (ML II), a special-purpose vehicle that would utilize a $1 billion equity contribution from AIG and a $19.5 billion senior loan from the FRBNY to purchase the illiquid RMBS. ML II would repay the loan with the proceeds from the

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[1] This case study is one of seven 2021 Yale Program on Financial Stability (YPFS) case modules considering the various elements of the government's rescue of American International Group:

- "The Rescue of Fannie Mae and Freddie Mac – Module A: The Conservatorships" by Daniel Thompson and Rosalind Z. Wiggins.
- "The Rescue of Fannie Mae and Freddie Mac – Module B: The Senior Preferred Stock Purchase Agreements (SPSPAs)" by Daniel Thompson.
- "The Rescue of Fannie Mae and Freddie Mac – Module C: GSE Credit Facility" by Emily Vergara.
- "The Rescue of Fannie Mae and Freddie Mac – Module D: Treasury's GSE MBS Purchase Program" by Michael Zanger-Tishler and Rosalind Z. Wiggins.
- "The Rescue of Fannie Mae and Freddie Mac – Module E: The Housing and Economic Recovery Act of 2008" by Daniel Thompson.
- "The Rescue of Fannie Mae and Freddie Mac – Module F: The Federal Reserve's Large-Scale Asset Purchase (LSAP) Program" by Daniel Thompson and Adam Kulam.
- "The Rescue of Fannie Mae and Freddie Mac – Module Z: Overview" by Rosalind Z. Wiggins, Benjamin Henken, Daniel Thompson, Adam Kulam, and Andrew Metrick.

Cases are available from the Journal of Financial Crises at https://elischolar.library.yale.edu/journal-of-financial-crises/.

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eventual sale of the RMBS. Upon the establishment of ML II, the SBF was terminated. ML II helped to lessen AIG's exposure to the illiquid RMBS market and avert a downgrade, both of which ultimately contributed to AIG's stabilization.

Keywords: AIG, asset purchase, Federal Reserve Bank of New York, Maiden Lane II, residential mortgage-backed securities, securities lending, senior loan

American International Group, Inc.: Maiden Lane II

At a Glance

In September 2008, American International Group (AIG) faced increasing pressure to return cash collateral to counterparties looking to terminate, rather than roll over, their securities lending agreements (US COP 2010, 68). The company faced difficulty meeting these obligations because it had invested the collateral into non-agency residential mortgage-backed securities (RMBS), which were becoming illiquid (McDonald and Paulson 2015, 86). In October 2008, the Federal Reserve Bank of New York (FRBNY) had provided AIG with up to $37.8 billion in cash through the Securities Borrowing Facility.[5] But AIG's life insurance subsidiaries had retained the distressed and illiquid residential mortgage-backed securities (RMBS) into which AIG had reinvested those counterparties' cash collateral (US COP 2010, 68-71).

Summary of Key Terms	
Purpose: To facilitate the purchase of non-agency RMBS from AIG insurance subsidiaries in order to reduce market exposure and relieve downgrade pressures relating to AIG's reinvestment of cash collateral in the illiquid RMBS market (FRBNY n.d.1).	
Announcement Date	November 10, 2008
Operational Date	December 12, 2008
Termination Date	November 12, 2014
Legal Authority	Section 13(3) of the Federal Reserve Act
Amount Authorized	Up to $22.5 billion senior loan to ML II from FRBNY
AIG Participation	$1 billion deferred purchase price
Peak Utilization	$19.5 billion from FRBNY to purchase RMBS with a par value of $39.3 billion
Participants	AIG, FRBNY

On November 10, 2008, the Federal Reserve Board and the US Treasury announced the first restructuring of federal financial support for AIG (FRBNY 2008a). Among other provisions, the updated arrangement allowed for the establishment of a special-purpose vehicle (SPV) in the form of a limited liability company to be named Maiden Lane II (ML II), which would purchase those securities from AIG (FRBNY 2008a; US COP 2010, 71; McDonald and Paulson 2015, 84).

The Federal Reserve Board (under Section 13(3) of the Federal Reserve Act) authorized the FRBNY to lend a maximum of $22.5 billion to ML II to acquire the RMBS (FRBNY 2008a). On December 12, 2008, ML II borrowed approximately $19.5 billion from the FRBNY in order to purchase from AIG a bundle of RMBS with a total fair market value of $20.5 billion, a 49% discount to their par value of $39.3 billion as of October 31, 2008 (FRBNY n.d.1). Proceeds

[5] See Buchholtz, Engbith, and Jeffereis 2021 for more information on AIG's Securities Borrowing Facility (SBF).

from the establishment of ML II were used to refund the cash collateral posted by the FRBNY in its assumed role as counterparty under the Securities Borrowing Facility (FRBNY 2008a). The AIG securities lending program and the associated Securities Borrowing Facility were thereby terminated (FRBNY 2008a).

In March 2011, the FRBNY announced it would be offering the purchased assets for sale in a series of competitive auctions, which occurred through February 28, 2012, when sales were completed (FRBNY 2011; FRBNY n.d.1). ML II and its associated operations were terminated on November 12, 2014 (FRBNY n.d.1). In total, the management of ML II would result in a net gain for the benefit of the public of approximately $2.8 billion (FRBNY 2012).

Summary Evaluation

The establishment of Maiden Lane II as a vehicle for the purchase of illiquid RMBS off AIG's balance sheet proved successful in reducing AIG's exposure to the distressed and illiquid RMBS market and arresting related cash demands, which helped it avert further credit-rating downgrades (Baxter and Dahlgren 2010, 4). Still, the intervention was subject to some questions and criticisms regarding the fit of its structure within Section 13(3) of the Federal Reserve Act and the fiscal soundness of lending for investment in risky RMBS (US COP 2010, 228, 251; McDonald and Paulson 2015, 103). However, the ability to avoid fire-sale prices through a buy-and-hold strategy allowed the FRBNY to realize a net gain when the assets were sold.

American International Group 2008: United States Context	
GDP (SAAR, Nominal GDP in LCU converted to USD)	$14,681.5 billion in 2007 $14,559.5 billion in 2008
GDP per capita (SAAR, Nominal GDP in LCU converted to USD)	$47,976 in 2007 $48,383 in 2008
Sovereign credit rating (five-year senior debt)	As of Q4, 2007: Fitch: AAA Moody's: Aaa S&P: AAA As of Q4, 2008: Fitch: AAA Moody's: Aaa S&P: AAA
Size of banking system	$9,231.7 billion in total assets in 2007 $9,938.3 billion in total assets in 2008
Size of banking system as a percentage of GDP	62.9% in 2007 68.3% in 2008
Size of banking system as a percentage of financial system	Banking system assets equal to 29.0% of financial system in 2007 Banking system assets equal to 30.5% of financial system in 2008
Five-bank concentration of banking system	43.9% of total banking assets in 2007 44.9% of total banking assets in 2008
Foreign involvement in banking system	22% of total banking assets in 2007 18% of total banking assets in 2008
Government ownership of banking system	0% of banks owned by the state in 2008
Existence of deposit insurance	100% insurance on deposits up to $100,000 for 2007 100% insurance on deposits up to $250,000 for 2008
Sources: Bloomberg, World Bank Global Financial Development Database, World Bank, Bank Regulation and Supervision Survey, Federal Deposit Insurance Corporation	

I. Overview

Background

Prior to the Global Financial Crisis, AIG operated a securities lending program under which its insurance subsidiaries lent out high-quality securities to counterparties in exchange for cash collateral (McDonald and Paulson 2015, 85). That collateral would then be reinvested by a separate arm of AIG (McDonald and Paulson 2015, 85). When counterparties wanted to exit the contracts, it was expected that the investments would be sold to produce cash to repay the collateral (McDonald and Paulson 2015, 86). In the time leading up to September 2008, AIG, primarily through a non-insurance subsidiary called AIG Global Securities Lending (GSL), had been reinvesting its counterparties' cash collateral primarily in the relatively illiquid residential mortgage-backed securities (RMBS) market (which was experiencing increasing strain) instead of the short-term, highly liquid securities usually relied on by securities lending programs (McDonald and Paulson 2015, 85). This resulted in a significant maturity mismatch, as most of the securities lending contracts were for a one-month term (McDonald and Paulson 2015, 85). In mid-2008, AIG's counterparties began withdrawing from lending agreements at an accelerated rate as AIG reported growing losses and was subject to credit rating downgrades (McDonald and Paulson 2015, 86). GSL was unable to meet the growing collateral obligations because of losses on its investments and increasing illiquidity (McDonald and Paulson 2015, 86-87).

In response to the critical liquidity situation stemming from securities lending contract withdrawals and other distressed businesses, on September 16, 2008, the Federal Reserve (under Section 13(3) of the Federal Reserve Act) extended to AIG an $85 billion loan in the form of the Revolving Credit Facility (RCF)[6] (US COP 2010, 55-57). However, the credit line proved insufficient in solving AIG's liquidity dilemma (Baxter and Dahlgren 2010, 4). By October 1, 2008, AIG had utilized approximately $62 billion of the RCF, some of which had been used to settle collateral transactions with counterparties returning (rather than rolling over) securities that had been borrowed through the securities lending program (US COP 2010, 137).

Given volatile market conditions and the expectation that counterparties would not want to renew their securities lending contracts, on October 8, 2008, the Federal Reserve Bank of New York (FRBNY) established the Securities Borrowing Facility (SBF)[7] (US COP 2010, 68-69). As part of the agreement, the FRBNY was authorized to extend to AIG subsidiaries an additional amount of credit, up to $37.8 billion. The FRBNY would effectively provide cash collateral to take over the positions of securities borrowers who were returning investment-grade, fixed-income securities to AIG's life insurance subsidiaries (US COP 2010, 68). The program would bolster AIG's liquidity and allow the FRBNY to hold the borrowed securities as collateral (US COP 2010, 68). However, while the SBF enabled AIG to return cash collateral to its counterparties, the company still had to contend with the falling values of the illiquid non-agency RMBS in which it had invested the cash collateral (Baxter and Dahlgren 2010, 4;

[6] See Buchholtz and Lawson 2021 for more information on AIG's Revolving Credit Facility (RCF).
[7] See Engbith, Buchholtz, and Jeffereis 2021 for more information on AIG's Securities Borrowing Facility (SBF).

McDonald and Paulson 2015, 87). If AIG had sold the securities under prevailing market conditions, it would have been forced to accept fire-sale prices, resulting in further losses for the firm (US COP 2010, 141).

Program Description

On November 10, 2008, the Fed and Treasury announced the first restructuring of the AIG rescue package in order to "establish a more durable capital structure, resolve liquidity issues, facilitate AIG's execution of its plan to sell certain businesses in an orderly manner, promote market stability, and protect the interests of the U.S. government and taxpayers" (BdofGov 2008). Among other actions, the restructuring included "the New York Fed [lending] up to $22.5 billion to a newly formed limited liability company (LLC) to fund the LLC's purchase of residential mortgage-backed securities from AIG's U.S. securities lending collateral portfolio." The new LLC would be named Maiden Lane II LLC (ML II) and would be a Delaware-based limited liability company characterized as a special-purpose vehicle (SPV) (US COP 2010, 228). Using the loan from the FRBNY, ML II would purchase non-agency RMBS assets from AIG subsidiaries and hold them for orderly liquidation (FRBNY 2008a; FRBNY n.d.1). AIG would use the proceeds received from ML II's purchases of RMBS to return the cash collateral posted by the FRBNY in transactions under the SBF, after which the SBF would terminate (US COP 2010, 71).

The purchase was financed by a $19.5 billion senior loan[8] from the FRBNY (FRBNY n.d.1). The loan specified a six-year duration that could be extended at the discretion of the FRBNY and an interest rate set at one-month LIBOR plus 100 basis points (2.6% as of December 16, 2008) (FRBNY 2008a). As part of the agreement, AIG was required to post $1 billion to cover potential losses, also known as the "Fixed Deferred Purchase Price" (FRBNY n.d.1). The AIG contribution would accrue at a rate of one-month LIBOR plus 300 basis points (4.6% as of December 16, 2008) (FRBNY 2008a).

Payments on the FRBNY loan would be made in monthly installments starting in January 2009, subject to receipt of proceeds from the RMBS portfolio (i.e., the principal interest from amortization of mortgages and other loans underlying the RMBS). Proceeds from the maturity and or sale of the RMBS (see Figure 1) were to be applied in a waterfall structure, starting with any expenses incurred by the LLC, then the outstanding FRBNY loan and interest, and finally AIG's Fixed Deferred Purchase Price and its interest (FRBNY 2008a). Any residual income or remaining funds would be divided between the FRBNY (83%) and AIG (17%) (FRBNY 2008a).

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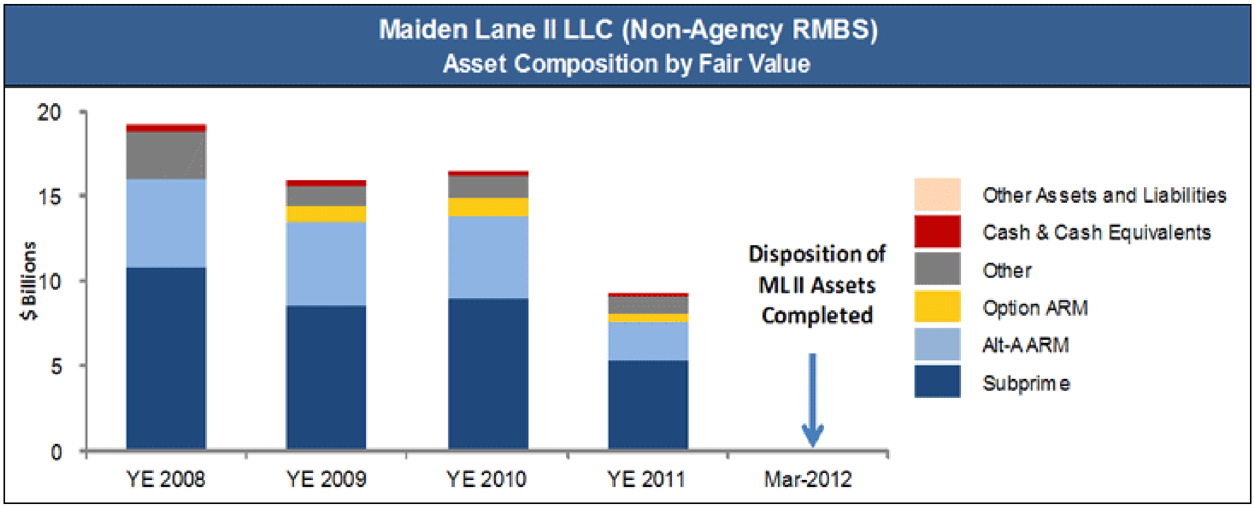
[8] It was originally thought that a FRBNY loan of $19.8 billion would be needed to purchase the RMBS, as the fair market value was first established at $20.8 billion; AIG would contribute $1 billion toward the purchase (the Fixed Deferred Purchase Price) (FRBNY n.d.1). However, because of interest and principal payments occurring between the initial valuation date of October 31, 2008, and the settlement date of December 12, 2008, which inured to AIG, the loan amount was reduced by $0.3 billion to $19.5 billion (FRBNY n.d.1).

On December 12, 2008, Maiden Lane II purchased RMBS from AIG subsidiaries at an estimated fair market value of $20.5 billion (as of October 31, 2008), par value $39.3 billion (FRBNY n.d.1).

Figure 1: Maiden Lane II LLC (Non-Agency RMBS) Asset Composition by Fair Value[9]



Source: "FRBNY n.d.1 "

Pursuant to an Amended and Restated Investment Management Agreement entered into by and among FRBNY, BlackRock Financial Management Inc. (BlackRock), and ML II, originally dated December 12, 2008 (and amended and restated August 23, 2010), the FRBNY retained BlackRock to act as investment manager for the ML II assets (Investment Management Agreement 2010, 1, 19). BlackRock's "objective for ML II LLC's portfolio was to repay the New York Fed's senior loan (including principal and interest) while striving to maximize sales proceeds and refraining from disturbing general financial market conditions" (FRBNY n.d.1). BlackRock was able to advise the FRBNY on the valuations of the assets and assist it in selecting those for purchase (FRBNY n.d.1). In accordance with the Investment Management Agreement, specific individuals in the Investment Support Office (ISO) of the FRBNY were appointed to manage the ongoing relationship with BlackRock and oversee its management of ML II assets (Investment Management Agreement 2010, 2). The ISO officer's responsibilities included acting as point of contact, assessing BlackRock's performance, modifying investment objectives and risk limits, monitoring the risk composition of assets held, and other functions outlined in the Investment Management Agreement (Investment Management Agreement 2010, 2-3). BlackRock was limited to reinvesting cash proceeds from the sale of assets solely in liquid, short-term securities such as US Treasury or agency securities with a remaining maturity of one year or less, US 2a-7 government money market funds, and reverse repurchase agreements collateralized US Treasury securities (FRBNY

[9] The recategorization of assets likely led the Option ARM RMBS balance appearing in YE 2009.

n.d.1). Moreover, when it came time to sell the assets, BlackRock ran the bid list process that was standard in the industry (FRBNY 2011).

FRBNY also hired Bank of New York Mellon, Deloitte and Touche LLP, and Ernst & Young LLP to perform various functions. Bank of New York Mellon acted as administrator and custodian on behalf of ML II. These services included accounting services, report preparation, reconciliation of cash and asset balances, valuation services, and other actions outlined in the Transaction Documents (Administration Agreement 2008, 2-7). Deloitte and Touche was contracted to perform audit services, performing an audit on the annual financial statements for ML II (FRBNY n.d.2; ML II LLC: Financial Statements 2014, 4-5). Ernst & Young provided closing work, performing an assessment on the operational and financial close procedures and assisting with the analysis of accounting matters (FRBNY n.d.2).

Outcomes

The sales of ML II assets and winding-down of the SPV's operations occurred over a three-year period, beginning in 2011 (see Figure 2). On March 30, 2011, the FRBNY declined AIG's $15.7 billion offer to buy back all of the ML II assets, instead deciding that it would sell the assets in competitive auctions over time (Roose 2012).[10] The FRBNY cited the improved conditions in the market for non-agency RMBS and a high level of interest from investors as justification that this strategy would work to both "maximize sale proceeds while also reducing the likelihood that any one institution ends up with concentrated exposure to the assets" (FRBNY 2011). According to a Reuters report at the time, Wall Street investors were also optimistic about the FRBNY's announcement because of rising scarcity value in the RMBS market "and because RMBS [as a class] at loss-adjusted yields near 7 percent are offering higher returns than junk-rated corporate debt" (Berkowitz and Cook 2011).

The process for selling the ML II assets as described by the FRBNY allowed for broad competitive bidding but also permitted firms to make targeted offers for specific groups of assets:

> "BlackRock Solutions will offer the securities for sale using the standard bid list process in the secondary market for RMBS securities. The bid list process involves marketing a list of securities from the portfolio via multiple broker dealers to obtain the best available price for each security.
>
> Over time, the Federal Reserve will also entertain investor inquiries to acquire specific parcels of securities where these offer superior value, though no such bid will be accepted without being put into competition with other interested investors. In such cases, investors may submit offers for parcels of securities directly (without necessarily going through a dealer)." (FRBNY 2011).

Between April 1, 2011, and June 30, 2011, Maiden Lane II sold assets worth approximately $4.7 billion to 22 purchasers over nine separate auctions (FRBNY 2011b). On January 19,

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[10] Despite the FRBNY's refusal to sell the entire RMBS portfolio to AIG, it was announced on February 24, 2012, by AIG Chief Executive Officer Robert H. Benmosche that the company had purchased $2.0 billion in ML II assets from "auction winners" (Roose 2012).

2012,[11] the FRBNY sold $7.01 billion (face value) of RMBS assets to Credit Suisse Securities (USA) LLC, as a result of a reverse bid process initiated by Goldman Sachs & Co., which lost in the competitive process that involved four broker-dealers (FRBNY 2012b). On February 8, 2012, the FRBNY announced that Goldman Sachs won the bid among five other broker-dealers to purchase ML II assets totaling $6.2 billion (face value) (FRBNY 2012a). The sale enabled the repayment of the entire remaining principal balance of the FRBNY loan to ML II in March 2012 ((FRBNY 2012a).

On February 28, 2012, it was announced that Credit Suisse had purchased the remaining $6.0 billion (face value) of ML II assets (FRBNY 2012c). Proceeds from this sale and previous sales, as well as cash flows from the RMBS prior to sale, enabled ML II to repay the accrued interest on the FRBNY loan (totaling approximately $580 million) and the AIG Fixed Deferred Purchase Price plus interest, as well as "provide residual income" to be disbursed according to the guidelines set forth in the original agreement (see Figure 3) (FRBNY 2012c). The FRBNY also reported that the sale of assets and repayment of the loan would result in "a net gain for the benefit of the public of approximately $2.8 billion" (FRBNY 2012c).

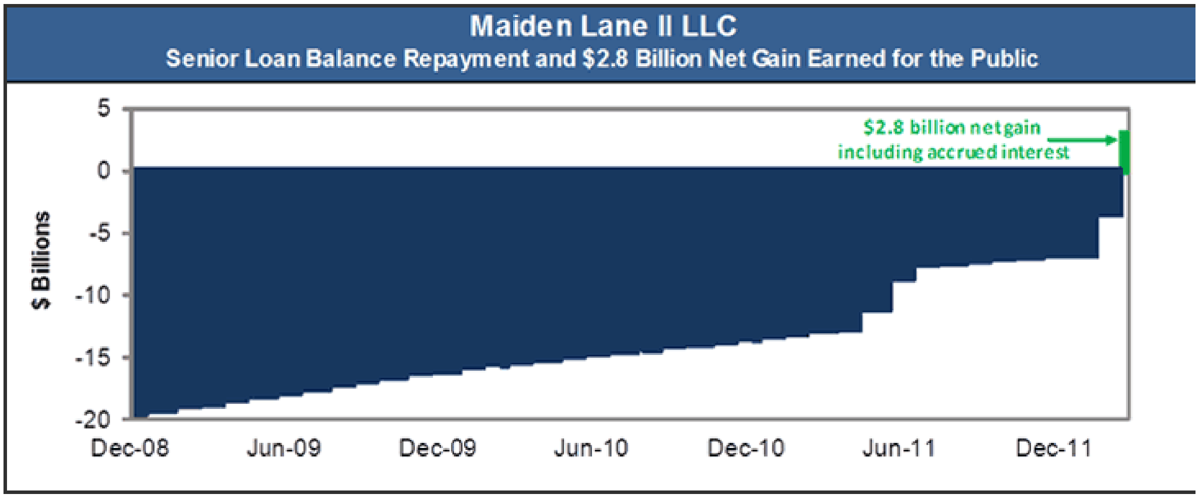
Figure 2: Sales of Maiden Lane II Assets in Competitive Auction Over Time

Announcement Date	April 1, 2011—June 30, 2011	January 19, 2012	February 8, 2012	February 28, 2012
Auction Winner	22 individual counterparties	Credit Suisse Securities (USA) LLC	Goldman Sachs & Co.	Credit Suisse Securities (USA) LLC
Face Value[12]	$9.96 billion	$7.01 billion	$6.22 billion	$6.02 billion
Cash Proceeds	$4.68 billion	$3.18 billion	$3.53 billion	$3.63 billion
Use of Proceeds	Pay down balance of the FRBNY senior loan	Pay down balance of the FRBNY senior loan	Pay off remaining balance of the FRBNY senior loan	Repay interest accrued on the FRBNY senior loan and the AIG junior deferred purchase price plus interest; provide "residual income"

Source: FRBNY n.d.1

[11] The FRBNY reported no transactions occurring between June 30, 2011, and December 31, 2011.
[12] Note that the face value of these transactions will not sum to original face value of $39.3 billion due to write-downs, matured assets, and interest paid on amortized loans.

Figure 3: Senior Loan Balance Repayment and $2.8 Billion Net Gain Earned for the Public



Source: FRBNY n.d.1

On September 15, 2014, all residual funds in ML II were distributed to the FRBNY and AIG, with 83% going to the FRBNY and 17% to AIG, according to the original agreement (FRBNY n.d.1). On November 12, 2014, Maiden Lane II formally ceased to exist as a legal entity after final repayment of all trailing expenses (FRBNY n.d.1).

II. Key Design Decisions

1. Maiden Lane II was created as part of a multifaceted intervention.

Maiden Lane II was one of a set of government interventions assisting AIG in addressing its liquidity and capital problems. It was announced alongside Maiden Lane III (ML III) in November 2008 as a restructuring of government financial support (FRBNY n.d.1). These two SPVs were aimed at removing assets from AIG's balance sheet to address continuing, significant liquidity drains and to improve its capitalization in the interest of avoiding rating downgrades (Baxter and Dahlgren 2010, 4). Specifically, ML II was the second action taken by the Fed to address the impact of the AIG securities lending program. The first was the establishment of the SBF in October 2008, which allowed the FRBNY to lend up to $37.8 billion on an overnight basis in exchange for fixed-income securities (US COP 2010, 68-69). At that time, it was acknowledged that while the SBF addressed the liquidity issues raised by the securities lending program, the RMBS still posed a problem, as they continued to lose value. Thus, ML II was seen as an ultimate solution (Interview with Sarah Dahlgren 2018). In all, AIG-targeted government interventions totaling $182 billion would be funded by the FRBNY and Treasury, including loans, asset purchases, and capital investments (Massad 2012).

2. The Federal Reserve authorized the loan to Maiden Lane II pursuant to its emergency lending authority under Section 13(3) of the Federal Reserve Act.

The Federal Reserve Board authorized the FRBNY to make a loan of up to $22.5 billion to fund ML II for the purpose of purchasing from AIG a portfolio of RMBS assets (BdofGov 2008; FRBNY n.d.1). This authorization was done pursuant to Section 13(3) of the Federal Reserve Act, the board's emergency lending authority, which had three basic requirements: (1) the Board must determine that "unusual and exigent" circumstances exist, by the affirmative vote of at least five members, (2) the loans must be secured to the satisfaction of the lending reserve bank, and (3) the lending reserve bank "must have obtained evidence that adequate credit was not available from other banking institutions" (Title 12 U.S.C. 343, 112). There has been little dispute regarding the first and third criteria.

However, ML II "provides a less straightforward fit with the Federal Reserve's authority under Section 13(3), and in particular the second criteria cited above, because of its more complicated structure," compared with the Fed's use of Section 13(3) for the two previous AIG lending facilities (US COP 2010, 228). Although an SPV is a "person" within the terms of Section 13(3) and thus could be eligible for a loan, the Congressional Oversight Panel (COP)[13] noted that "In substance, however, FRBNY was lending money to itself under Section 13(3) and then using the funds to purchase RMBS" (US COP 2010, 229). Despite this structure, undertaken for practical administrative purposes, the Fed Board staff defended the transaction as consistent with Section 13(3) (US COP 2010, 229). It argued that looking through the SPV, the Fed was in essence discounting "each RMBS [which] was itself a promissory note or debt obligation so FRBNY was essentially purchasing a note or debt obligation at a discount (a practice that fits more neatly under its 13(3) lending authority)" (US COP 2010, 229). The Board staff also characterized these transactions as involving a "haircut" because of the difference (almost 50%) between the loan amount (used to purchase the RMBS) and their face value (US COP 2010, 229). The COP did not agree with this characterization, arguing that the loan "did not require a 'haircut' in the normal sense of the term" because "securities lending counterparties were not required to take a haircut or make concessions." Still, COP concluded that because of the great difference in the purchase price and face value of the RMBS, which secured the loan, the FRBNY was justified in finding the loan secured to its satisfaction as required by Section 13(3) (US COP 2010, 229).

3. Legal and time constraints led the FRBNY to reject alternative options.

There were a number of alternatives that aimed to resolve the RMBS issues facing AIG that were considered in the lead-up to the creation of ML II (GAO 2011, 47). One potential strategy included propping up the insurance subsidiaries and maintaining their credit rating until their sale (GAO 2011, 47). This would have been achieved through "keepwell"

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[13] The Congressional Oversight Panel (COP) was a standing committee established by the US Congress following the implementation of the Troubled Assets Relief Program (TARP) on October 3, 2008 and was dissolved in 2011. The COP's mandate was to "review the current state of financial markets and the regulatory system." It was able to hold hearings, review official data, and write reports on actions taken by Treasury and financial institutions and their effect on the economy.

agreements and excess-of-loss reinsurance agreements (GAO 2011, 47). The keepwell agreements would have required the Fed to maintain minimum measures for each subsidiary such as capital and net worth, while the excess-of-loss reinsurance would have covered situations when subsidiaries failed to make a payment on a claim, subject to certain limitations (GAO 2011, 47). Although this strategy would have insulated the credit rating of the subsidiaries from the credit rating of their AIG parent company, it ran into legal hurdles (GAO 2011, 48). In particular, there were questions regarding whether the government could protect the value of subsidiaries that were currently acting as collateral for the Revolving Credit Facility (GAO 2011, 48). There were also concerns regarding whether the Fed could prevent the subsidiaries from being seized by state regulators (GAO 2011, 48).

Ring-fencing subsidiaries by segregating specific assets was considered as well (GAO 2011, 48). However, it was rejected because of time constraints and lack of a legal framework (GAO 2011, 48).

4. **The Fed decided to purchase non-agency RMBS from AIG insurance subsidiaries to alleviate liquidity pressures and cap AIG's losses associated with its securities lending portfolio.**

The previous creation of the SBF had alleviated liquidity pressures originating from securities lending counterparties terminating rather than rolling over their contracts. But AIG faced continued exposure to "further declines in the value of the RMBS portfolio (par value approximately $40 billion) purchased with the proceeds of these securities lending transactions" (Section 129 2008, 7). By September 30, 2008, AIG had already suffered approximately $16.5 billion in mark-to-market losses on the RMBS portfolio (Section 129 2008, 7).

In considering how to resolve the problem posed by the RMBS related to AIG's Securities Lending Program, the FRBNY consulted BlackRock, whose analysts concluded that the securities would return a higher value if held over a longer time period (US COP 2010, 141). Although these RMBS were distressed, they were rated AAA and senior tranche in their respective capital structures (US COP 2010, 35). This increased the likelihood of material interest and principal income over a longer holding period. As a result, the FRBNY decided to purchase the RMBS from AIG, which resulted in the termination of the Securities Borrowing Facility and permanent relief of related liquidity pressures. Unlike AIG or other financial institutions in distress, the FRBNY did not face intense pressures that would necessitate the fire sale of securities (US COP 2010, 141). Thus, it could bear the risk involved in holding the RMBS for a longer period of time, and ideally the market could stabilize.[14]

[14] Even following their purchase by and transfer to ML II, the value of the RMBS underlying transactions made by AIG's insurance subsidiaries kept falling at an alarming rate as real estate prices plummeted and foreclosure numbers soared (McDonald and Paulson 2015, 86, 97-98). Additionally, there was widespread and justifiable anxiety that the assets would continue to suffer losses even after government rescue (US COP 2010, 77). Despite this market pessimism, when the last of the assets were sold in February 2012, the government had realized a net profit of $2.8 billion (FRBNY 2012c).

The RMBS purchased were reviewed and selected by the FRBNY in conjunction with financial adviser BlackRock Financial Management Inc. (FRBNY n.d.1).[15] In addition to limiting AIG's exposure to the falling values of illiquid RMBS, the creation of ML II allowed the FRBNY to meet its objective of helping AIG avoid further credit rating downgrades, which likely would have triggered new rounds of collateral calls from counterparties to other AIG businesses (US COP 2010, 141; Baxter and Dahlgren 2010, 3-4). The FRBNY senior loan was to be repaid using the cash flows from the RMBS and proceeds from the sale of assets (FRBNY 2008a).

The Fed established ML II as a legally independent entity to facilitate the acquisition of non-agency RMBS from AIG subsidiaries (FRBNY 2008a). On December 12, 2008, ML II, borrowing $19.5 billion from the FRBNY senior loan and utilizing a $1.0 billion cash contribution posted by AIG in the form of a Fixed Deferred Purchase Price (for a total purchase price of $20.5 billion), acquired RMBS with a face value of $39.3 billion from several AIG insurance subsidiaries (FRBNY n.d.1).

5. **The Fed created a special-purpose vehicle to purchase the AIG RMBS assets rather than acquire them directly.**

The Federal Reserve did not possess the authority to purchase the RMBS directly off the balance sheets of AIG insurance subsidiaries (Title 12 U.S.C. 342, 111). It was, however, able to facilitate the senior loan to ML II, an SPV and independent legal entity that it created for that purpose (FRBNY 2008a). Holding the RMBS assets in an independent entity made it easier for the FRBNY to isolate and manage the assets, even though they were consolidated onto the Fed's balance sheet (US COP 2010, 228-229). Although ML II was a separate entity, the FRBNY retained all authority to manage the SPV as long as its loan was outstanding (FRBNY 2008a).

6. **The FRBNY retained BlackRock Financial Management Inc. as the investment manager along with other outside vendors for various duties.**

As the controlling party of ML II, the FRBNY was tasked with the day-to-day management of ML II's assets and engaged a number of vendors based on their expertise, rather than developing internal departments for each need. However, the FRBNY did increase its internal expertise through targeted hiring in order to assist in decision-making and effectively evaluate recommendations from external vendors. The Investment Support Office department, which managed vendor relations, grew from just a few staff members to a sizable business unit once all three SPVs were being managed. The FRBNY chose to retain BlackRock Financial Management Inc., which was "acknowledged as an expert in mortgages, loans, structured finance and risk management" to act as investment manager (Investment Management Agreement 2010, 1; FRBNY n.d.1). Prior to being brought on to work on ML II,

[15] A tangential issue arose in 2011 when AIG sued Bank of America (acquirer of Countrywide) on claims of fraud relating to the quality of RMBS that AIG had purchased from Countrywide and later were purchased by ML II (Stempel 2013). Bank of America claimed that AIG had lost its right to sue when it sold the assets to ML II, and that any recovery would be double-dipping (McEvoy 2013). A US District Court determined in May 2013 that AIG had not transferred certain of its litigation rights to ML II and could pursue claims against Bank of America, causing AIG to drop a lawsuit against the FRBNY over the issue (Stempel 2013).

BlackRock had already been contracted by the FRBNY to manage ML I[16] and ML III assets (Anantharaman 2008).

The FRBNY also hired Bank of New York Mellon as administrator and custodian, Deloitte and Touche as external auditor for annual financial statements, and Ernst & Young to perform closing work (Administration Agreement 2008, 2-7; FRBNY n.d.2; ML II LLC: Financial Statements 2014, 4-5). Although the FRBNY devoted significant attention to the implications of engaging outside vendors, there were a number of potential conflicts of interests that arose between the FRBNY and vendors, which were dealt with on an ad hoc basis (GAO 2011, 122).

7. AIG was required to invest $1 billion on a junior basis.

The volatile state of the financial markets and the uncertainty surrounding the performance of the RMBS purchased by ML II compelled the Fed to require an equity contribution by AIG to cover the first billion dollars in potential losses (Baxter and Dahlgren 2010, 4-5). The Fixed Deferred Purchase Price would be returned to AIG only after the payment of all costs associated with the creation of ML II and repayment of the principal and interest on the FRBNY's senior loan (FRBNY 2008a). It was announced on February 28, 2012, that the AIG contribution had been repaid in full, including accrued interest, using proceeds from the sale of remaining ML II securities (FRBNY 2012c).

8. The interest rates for the FRBNY senior loan and AIG's Fixed Deferred Purchase Price were based on the one-month LIBOR.

The interest rates calculated on the FRBNY senior loan and AIG's Fixed Deferred Purchase Price referenced the one-month LIBOR (FRBNY 2008a). The FRBNY considered a number of factors when deciding how to set rates for its interventions, including risk and characteristics of the assets being purchased (GAO 2011, 90-91). Since ML II held securities that paid monthly interest based on the one-month LIBOR, officials felt this was an appropriate rate to use for the loan (GAO 2011, 90-91).

9. BlackRock Financial Management Inc. conducted mid-market pricing estimates of the RMBS, which were used to negotiate purchase prices.

In order to value the RMBS that ML II was planning on purchasing, BlackRock provided mid-market pricing estimates based on projected cash flows from those RMBS (Asset Purchase Agreement 2008, 9). These estimates used assumptions that were agreed upon by both parties and were the basis for negotiations that took place between ML II and AIG regarding the actual purchase price (Asset Purchase Agreement 2008, 9). It is important to note that the mid-market pricing estimates provided by BlackRock may not have reflected the mark-

[16] Maiden Lane (ML I) was an SPV created in March 2008 to facilitate JPMorgan Chase & Co.'s purchase of Bear Stearns Companies Inc.

to-market price, in the case that there was a market for the product, because of the illiquid nature of the RMBS market at the time (Asset Purchase Agreement 2008, 9).

10. The FRBNY did not specify a termination date or schedule for the loan, instead setting the term at six years with the option for extension.

The terms of the loan to ML II specify that the senior loan was intended to be repaid from interest and principal payments received from assets if held to maturity, or the proceeds from their sale (FRBNY 2008a). As previously mentioned, the analysts at BlackRock concluded that the securities would realize more value if held for a longer period of time. This alleviated the risk of potential losses to the public by undertaking a buy-and-hold strategy (US COP 2010, 141). If it was determined that liquidation was not the profit-maximizing option, ML II would be able to hold these assets to maturity, as the hold-to-maturity proceeds were predicted to be greater than the FRBNY's senior loan (Baxter and Dahlgren 2010, 6). The FRBNY announced its intention to begin liquidating the ML II portfolio on March 30, 2011, citing improved market conditions and investor interest. At this time, it also opted against outlining a fixed timeline for completing the sale. Rather, it allowed for flexibility in order to maximize return: "There will be no fixed timeframe for the sales and at each stage the Federal Reserve will only transact if the best available bid represents good value for the public" (FRBNY 2011a). Sales were completed when the remainder of the assets held by ML II were liquidated on February 28, 2012 (FRBNY 2012c).

11. ML II assets were sold off at competitive auctions over the course of an unspecified time frame.

On March 30, 2011, it was announced that the FRBNY rejected AIG's initial offer to buy back all of the ML II assets (FRBNY 2011a). Instead, the FRBNY pursued a strategy of selling ML II securities "individually and in segments rather than as a single block," which would "give a larger set of investors opportunity to bid for the assets [and] maximize sale proceeds while also reducing the likelihood that any one institution ends up with concentrated exposure to the assets" (FRBNY 2011a). In the event, the result was that, while $9.96 billion was sold in a broad competitive bidding process to 22 bidders, the overwhelming majority of the assets were sold in large blocks to major broker-dealers, resulting in some concentrated exposure to the portfolio (see Figure 2: Sales of Maiden Lane II Assets in Competitive Auction Over Time). The FRBNY discovered that after an initial positive reaction to individual auctions, the market quickly grew weary of this protracted process. Demand was significantly greater if investors had assurances that they could access larger segments of the portfolio. Therefore, the second set of auctions consisted of large blocks, which remained open and competitive but resulted in greater efficiency and better relative pricing.

The FRBNY finished selling the assets in February 2012, realizing a total residual profit of $2.8 billion for the US government once ML II was terminated on November 12, 2014 (FRBNY 2012c; FRBNY n.d.1).

12. The FRBNY followed a plan of transparency in disclosing information regarding ML II.

Knowing that AIG was due to report a substantial loss for the third quarter on November 10, 2008, the FRBNY made the decision to announce its financial support restructuring on the same day (US COP 2010, 138; GAO 2011, 53). Credit agencies had notified the FRBNY that they would likely downgrade AIG in the wake of the disappointing earnings announcement, and the potential for ensuing market turmoil led the FRBNY to communicate its plans earlier than it might have otherwise (GAO 2011, 53). At 6:00 a.m. EST on November 10, 2008, the Federal Reserve Board of Governors and Treasury Department issued a press release that outlined a restructuring of financial support to AIG (BdofGov 2008). This restructuring included purchasing $40 billion of preferred shares in AIG using Troubled Assets Relief Program (TARP) funds, changes to the terms of the Revolving Credit Facility, and the introduction of ML II and ML III (BdofGov 2008). The release describes these measures as an attempt to "establish a more durable capital structure, resolve liquidity issues, facilitate AIG's execution of its plan to sell certain of its businesses in an orderly manner, promote market stability, and protect the interests of the U.S. government and taxpayers." (BdofGov 2008). Announcement of the restructuring preceded its actual implementation by weeks.

In general, the FRBNY took a stance of transparency regarding ML II. It announced developments and progress regularly and provided extensive detail on the assets held. For example, in November 2008, it announced the intent to form ML II and purchase the RMBS from AIG, and on March 30, 2011, it announced its intent to begin selling the assets over time (BdofGov 2008; FRBNY 2011a). Included in that announcement was a commitment to transparency and to providing information "as soon as is practicable," as well as a detailed communication plan (FRBNY 2011a):

> "The New York Fed already publishes on its website a list of all the securities in its portfolio. In order to allow the public to track progress on asset dispositions, the New York Fed will provide monthly updates on portfolio holdings and a list of the securities sold within the prior month. In addition, it will provide quarterly updates on total proceeds from sales, and the total amount purchased by each counterparty. Finally, the New York Fed will provide further details regarding these transactions, including an account showing the acquirer and the price paid for each individual security three months after the last asset is sold, ensuring timely accountability without jeopardizing the ability to generate maximum sale proceeds for the public."[17]

III. Evaluation

The Fed established Maiden Lane II as a temporary facility, the funding for which (i.e., the FRBNY senior loan) could be extended indefinitely. Its purpose was to remove distressed and illiquid RMBS from AIG's balance sheet in order to address liquidity issues and relieve rating-downgrade pressures arising from their falling values (Baxter and Dahlgren 2010, 4-5). The main objective was met, and ML II profitably sold off the assets in a series of

[17] This reported data can be found at FRBNY n.d.1.

competitive auctions after having held them for approximately three years while the markets stabilized, resulting in a net gain of approximately $2.8 billion (Baxter and Dahlgren 2010, 5; FRBNY 2012c). However, there has been much criticism surrounding both the legality and fiscal soundness of its utilization.

Because of ML II's "complicated structure," as discussed in Key Design Decision No. 2, the Congressional Oversight Panel in hindsight adjudged the creation of the ML II facility to be a "less straightforward fit with the Federal Reserve's authority under Section 13(3)," compared with the Fed's two earlier loans to AIG. The COP noted that the Fed was "lending money to itself" in order to purchase RMBS securities, each of which represented "a promissory note or debt obligation" at a discount (US COP 2010, 228-229). Nevertheless, despite ML II's unusual form, the panel concluded that the facility was within the parameters of the Fed's Section 13(3) authority (US COP 2010, 228-229). Also, the 2011 GAO Report, while critically considering several elements of the ML III facility, does not raise issues regarding ML II (GAO 2011).

Still, some have questioned the risks the Fed took in establishing ML II for the purpose of purchasing RMBS (US COP 2010, 251; McDonald and Paulson 2015, 99-100). What at first seemed like an "insightful investment opportunity for the taxpayers," reported the Congressional Oversight Panel, was actually a "fortuitous and unanticipated rebound in the markets" (US COP 2010, 251). In other words, because "most of [the assets purchased] were arguably below junk status . . . there was no reasonable expectation that the RMBS . . . markets would turn in the near future" (US COP 2010, 251).

The analysis by McDonald and Paulson (2015) reveals that the ML II assets suffered further write-downs after the government sold them to Goldman Sachs and Credit Suisse (McDonald and Paulson 2015, 99-100). At the time of the sales in 2012, they show that 17.5% of ML II securities had been written down since the beginning of ML II, representing a loss of 1.8% for ML II. But the securities experienced further losses. As of October 31, 2014, 36% of the ML II securities had experienced write-downs, representing a loss of 5.1% since the beginning of ML II. Further losses appeared possible (McDonald and Paulson 2015, 100). They conclude that the fact that ML securities "suffered write-downs means that we can reject the stark claim that they were 'money good'" at the time ML II was created (McDonald and Paulson 2015, 100).

Despite the assets' depressed value, BlackRock and FRBNY analysts concluded in 2008 that the strategy of holding the assets to maturity while collecting interest income and principal repayments would return greater proceeds than ML II's debt to the FRBNY. Additionally, the RMBS were previously rated AAA and were the senior tranche in their respective capital structures (US COP 2010, 35). These assurances provided additional comfort to the FRBNY regarding its decision to lend to ML II (Baxter and Dahlgren 2010, 6). Ultimately, markets did rebound, and ML II liquidated its unmatured assets by the end of February 2012, fully paying back the FRBNY and AIG and providing residual earnings (FRBNY 2012c; FRBNY n.d.1). In short, according to an analysis by two economists, ML II purchased securities in 2008 for $20.5 billion (at 53% of their par value), received $8.9 billion in interest and principal, and sold them for $15.1 billion (51% of par), resulting in a nonannualized return of 17% (McDonald and Paulson 2015, 98).

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