4-30-2010

FCIC memo of staff interview with Michael Alix, Bear Stearns

Michael Alix

MEMORANDUM FOR THE RECORD

Event: Michael Alix

Type of Event: Group interview, not taped

Date of Event: April 30, 2010

Team Leader: Dixie Noonan

Location: Federal Reserve Bank of New York, 33 Liberty Street, New York, NY

Participants - Non-Commission:

- James Mahoney
- Shari Leventhal
- Michael Alix

Participants - Commission:

- Dixie Noonan
- Chris Seefer *(by phone)*
- Mike Easterly *(by phone)*
- Clara Morain

Date of MFR: April 30, 2010

Summary of the Interview or Submission:

This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted except where clearly indicated as such.

Dixie opened the meeting by summarizing the FCIC's mandate and explaining that the FCIC is interested in learning about the causes of the problems at AIG. She then asked Mr. Alix to provide an overview of his background.

Prior to joining the NY Fed, Mr. Alix worked for 12 years at Bear Stearns and served as its Chief Risk Officer from 2006 until June of 2008. He joined the NY Fed on November 3, 2008 as a senior advisor, and began work immediately on AIG, and the Maiden Lane 3 transaction specifically. He said he was given "a variety of things to look at, but they asked me to assist the AIG monitoring team in evaluating risks in AIG FP, and to help with the execution of Maiden Lane 3." He said that his first week was dominated by work on Maiden Lane 3 and AIG FP, and then he became more involved in other aspects of the NY Fed's AIG monitoring effort with the company's other affiliates and subsidiaries.

Dixie asked Mr. Alix if he had any experience with AIG prior to joining the New York Fed. He said that AIG was a "modest counterparty to Bear, so I had awareness of AIG and AIG FP from the marketplace." He said that he followed from an outsider's perspective the problems at the company and its ultimate government rescue, but that was the extent of his involvement.

Dixie asked Mr. Alix how he got up to speed on the situation at AIG FP, specifically on the firm's CDS portfolio. He said, "I picked up a lot of already done analysis to bring myself up to speed. Not a lot of primary work was necessary by the time I got there to understand the CDS portfolio. The AIG FP monitoring effort since the decision was made to relieve FP of its CDS, the FP issue was really about getting your arms around what was left." Dixie asked what was left that didn't go into Maiden Lane 3. Mr. Alix explained that "after termination of the CDS in the multi-sector CDO book, [there were] relatively small positions in other derivatives on CDOs which were not moved into Maiden Lane 3." He said those were a set of guarantees on loan portfolios for European banks to improve their regulatory capital ratios. He said the transactions were typically not hedged, and were exposed fully to credit risk. Dixie asked Mr. Alix if he had any insight into why the multi-sector CDO book was not hedged, and he said, "there's some anecdotal evidence that the origins of AIG FP was to do long term trades – it's initial raison d'etre was to take advantage of the high quality credit rating which was attractive to credit sensitive end users, and leveraging the credit rating made them able to attract spread relative to lower quality counterparties. They started out being hedged, so then the question is why they engaged in business that wasn't hedged. The story goes that they made the transition in the 2000s to engaging in transactions where the estimate of risk suggested that risk of loss was so remote that didn't need to be hedged under their management approach. They had traditionally been a hedged market maker, then they became an un-hedged credit insurer," he said.

Dixie asked if the contracts in the regulatory arbitrage portfolio or the interest rate, foreign exchange, or commodities books involved the same liquidity risk as the multi-sector CDO portfolio. He said that "typically, the contracts applied to all transactions. From AIG's perspective, whether or not they were hedged, they'd have interest rate transactions, foreign exchange transactions, commodities transactions, etcetera, and the counterparty wouldn't know as a legal matter whether AIG had hedged that position. Yes, they had downgrade provisions with collateralization, but if the question is whether or not it's the same kind of liquidity risk, the answer is no because of the [way it was hedged]."

Dixie asked Mr. Alix what work he did to establish Maiden Lane 3. Ms. Leventhal said, "Mike came on board and the decision was made to try to get counterparty concessions, given that AIG was facing imminent downgrade and if something wasn't done about CDS exposures, a huge cascade of events… the priority was to get the deal done. The priority was not getting concessions; the priority was to get the deal done." Mr. Alix added that "it's important to recognize that on November 3, a lot of work was done in the prior weeks by the Fed and BlackRock and DPW. And there was discussion with colleagues and Washington and the Board and the Treasury. I came in after that had been done, and the primary mission I had was to understand and comment on the structure, and to help complete the task, which was to remove the liquidity and P&L risk that existed at FP… in a way that was safe and sound and in the Fed's interest. That was a seven day process from the time I arrived until the announcement that included Maiden Lane 3." He said that "it's amazing it was done in a week. Large numbers of counterparties - 8 large and 16 or 17 total - that had different kinds of portfolios, different issues. There was an enormous amount of legal work needed to be done to craft agreements and vet and execute them. It really was quite amazing that all of that was accomplished within a week, and with care and diligence. One of the things that facilitated that was the simplicity of the structure – tear up of CDS, purchase of assets, retention of collateral."

Ms. Leventhal added that "the structure was under discussion and planning for some time," and Mr. Alix agreed, saying that the "structure was done when I showed up."

Dixie asked if Mr. Alix worked with counterparties during that week, and he said that he worked with a team that worked with counterparties. He said that the two members of the AIG team assigned to execute the transaction were Paul Shynot and Littori (phonetic). Shynot and Littori worked with BlackRock on the structure and were tasked communicating with counterparties, closing the transaction and funding it, he said. Mr. Alix said that he advised them and other senior management on the structural and economic issues the counterparties might raise. He said that "the question of concessions came up very early in that week, and BlackRock provided background research. The economic questions were really, [] from a counterparty perspective, what's the right level at which to unwind the transaction? How does each side look at the risk? A problem that we faced was that these contracts were very favorable to counterparties – almost all generally provided that if AIG was downgraded, the counterparty could terminate the transaction in an environment where abundant liquidity was available from the Fed facility. So they could terminate to no loss to themselves."

Dixie asked Mr. Alix to explain the issues surrounding counterparty concessions, given the high degree of public criticism about the treatment of counterparties in the transaction. He said that it may be counterintuitive, but it would have actually been good for counterparties for the insured assets to decline in value, and it would have been good for the counterparties to terminate the CDS contracts with AIG. He explained that if AIG was downgraded, the counterparties had the right to terminate the contracts, and the price to AIG of terminating the contract "would be the price that another party was willing accept for stepping into the counterparty's shoes." In the market environment in late 2008, that price would have been highly unfavorable to AIG. Mr. Alix explained that AIG faced a situation in which a counterparty held an asset with diminished value, the collateral AIG was required to post, and the right to terminate the CDS contract at terms unfavorable to AIG. Therefore, AIG would have had to pay more than par to terminate the CDS contracts – the collateral, plus the tear-up cost of the contract. Making the situation yet more unfavorable to AIG, the counterparty would keep the asset, so AIG got none of the upside, if the assets ever regained value. "You'd mark-to-market the swap, which would take into consideration the downside risk of the asset, so the cost of termination and the fair market value of the asset would be more than par, and so that's why, in my judgment, counterparties were very reluctant to unwind the transaction at anything less than par," he said. He explained that "the situation flips in the event of any doubt about AIG's ability to perform. So if there was a doubt of default then those counterparties would've been more likely to negotiate," but the presence of the $85 million facility from the Fed assured counterparties that the company would be able to perform.

Mr. Alix said that the "beauty of the Maiden Lane 3 structure [was that the Government] got the assets back and preserved the upside of that asset – one third for AIG and two thirds for the taxpayer - although ultimately, it's all for the taxpayer at this point. Given the incredible distress in the market, the ability to have and hold that asset was a benefit to unwinding the transaction, because otherwise, the counterparty would've been able to keep the upside. So Maiden Lane 3 helped preserve the ability for upside gains for taxpayers down the road."

Dixie asked what documents BlackRock presented to Mr. Alix when he arrived at the Fed to help him understand the structure. He said that "counterparty briefers, discussions with BlackRock and with Davis Polk answered questions that I had about those transactions. But the concepts weren't new to me, I understood derivatives."

Dixie asked Mr. Alix if in his experience, the collateral provisions in AIG's CDS contracts were typical across the industry. He said, "having a swap agreement where you're protected from a downgrade of the rating of the counterparty - that was typical. Maybe it was not typical for counterparties to write gigantic CDS and apply it to portfolios in a way that generated huge liquidity risk. [AIG] did not anticipate collateral, they didn't have the reporting to figure that out. They wrote these contracts and said at the outset that these are money good contracts, it's not going to be a big do if we have to post a little collateral. They didn't behave as if they thought $30 billion of collateral moving out the door."

Mike Easterly asked how Maiden Lane Three got the underlying assets if the contracts didn't call for AIG getting the underlying assets back. Mr. Alix said, "It was a negotiation. There was no event which required the counterparties to do anything. And what I suggested before, the counterparties knowing the perilous state of AIG, said, 'ok we'll be fine if there's a downgrade, there's even an upside,' so there was really nothing compelling the counterparties to act at all. In fact, though there's been a lot said about paying par, the negotiation was about *motivating* counterparties to do the transactions in order to protect AIG and its government constituents because they could've received *more* than par. The effect of it is that AIG would've paid more than par." Ms. Leventhal added that "everyone gets hung up on concessions, and really they were just a little piece."

Dixie asked how fair market value of the assets was determined given the state of the market. Mr. Alix said that a difference between Maiden Lane 2 and 3 was that "AIG had attempted to unwind trades at various times prior to Maiden Lane 3 and got some market color from that, so there was the independent process AIG went through, and then that was overlaid with BlackRock's process. Fair value, given the incredible illiquidity in the market, was arrived at using discounted cash flow so it wasn't a fire sale."

He added that what was important was for the face value of the assets and the collateral to add up to par for the counterparties, for AIG and Maiden Lane III to agree on a price at which the assets were transferred, and for AIG to tear up the CDS contracts so that AIG could not lose any more money on deals.

Dixie said that the FCIC may have follow up questions, thanked Mr. Alix for his time, and concluded the interview.

4823-9243-2390, v. 1