Overview

On October 6, 2008, the Board of Governors of the Federal Reserve System (Board), by the unanimous vote of its five members, approved under section 13(3) of the Federal Reserve Act (12 U.S.C. § 343) the establishment by the Federal Reserve Bank of New York (FRBNY) of a new lending facility for American International Group, Inc. (AIG). Under the new facility (the Secured Borrowing Facility), FRBNY may engage in securities borrowing transactions with AIG through which FRBNY lends cash to AIG in exchange for collateral in the form of investment grade debt obligations. The maximum amount of credit that may be extended at any time under the facility is $37.8 billion.

Background and Details on the AIG Securities Borrowing Facility

AIG is a large, diversified financial services company that, as of June 30, 2008, reported consolidated total assets of slightly more than $1 trillion and stockholders’ equity of $78 billion. AIG operates in four general business lines through a number of subsidiaries: (i) General Insurance, (ii) Life Insurance and Retirement Services, (iii) Financial Services, and (iv) Asset Management. In 2007, net premiums written for AIG’s General Insurance businesses aggregated $47.1 billion. Also, in 2007, total revenues for the Life Insurance and Retirement Services business line and Asset Management business line were $53.6 billion and $5.6 billion, respectively. Revenue for the Financial Services business lines was ($1.3) billion in 2007, due to losses in the company’s capital markets business. In addition to its on-balance-sheet positions, AIG is a major player in a wide range of derivatives markets through its Financial Services division, and particularly through its AIG Financial Products subsidiary, and is a significant counterparty to a number of major national and international financial institutions.

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1 Certain of AIG’s regulated insurance subsidiaries operate a securities lending program under which the subsidiaries, with the approval of their appropriate state insurance authority, pool together and lend out high-quality, fixed-income securities owned by the insurance companies to third parties in exchange for cash. FRBNY will engage in securities borrowing transactions with these regulated insurance companies, either directly or through the pool established by such companies to conduct their securities lending program.
On September 16, 2008, the Board authorized FRBNY to lend up to $85 billion to AIG under section 13(3) of the Federal Reserve Act (September Facility). The Board determined that, under the circumstances at that time, a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance. The September Facility was authorized to assist AIG in meeting its obligations as they come due and facilitate a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy. Importantly, the September Facility has terms designed to protect the Federal Reserve and the taxpayer. All draws under the September Facility are collateralized by all the assets of AIG, and of its primary non-regulated subsidiaries. These assets include the stock of substantially all of AIG’s regulated subsidiaries. The loan is expected to be repaid from the proceeds of the sale of the firm’s assets. The U.S. government also received a 79.9 percent equity interest in AIG and the right to veto the payment of dividends to common and preferred shareholders. The Board separately will provide a report on the September Facility pursuant to, and within the time frame established by, section 129(d) of the Emergency Economic Stabilization Act.

As of October 1, AIG had drawn down approximately $62 billion of the September Facility. As expected, drawdowns by AIG under the September Facility have been used, in part, to settle transactions with counterparties returning securities that they borrowed from AIG.

In light of the foregoing, the expectation that additional securities borrowing counterparties would decide to not renew their securities borrowing positions with AIG, and the continuing fragile position of the financial markets, the Board determined that unusual and exigent circumstances existed that warranted approval of the Secured Borrowing Facility. The Secured Borrowing Facility addresses the liquidity strains placed on AIG due to the ongoing withdrawal of counterparties from securities borrowing transactions and permits AIG to use the remaining amounts of the September Facility for other uses. The Secured Borrowing Facility will reduce the pressure on AIG to liquidate immediately the portfolio of residential mortgage-backed securities (RMBS) that were purchased with the proceeds of the securities lending transactions. Establishment of the Securities Borrowing Facility was supported by the State insurance authorities for AIG’s regulated insurance subsidiaries participating in the securities lending program. Consistent with the purposes of the September Facility, the Securities Borrowing Facility will help stabilize AIG’s liquidity situation in the near term and preserve
the value of its subsidiaries, including its regulated insurance subsidiaries, by providing the company additional time to arrange and complete the orderly sales of certain operations in a manner that minimizes disruption to the financial markets and the overall economy.

The size of the Secured Borrowing Facility will permit the Reserve Bank, if necessary, to replace all remaining securities borrowing counterparties of AIG. All advances made under the new facility will be fully collateralized by investment grade debt obligations that are subject to an appropriate haircut consistent with the Reserve Bank’s usual discount window lending practices. These obligations currently are owned by the insurance subsidiaries of AIG and pledged under existing securities lending arrangements and, thus, are not available to FRBNY as collateral for the September Facility. The debt obligations that will serve as collateral consist primarily of corporate debt obligations, agency pass-through certificates, collateralized mortgage obligations and obligations of foreign and local governments. The secured borrowing transactions conducted under the facility will have a term of one day, although they may be rolled over for multiple one-day terms. As of the close of business on October 10, 2008, the outstanding amount advances under the Secured Borrowing Facility was $10.3 billion.

Advances will bear an interest rate of 100 basis points above the average overnight repo rate offered by dealers on the relevant collateral type, based on a daily survey of dealers conducted by FRBNY’s market desk. The U.S. government did not receive additional warrants or rights to equity securities in connection with the Secured Borrowing Facility. The Securities Borrowing Facility has the same maximum duration as the September Facility (September 16, 2010) in order to allow the company to conduct an orderly disposition of certain of its assets. Because advances made under the Secured Borrowing Facility will be with recourse to AIG and fully secured by investment grade debt obligations, it is not expected that the advances will result in any losses to the Federal Reserve or the taxpayer.