AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

S. HRG. 111–809

TARP AND OTHER GOVERNMENT ASSISTANCE FOR AIG

HEARING

BEFORE THE

CONGRESSIONAL OVERSIGHT PANEL

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

MAY 26, 2010

Printed for the use of the Congressional Oversight Panel

TARP AND OTHER GOVERNMENT ASSISTANCE FOR AIG

S. HRG. 111–809

TARP AND OTHER GOVERNMENT ASSISTANCE FOR AIG

HEARING

BEFORE THE

CONGRESSIONAL OVERSIGHT PANEL

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

MAY 26, 2010

Printed for the use of the Congressional Oversight Panel

U.S. GOVERNMENT PRINTING OFFICE

63–515 WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

CONGRESSIONAL OVERSIGHT PANEL

PANEL MEMBERS

ELIZABETH WARREN, *Chair*

J. MARK MCWATTERS

KENNETH TROSKE

RICHARD H. NEIMAN

DAMON SILVERS

CONTENTS

	Page
Statement of Elizabeth Warren, Chair, Congressional Oversight Panel	1
J. Mark McWatters, Member, Congressional Oversight Panel	5
Damon Silvers, Member, Congressional Oversight Panel	10
Kenneth Troske, Member, Congressional Oversight Panel	14
Scott G. Alvarez, General Counsel, Federal Reserve Board	18
Thomas C. Baxter, Jr., General Counsel and Executive Vice President of the Legal Group, Federal Reserve Bank of New York	40
Sarah Dahlgren, Executive Vice President, Special Investments Management and AIG Monitoring, Federal Reserve Bank of New York	41
Michael E. Finn, Northeast Regional Director, Office of Thrift Supervision	58
Robert Willumstad, Former Chairman and Chief Executive Officer, American International Group, Inc.	76
Martin Bienenstock, Partner and Chair of Business Solutions and Government Department, Dewey & LeBoeuf	113
Statement of Rodney Clark, Managing Director, Insurance Ratings, Standard & Poor's	120
Michael Moriarty, Deputy Superintendent for Property and Capital Markets, New York State Insurance Department	132
Clifford Gallant, Managing Director, Property & Casualty Insurance Research, Keefe, Bruyette & Woods	155
Robert Benmosche, President and Chief Executive Officer, American International Group, Inc.	164
Jim Millstein, Chief Restructuring Officer, U.S. Department of the Treasury	196
Keith M. Buckley, CFA, Group Managing Director, Global Insurance, Fitch Ratings	231

HEARING ON TARP AND OTHER GOVERNMENT ASSISTANCE FOR AIG

WEDNESDAY, MAY 26, 2010

U.S. CONGRESS,
CONGRESSIONAL OVERSIGHT PANEL,
Washington, DC.

The Panel met, pursuant to notice, at 10:00 a.m., in room SD–342, Dirksen Senate Office Building, Washington, DC, Elizabeth Warren, (chair of the panel) presiding.

Present: Ms. Elizabeth Warren (presiding), Mr. Damon Silvers, Mr. J. Mark McWatters, and Dr. Kenneth Troske.

OPENING STATEMENT OF ELIZABETH WARREN, CHAIR, CONGRESSIONAL OVERSIGHT PANEL

Chair WARREN. I call this hearing to order.

Good morning. My name is Elizabeth Warren. This is the 20th public hearing of the Congressional Oversight Panel for the Troubled Asset Relief Program.

Before we begin, I'd like to note the presence of our newest panel member, Professor Kenneth Troske. Welcome. We are glad to have you join us and we look forward to your contributions on this panel.

So I'm here today as the chair of the Congressional Oversight Panel but that is not my only job. I am also a law professor and in that role I've taught bankruptcy for nearly 30 years now.

Bankruptcy's an enormously complicated field with enough subtleties to fill thousands of pages, but the essentials could fit on the back of a napkin. In short, there are times when businesses fail and when they do someone has to pick up the pieces. When a company digs itself in so deeply in debt that it cannot escape, then our legal system provides a set of strict and simple rules to force the business to bear as much of the cost of that failure as possible and to minimize the impact on others.

Of these rules, two are paramount. When there's not enough money to go around, the shareholders are wiped out and, second, the business creditors lose money and, depending on how deep that hole is, they may lose a great deal of money. The rules may seem harsh but they are fundamental to the functioning of a free market. After all, the parties that gain the most when a business succeeds should be the parties who lose the most when a business fails.

As I open today's hearing, I list the rules of bankruptcy because we are about to examine a bankruptcy that broke all the rules. In fact, the rescue of AIG was so extraordinary that it bypassed the

entire process of bankruptcy. In saving AIG, the Government invented a new process out of whole cloth, a parallel set of rules devised and executed for the benefit of only one company.

By the time the Federal Government intervened in late 2008, AIG's stock price had plummeted 79 percent in two weeks. The sharp decline in mortgage-linked asset prices and the failure of Lehman Brothers had led to staggering collateral calls from AIG's counterparties and AIG simply did not have enough cash to pay everyone in full.

The next steps ordinarily would have been straightforward. Under the rules that apply to everyone else in America, AIG shareholders should have lost everything and its creditors should have taken substantial losses. Yet, even today, AIG continues to trade on the New York Stock Exchange and no creditor lost a penny on its dealings with the company.

Put another way, under the rules that apply to everyone else in America, the cost of AIG's mistakes should have been borne by AIG and its creditors, but under this new ad hoc set of rules, the cost of AIG's mistakes were borne by the rest of us, the American taxpayers.

To be clear, I do not mean to suggest that traditional bankruptcy would have been the best or most appropriate choice for AIG. The company was a corporate Frankenstein, a conglomeration of banking and insurance and investment interests that defy regulatory oversight and that would not have fit easily into the existing bankruptcy structure. Its complexity, its systemic significance, and the fragile state of the economy may all arguably have been reasons for unique treatment, but no matter the justification, the fact remains that AIG's rescue broke all the rules and each rule that was broken poses a question that must be answered.

Today's hearing is an effort to find those answers as well as to determine how taxpayer money was spent and how it might one day be repaid. This hearing is the culmination of months of preparatory work on the part of the panel and our staff and it will serve as the foundation for our forthcoming June Oversight Report.

We will begin this hearing by having testimony from officials who, during the crisis of 2008, made the fateful decision that set the course for the Government's future involvement in AIG. We will then hear about the aftermath of those choices and about AIG's prospects of continuing operations and repayment for the American taxpayer.

I want to express our sincere gratitude to our witnesses for their willingness to share their knowledge and their perspectives.

[The prepared statement of Chair Warren follows:]

ELIZABETH WARREN, CHAIR
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK McWATTERS
KENNETH R. TROSKE

732 NORTH CAPITOL STREET, NW
ROOM C-320
WASHINGTON, DC 20401

Congress of the United States
CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Elizabeth Warren

Congressional Oversight Panel Hearing on TARP and Other Assistance to AIG

May 26, 2010

Good morning. My name is Elizabeth Warren, and this is the 20th public hearing of the Congressional Oversight Panel for the Troubled Asset Relief Program. Before we begin, I would like to note the presence of our newest Panel member, Professor Kenneth Troske. We are grateful to have you join us and look forward to your insights.

I am here today as the chair of the Congressional Oversight Panel, but that is not my only job. I am also a law professor, and in that role I have taught bankruptcy law for more than 30 years.

Bankruptcy is an enormously complicated field with enough subtleties to fill thousands of pages, but the essentials could fit on the back of a napkin. In short, there are times when businesses fail, and when they do, someone has to pick up the pieces. When a company digs itself so deeply into debt that it cannot escape, our legal system provides a set of strict and simple rules to force the business to bear as much of the cost of its mistakes as possible and to minimize the impact on others.

Of these rules, two are paramount. First, the business's owners – its shareholders – lose everything. Second, the business's creditors – including its bondholders and counterparties – lose money, and depending on how deep the hole, they could lose a great deal.

The rules may seem harsh, but they are fundamental to the functioning of a free market. After all, the parties that gain the most when a business succeeds should also lose the most when a business fails.

I open today's hearing by listing the rules of bankruptcy because we are about to examine a bankruptcy that broke all the rules. In fact, the rescue of the American International Group was so extraordinary that it bypassed the entire legal process of bankruptcy. In saving AIG, the government invented a new process out of whole cloth, a parallel set of rules devised and executed for the benefit of only one company.

By the time the federal government intervened in late 2008, AIG was a poster child for the need for a well-functioning bankruptcy system. Its stock price had plummeted 79 percent in only two weeks. The sharp decline in mortgage-linked asset prices and the failure of Lehman Brothers

had led to staggering collateral calls from AIG's counterparties, and AIG simply did not have enough cash on hand to keep its doors open.

The next steps would ordinarily have been straightforward. Under the rules that applied to everyone else in America, AIG's shareholders should have lost everything, and its creditors should have taken substantial losses. Yet even today AIG continues to trade on the New York Stock Exchange, and no creditor has lost a penny on its dealings with the company.

Put another way, under the rules that applied to everyone else in America, the costs of AIG's mistakes should have been borne by AIG and its partners. But under this new, *ad hoc* set of rules, the costs of AIG's mistakes were borne by the rest of us – the American taxpayers.

Let me be clear. I do not mean to suggest that a traditional bankruptcy would have been the best or most appropriate choice for AIG. The company was a corporate Frankenstein, a conglomeration of banking and insurance and investment interests that defied regulatory oversight and that would not have fit easily into the existing bankruptcy structure. Its complexity, its systemic significance, and the fragile state of the economy may all arguably have been reasons for unique treatment. But no matter the justification, the fact remains that AIG's rescue broke all the rules, and each rule that was broken poses a question that must be answered.

Today's hearing is an effort to find those answers, as well as to determine how taxpayer money was spent and how it might one day be repaid. This hearing is the culmination of months of preparatory work on the part of the Panel and our staff, and it will serve as the foundation for our forthcoming June oversight report. It falls under the Panel's statutory mandate to examine "the use by the Secretary of authority under" the TARP, as well as "the impact of purchases made under the Act on the financial markets and financial institutions."

We will begin by hearing testimony from officials who, during the crisis of 2008, made the fateful decisions that set the course for the government's future involvement in AIG. We will then hear about the aftermath of those choices and about AIG's prospects as a continuing operation today. We intend to ask tough and detailed questions, but I want to first express sincere gratitude to our witnesses for their willingness to share their knowledge and perspectives.

Before we proceed with the testimony, I would like to offer my colleagues on the Panel an opportunity to make their own opening remarks.

Chair WARREN. Before we proceed with the testimony, I'd like to offer my colleagues on the panel an opportunity to make their own opening remarks.

Mr. McWatters.

STATEMENT OF J. MARK MCWATTERS, MEMBER, CONGRESSIONAL OVERSIGHT PANEL

Mr. MCWATTERS. Thank you, Professor Warren. I very much appreciate the attendance of the witnesses and I look forward to hearing their testimony.

The rescue of AIG has required the allocation of more taxpayer-funded resources than any other bailout undertaken by the Government since the inception of the current economic crisis.

The Congressional Budget Office has estimated that the TARP investment in AIG will cost the taxpayers $36 billion out of $70 billion committed or disbursed, and the Office of Management and Budget has projected that the investment will cost the taxpayers $50 billion.

Since our national resources are limited, the bailout of AIG will unfortunately require the Government to reduce the expenditures, increase tax revenue, or both. The American taxpayers were told in the last quarter of 2008 that they had no choice but to bail out AIG because, absent such action, the world financial system might very well collapse due to the systemic risk presented by and the financial interconnectedness of AIG.

That may indeed have been an accurate assessment, but it's critical to note that the world financial system does not consist of a single monolithic institution but, instead, is comprised of an array of too-big-to-fail financial institutions, many of which, interestingly, were also counterparties on AIG credit default swaps and securities lending transactions.

In other words, the concept of a world financial system is really just another term for the biggest of the big financial institutions and there remains little doubt to me that the principal purpose in bailing out AIG was to save these institutions as well as AIG's insurance business from bankruptcy or liquidation.

It is ironic that although the bailout of AIG may have rescued many of its counterparties, none of these institutions are willing to share the pain of the bailout with the taxpayers and accept a discount on the termination payments.

Instead, they left the American taxpayers with the full burden of the bailout. It is likewise intriguing that these too-big-to-fail institutions were paid at par, that is, 100 cents on the dollar, at the same time the average American's 401(k) and IRA accounts were in free fall, unemployment rates were skyrocketing, and home values were plummeting.

It is also critical to recall at this time that many of the AIG counterparties were most likely experiencing their own severe liquidity and insolvency challenges and were under attack from short sellers and purchasers of credit default swaps over their debt instruments. By receiving payment at par, some of the counterparties were able to convert illiquid and perhaps mismarked CDOs and other securities into cash during the worst liquidity crisis in generations.

In addition, by avoiding the inherent risk in an AIG bankruptcy and the issues regarding debtor-in-possession financing, some of the counterparties were also able to accelerate the conversion of their AIG contracts into cash and in late 2008 cash was king. Although some counterparties may argue that they held contractual rights to receive payment at par and were the beneficiaries of favorable provisions of the Bankruptcy Code, such rights and benefits would have been of diminished assistance since, in late 2008, AIG was out of cash.

It also appears problematic that AIG would have been able to obtain sufficient post-petition financing following the implosion of the financial system that, according to the wisdom of the day, would have followed the bankruptcy of AIG.

Thus, without the taxpayer-funded bailout, AIG would have held insufficient cash to honor in full its contractual obligations, notwithstanding the special rights and benefits afforded the counterparties.

In light of this reality, it does not appear inappropriate for the taxpayers to expect a discount to par upon the termination of AIG's contracts with those counterparties who held the referenced securities but were not otherwise fully hedged against AIG-related risk with posted cash collateral.

I appreciate that senior management and counsel of some of the AIG counterparties may cite standards of fiduciary duty as a defense to their unwillingness to accept a discount to par. It is quite possible, however, that these officers owed a higher fiduciary duty which was to save their institution from the very real threat of bankruptcy or liquidation that existed in the final quarter of 2008.

After all, who can forget the photograph of the $2 bill taped to the door of Bear Stearns' New York office? That image, like Charles Dickens' "Ghost of Christmas Future," told the story of what would come to pass for other financial institutions, such as AIG and its counterparties, absent the intercession of the American taxpayers.

In the dark days of late 2008, when AIG faltered, the American taxpayers, not the New York Fed, not Treasury, stood as the last safe harbor for many of these financial Institutions and much of today's Main Street versus Wall Street debate would have never arisen if Wall Street had properly acknowledged the American taxpayers as its sole benefactor.

As such, after the bailouts, it has become exceedingly difficult for many Americans to accept that what's good for Wall Street is necessarily good for Main Street.

Thank you for joining us today, and I look forward to our discussion.

[The prepared statement of Mr. McWatters follows:]

ELIZABETH WARREN, CHAIR
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK McWATTERS
KENNETH R. TROSKE

732 NORTH CAPITOL STREET, NW
ROOM C-320
WASHINGTON, DC 20401

Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of J. Mark McWatters

Congressional Oversight Panel Hearing on TARP and Other Assistance to AIG

May 26, 2010

Thank you Professor Warren.

I very much appreciate the attendance of the witnesses and I look forward to hearing their views.

The rescue of AIG has required the allocation of more taxpayer funded resources than any other bailout undertaken by the government since the inception of the current economic crisis. The Congressional Budget Office (CBO) has estimated that the TARP investment in AIG will cost the taxpayers $36 billion out of $70 billion committed or disbursed,[1] and the Office of Management and Budget (OMB) has projected that the investment will cost the taxpayers $49.9 billion.[2] Since our national resources are limited, the bailout of AIG will unfortunately require the government to reduce expenditures, increase tax revenue or both.[3]

The American taxpayers were told in the last quarter of 2008 that they had no choice but to bail out AIG because absent such action the world financial system might very well collapse due to the systemic risk presented by and the financial interconnectedness of AIG. That may indeed have been an accurate assessment, but it's critical to note that the world financial system does not consist of a single monolithic institution but, instead, is comprised of an array of too-big-to-fail financial institutions many of which, interestingly, were also counterparties on AIG credit default swaps (CDS) and securities lending transactions (SL). In other words, the concept of a "world financial system" is really just another term for the biggest of the big financial institutions and there remains little doubt to me that the principle purpose in bailing out AIG was to save these institutions as well as AIG's insurance business from bankruptcy or liquidation.

---

[1] Link to CBO's "Report on TARP:" http://www.cbo.gov/ftpdocs/112xx/doc11227/03-17-TARP.pdf.

[2] Link to President's Budget: http://www.whitehouse.gov/omb/budget/fy2011/assets/econ_analyses.pdf.

[3] As I have done in prior hearings, I think that it's instructive to add some perspective to the magnitude of the loss the taxpayers may suffer as a result of the AIG bailout. By comparison, for fiscal year 2011 the National Institute of Health (NIH) has requested $765 million for breast cancer research, and the latest Nimitz-class aircraft carrier commissioned by the Navy cost approximately $4.5 billion. [See NIH "Estimates of Funding for Various Research, Condition and Disease Categories (RCDC)" at http://report.nih.gov/rcdc/categories/ and See "Information about the Ship," at http://up-www01.ffc.navy.mil/cvn77/static/aboutus/aboutship.html.] It is entirely appropriate for the taxpayers who funded the TARP program to ask if the bailout of AIG with a CBO estimated cost of $36 billion merited 47 years of breast cancer research or eight (8) Nimitz-class aircraft carriers. The "guns v. butter v. AIG" comparison demonstrates that our national resources are indeed limited and that the bailout of AIG will require the government to reduce expenditures, increase tax revenue or both.

It is ironic that although the bailout of AIG may have rescued many of its counterparties, none of these institutions were willing to share the pain of the bailout with the taxpayers and accept a discount on their termination payments. Instead, they left the American taxpayers with the full burden of the bailout. It is likewise intriguing that these too-big-to-fail financial institutions were paid at par—that is, 100 cents on the dollar—at the same time the average American's 401(k) and IRA accounts were in free-fall, unemployment rates were sky-rocketing and home values were plummeting.

It is also critical to recall that at this time many of the AIG counterparties were most likely experiencing their own severe liquidity and insolvency challenges and were under attack from short-sellers and purchasers of CDSs on their debt instruments. By receiving payment at par, some of the counterparties were able to convert illiquid and perhaps mismarked CDOs and other securities into cash during the worst liquidity crisis in generations.[4] In addition, by avoiding the risk inherent in an AIG bankruptcy and the issues regarding debtor-in-possession financing, some of the counterparties were also able to accelerate the conversion of their AIG contracts into cash, and in late 2008, cash was king.[5] Although some counterparties may argue that they held contractual rights to receive payment at par and were the beneficiaries of favorable provisions of the bankruptcy code, such rights and benefits would have been of diminished assistance since in late 2008 AIG was out of cash. It also appears problematic if AIG would have been able to obtain sufficient post-petition financing following the implosion of the financial system that—according to the wisdom of the day—would have followed the bankruptcy of AIG. Thus, without the taxpayer funded bailout, AIG would have held insufficient cash to honor in full its contractual obligations notwithstanding the special rights and benefits afforded the counterparties.[6] In light of this reality, it does not appear inappropriate for the taxpayers to expect a discount to par upon the termination of AIG's contracts with those counterparties who held the referenced securities but were not otherwise fully hedged against AIG-related risk with posted cash collateral.[7]

---

[4] If you're inclined to challenge this analysis, ask yourself one question: In the last quarter of 2008 what would you have rather owned—(i) a CDS with a bankrupt AIG that is searching the world for post-petition financing or (ii) U.S. dollars equal to the full face amount of the referenced securities underlying your CDS?

[5] While the facts and circumstances no doubt differed with respect to the contractual and economic relationships of the various counterparties with AIG, the bailout of AIG—at a minimum—reduced systemic risk throughout the world-wide financial system to the benefit of the counterparties and most certainly allowed some of the counterparties to receive a greater distribution than they would have received following the bankruptcy of AIG.

[6] It is worth noting that the amount of any discount to par is not the key issue. The American taxpayers have repeatedly proven themselves profoundly generous to the commercial and investment banking communities over the past two years. The acceptance of the numerous bailouts by the taxpayers, however, is founded upon the implicit understanding that Wall Street share the financial burden with the taxpayers. The bailout of the AIG counterparties at par without a gesture of support to the taxpayers breached that agreement.

[7] If an AIG counterparty was fully hedged with cash collateral posted by the protection seller to the AIG counterparty as the protection buyer under a CDS over AIG, the AIG counterparty would most likely recover the full benefit of its bargain even if AIG failed and was liquidated. Under these circumstances it appears unlikely that the AIG counterparty would offer a discount to AIG upon the bailout of AIG by the taxpayers because the AIG counterparty would be indifferent regarding the bailout of AIG by the taxpayers. Conversely, if the AIG

I appreciate that the senior management and counsel of some of the AIG counterparties may cite standards of fiduciary duty as a defense to their unwillingness to accept a discount to par. It is quite possible, however, that these officers owed a higher fiduciary duty which was to save their respective institutions from the very real threat of bankruptcy or liquidation that existed in the final quarter of 2008. After all, who can forget the photograph of the two-dollar bill taped to door of Bear Stearns's New York offices?[8] That image—like Charles Dickens's ghost of Christmas future—told the story of what *would* come to pass for other financial institutions, such as AIG and its counterparties, absent the intercession of the American taxpayers. In the dark days of late 2008 when AIG faltered the American taxpayers—not the New York Fed or Treasury—stood as the last safe-haven for many of these financial institutions and much of today's Main Street v. Wall Street debate would have never arisen if Wall Street had properly acknowledged the American taxpayers as its sole benefactor. As such, after the bailouts, it has become exceedingly difficult for many Americans to accept that what's good for Wall Street is necessarily good for Main Street.

Thank you for joining us today and I look forward to our discussion.

---

counterparty was not fully hedged regarding the default by AIG under the CDS with the AIG counterparty, the AIG counterparty should be willing to offer AIG a discount to tear-up the CDS because—without the bailout of AIG by the taxpayers—the AIG counterparty would most likely suffer a loss upon the bankruptcy of AIG due to the collapse of the financial system (which includes the CDO and the DIP financing markets) that would follow such event.

In addition, since the counterparties under the CDSs that the AIG counterparties used to hedge their AIG-related risk were in effect bailed out upon the bailout of AIG, it would also not appear unreasonable for the taxpayers to expect a discount to par from such counterparties.

[8] See "Bear Stearns and the $2 Bill," Reuters, March 17, 2008, at http://blogs.reuters.com/reuters-dealzone/2008/03/17/bear-stearns-and-the-2-bill/.

Chair WARREN. Thank you, Mr. McWatters. Deputy Chair Silvers.

STATEMENT OF DAMON SILVERS, MEMBER, CONGRESSIONAL OVERSIGHT PANEL

Mr. SILVERS. Thank you, Chair Warren. Good morning.

This is the third hearing that our panel has held on assistance provided to a particular firm. Before I discuss the firm itself, I want to note, together with my fellow panelists, our gratitude to both this panel and the panels that follow for being with us today. I think we have an extraordinarily comprehensive set of witnesses in relation to the events we are interested in.

I want to particularly note that this panel is comprised of individuals whom have spent a tremendous amount of time with our oversight panel in helping us understand these events and lest I be misunderstood in what I'm going to say following these remarks, I want to be clear that I believe that the United States owes a great debt of gratitude to the individuals before us who have dedicated their careers, for decades in some cases, to serving the public in the context of the financial sector where, obviously, great rewards await those who serve themselves only. And these individuals were faced in this matter of AIG with a profound crisis outside of their experience and outside of really the experience of the institutions they were helping to lead.

And in the course of our oversight work, I think it's very important that nothing that we say or I say be understood to be in any sense anything other than our doing our job in the context we're doing it. There's no doubt that these individuals, and I note here that these are individuals whose names are not famous and who do a lot of work that doesn't often get a lot of credit, that these individuals have served their country admirably and it gives me great pleasure to have the opportunity to say that.

Now, there are a lot of good reasons for us to focus on AIG. AIG received more TARP funds, as my colleague Mr. McWatters notes, AIG received more TARP funds than any other beneficiary and is the largest continuing holder of TARP funds in the financial system, but it's not really the size of the AIG bailout that has, I think, driven the continuing controversy associated with it.

That controversy is really driven by several factors. One is the complexity and opacity associated with the collapse and bailout of AIG, and the way in which AIG was at the center of—and I think Mr. McWatters talked about this in a very compelling way—at the center of a web of relationships among large financial institutions, including, notably, the firm of Goldman Sachs and a group of French banks.

Another reason that the AIG bailout looms large over the TARP are the implications of the bailout in terms of the degree that the public turns out to have been guaranteeing the shadow banking system, an outcome that I think ex ante, sort of before the fact, would appear to be completely inappropriate.

I think we've heard about how the central facts in the collapse of AIG were AIG's collateral obligations under credit default swaps, a kind of unregulated bond insurance, and AIG's obligations under some securities lending transactions.

The public made good on these obligations, arguably signaling that these completely unregulated markets had a better quality government guarantee than an FDIC-insured bank account which, after all, has a relatively low limit of insurance, or a PBGC-insured pension, again which has a very low limit, not running into the billions of dollars.

These are two of the most heavily-regulated financial obligations in our system. They're only partially guaranteed. It turns out that a credit default swap, at least in the AIG context, turned out to be a 100 percent guarantee.

Now, I have a further interest, and I think the Congress and the public ought to have a further interest in AIG for a completely different and sort of ironically opposed reason, and that is that the AIG bailout represented a model for how to at least significantly impair equity, if not, as our chair has pointed out, wipe it out, in that the Government, in exchange for rescuing AIG, took 80 percent of the equity of the firm upfront.

It has been a continuing puzzlement to me in my capacity in this oversight panel that that was not the model for dealing with, shall we say, systemically-significant failing institutions going forward.

Now, so I think there are four questions that need to be addressed in our work here and in doing so, I want to make clear that I just do not agree with and think it is inconsistent with any meaningful oversight to accept the proposition that in this matter, or any other matter, the choices facing the Government were to do exactly what the Government actually did or do nothing. I do not believe that is an adequate way to think about either AIG or any other matter in which our Government takes action.

So I'll run through the four questions quickly. The first question is, why did it turn out not to occur? Why did a private bailout of AIG not occur under the leadership of the New York Fed?

Two, and this has been discussed by my fellow panelists, why did it turn out not to occur that there was any haircut asked of those parties who were substantially rescued by the public?

Third, and this question we may be in the midst of being answered today, third, where are the legal documents and why has the public not had access to the legal documents embodying the transactions that the public bailed out?

I understand that we are in the process, the Panel is in the process, of receiving these documents from AIG today. I hope that turns out to be true and complete.

Fourth, and I mentioned this earlier, why was the AIG model in relation to the equity taken, not the model for other failed institutions?

And finally, obviously, we need to address, and we will address, what course of action from here going forward is likely to produce the best risk-adjusted return to the public for our funds we have invested in AIG, and to what extent does AIG remain a threat to the financial system?

We have set aside an entire day for this hearing which hopefully will allow us to explore these questions in some depth, and I look forward to hearing from our witnesses.

Thank you.

[The prepared statement of Mr. Silvers follows:]

ELIZABETH WARREN, CHAIR
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK McWATTERS
KENNETH R. TROSKE

732 NORTH CAPITOL STREET, NW
ROOM C-320
WASHINGTON, DC 20401

Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Damon Silvers

Congressional Oversight Panel Hearing on TARP and Other Assistance to AIG

May 26, 2010

Good morning. This is the third hearing the Congressional Oversight Panel has conducted on the assistance provided to a particular firm. There are very good reasons for us to focus on AIG. AIG has received more TARP funds than any other financial institution. AIG remains, together with the auto companies, the largest continuing holder of TARP funds.

But it is not AIG's size that really drives the continuing intense interest of the public and Congress in the AIG bailout.

The complexity and opacity associated with the collapse and bailout of AIG, and AIG's central position in a web of relationships among financial institutions, including notably Goldman Sachs and a group of French banks, are part of the reason for the interest in AIG.

Another reason the AIG bailout looms large over TARP are the implications of the bailout in terms of the degree the public turns out to have been guaranteeing the shadow banking system. There is not much disagreement that the proximate cause of AIG's collapse was AIG's inability to pay billions of dollars it owed in September 2008 as a result of its sale of unregulated bond insurance in the form of over the counter derivatives called credit default swaps and obligations AIG had as a result of securities lending transactions. The public made good on these obligations, arguably signaling that these completely unregulated markets had a better quality government guarantee than an FDIC insured bank account or a PBGC insured pension, two very heavily regulated financial instruments.

Finally, ironically, I am interested in AIG because in part the structure of the AIG bailout was more aggressive in its approach to AIG's equity holders than subsequent bailouts under TARP, and to my view, should have been taken more seriously as a model for those subsequent bailouts.

There are four questions I hope to focus on in today's hearing about the beginning of the AIG bailout, and two questions about the future. In asking these questions, I should make clear that I think there is little doubt that AIG's collapse in September, 2008 was a systemic threat, and needed to be managed by the government. But saying that does not mean that the way the government managed it was the best way. Responsible oversight begins with rejecting the proposition that the only alternative to what a government body did was to not act at all.

The first question is why the Federal Reserve Bank of New York failed to work with private parties to provide liquidity to AIG, as the Federal Reserve Bank of New York had previously done with a number of other failing systemically significant financial institutions?

The second question is why having decided to act, did the Federal Reserve Bank of New York and later the Treasury Department under TARP fail to extract concessions from AIG's counterparties?

Third, why are the legal documents embodying the derivatives deals and securities lending deals that led to AIG's collapse still secret from the public that ultimately paid for those deals?

And fourth, ironically, is why was the AIG model bailout, where the government took 80% of the equity up front for rescuing a failing institution, not applied to the next two failing institutions that Treasury rescued under TARP—Citigroup and Bank of America?

Finally, looking forward, there are two obvious questions—what course of action is most likely to get the best risk adjusted return to the public for our investment in AIG, and to what extent does AIG remain a threat to the financial system?

We have set aside most of the day for this hearing, which hopefully will allow us to explore these questions in some depth. I look forward to hearing from our witnesses.

Chair WARREN. Thank you. And now we will hear from our fourth panelist, Professor Troske.

STATEMENT OF KENNETH TROSKE, MEMBER, CONGRESSIONAL OVERSIGHT PANEL

Dr. TROSKE. Thank you, Professor Warren. As Professor Warren mentioned, my name is Ken Troske.

As many of you know, I am the newest member of the Congressional Oversight Panel, having been appointed to the Panel all of last Thursday by Senator Mitch McConnell to fill the vacancy left by Paul Atkins' departure.

As a way of introduction, I am also the William B. Sturgill Professor and the Chairman of the Economics Department at the University of Kentucky.

Since this is my first hearing and since I have been preparing for it since Thursday, I am going to keep my opening remarks brief and fairly general.

Let me start out by saying how honored I am at being appointed to the Panel. This panel has been given very challenging tasks, including monitoring how the money from the Troubled Asset Relief Program has been or is being spent and to determine whether these actions are in the best interests of the American economy and its people.

I know the Panel has already done an enormous amount of work in the past 19 months to carry out this charge. Hopefully I will be able to provide some additional insight and energy as the Panel continues and hopefully completes these tasks over the coming year.

I would like to thank Senator McConnell for appointing me to this panel. I would like to recognize Paul Atkins for his service on the Panel prior to me and thank him for helping familiarize me with the work the Panel has done in the past.

I'm very grateful to my fellow panel members, especially Chair Elizabeth Warren and Mark McWatters, for helping me understand some of the issues that we'll discuss today.

Finally, and perhaps most importantly, I would like to thank the Panel staff for their help in navigating all of the myriad of details involved in getting me on the Panel and actually getting me here today on short notice.

I want to make clear that I strongly support what I understand is one of the main goals of this panel: increasing the transparency and the public's understanding of the TARP. Given the size of this program, the speed with which it was approved, and the way the program has evolved over time, it is not surprising that many people remain confused and deeply suspicious of the TARP.

I view this panel as an important vehicle through which the American people can gain assurances that this program was necessary and is being conducted in a manner that enhances the welfare of all citizens and not just a chosen few.

I also believe it is important for the Panel to ensure that officials involved in the TARP learn from what happened so that we are not doomed to repeat this process in the future. I think all of us would agree that we want to avoid having the Government purchase in-

solvent private firms because of the fear that the economy will collapse if the firms fail.

While I am not naive enough to believe that the Government or any organization, for that matter, can prevent future recessions, I do believe that by learning from the past mistakes we can be better prepared to deal with future crises.

Let me conclude by thanking the witnesses who are joining us today. I appreciate you taking your time to come and help us better understand the events surrounding the Government's decision to provide financial assistance to AIG.

[The prepared statement of Dr. Troske follows:]

ELIZABETH WARREN, CHAIR
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK McWATTERS
KENNETH R. TROSKE

732 NORTH CAPITOL STREET, NW
ROOM C-320
WASHINGTON, DC 20401

Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Kenneth R. Troske

Congressional Oversight Panel Hearing on TARP and Other Assistance to AIG

May 26, 2010

Thank you Professor Warren.

My name is Kenneth Troske. As many of you know, I am the newest member of the Congressional Oversight Panel (COP), having been appointed to the panel last Thursday by Senator Mitch McConnell to fill the vacancy left by Paul Atkins' departure. As way of introduction, I am the William B. Sturgill Professor and the Chairman of the Economics Department at the University of Kentucky. Since this is my first hearing with the Panel I will keep my opening remarks brief.

Let me start out by saying how honored I am at being appointed. This Panel has been given several challenging tasks including monitoring of how the money from the Troubles Asset Relief Program (TARP) has been or is being spent and to determine whether these actions are in the best interests of the American economy and its people. I know the Panel has already done an enormous amount of work in the past nineteen months to carry out this charge. Hopefully, I will be able to provide some additional insight and energy as the panel continues (and hopefully completes) these tasks over the coming year.

I would like to thank Senator McConnell for appointing me to this panel. I would also like to recognize Paul Atkins for his service and to thank him for his help in familiarizing me with the previous work the Panel has done. I am grateful to my fellow panel members—especially the Chair Elizabeth Warren and Mark McWatters—for helping me understand some of the issues that we will discuss today. Finally, and perhaps most importantly, I would like to thank the COP staff for their help in navigating all of the details involved in getting me on the Panel and to this hearing today.

I want to make clear that I strongly support what I understand is one of the main goals of this panel—increasing the transparency and the public's understanding of the TARP. Given the size of this program, the speed with which it was approved, and the way the program has evolved over time, it is not surprising that many people remain confused about and deeply suspicious of the TARP. I view this Panel as an important vehicle through which the American people can gain assurances that this program was necessary and is being conducted in a manner than enhances the welfare of all citizens and not just a chosen few.

I also believe it is important for the Panel to ensure that the officials involved in the TARP learn from what happened so that we are not doomed to repeat the process in the future. I think all of us would agree that we want to avoid having the government purchase insolvent private firms because of the fear that the economy will collapse if these firms fail. While I am not naive enough to believe that the government, or any organization for that matter, can prevent future recessions, I do believe that by learning from past mistakes, we can be better prepared to deal with future crises.

Let me conclude by thanking the witnesses who are joining us today. I appreciate you taking time to come and help us better understand the events surrounding the government's decision to provide financial assistance to AIG.

Chair WARREN. Thank you, Professor. So we will start with our first panel. I'm going to introduce everyone.

Scott Alvarez is general counsel of the Board of Governors of the Federal Reserve. Tom Baxter is general counsel and executive vice president of the Legal Group of the Federal Reserve Bank of New York. Sarah Dahlgren is executive vice president and head of Special Investments Management and the AIG Monitoring Group of the Federal Reserve Bank of New York. Michael Finn is the northeast regional director of the Office of Thrift Supervision. Robert Willumstad served as CEO of AIG from June 2008 until September 2008.

Thank you all for being here with us today. I'm going to ask each of you to make opening remarks and I'm going to ask you to hold them to five minutes. I'm going to be fairly rigid on that just so that we can get all the way through the panel and have time for questions and for the panels that follow.

So thank you all for being here. Mr. Alvarez, would you like to start?

STATEMENT OF SCOTT G. ALVAREZ, GENERAL COUNSEL, FEDERAL RESERVE BOARD OF GOVERNORS

Mr. ALVAREZ. Thank you, Chair Warren and distinguished members of the Panel, for the opportunity to discuss the authority and role of the Federal Reserve with regard to AIG.

Section 13(3) of the Federal Reserve Act empowers the Board to authorize a Federal Reserve bank to extend credit to any individual, partnership, or corporation. Section 13(3) requires that, first, the Board find that unusual and exigent circumstances exist, (2) that the loan be authorized by an affirmative vote of not less than five members of the Board, (3) that the loan be secured to the satisfaction of the Reserve Bank, (4) that the Reserve Bank obtain evidence that the borrower is unable to obtain adequate credit accommodations from other banking institutions, and, finally, that the interest rate be determined by the Reserve Bank and approved by the Board.

This authority was granted by Congress during the Great Depression in 1932 precisely to allow the Federal Reserve to lend to individuals and non-banking entities to relieve financial pressures that might otherwise lead to financial disaster. This type of lending authority is common among central banks worldwide and is considered an essential tool of central banks for providing liquidity during times of economic and financial stress in order to mitigate the effects of illiquidity and failure on broader markets and the economy.

Each of the conditions established by Section 13(3) was met in the case of the loans extended by the Federal Reserve to AIG and to the two related Maiden Lane facilities. In particular, the economic conditions at the time of the lending were unusual and required expedited action.

During the summer and fall of 2008, the U.S. economy and financial system were confronting substantial challenges. Labor markets were weakening and stresses in financial markets were high and intensifying significantly. Falling home prices and rising mortgage delinquencies had led to major losses at many financial institu-

tions, strained conditions in financial markets and the slowdown of the broader economy. Equity prices dropped sharply. The cost of short-term credit where it was available spiked upwards, and liquidity dried up in many markets. Tight credit conditions, the ongoing housing contraction, and elevated energy prices were seen as likely to weigh on economic growth for the foreseeable future.

In early September 2008, Fannie Mae and Freddie Mac were placed into conservatorship. A little over a week later, Lehman Brothers, one of the largest investment banking firms in the United States, collapsed. The failure of Lehman ended any chance of securing a private sector solution for AIG within the time needed to address its critical funding needs.

So on September 16th, one day after the collapse of Lehman and during this period of tremendous economic instability and financial turmoil, the Federal Reserve, in coordination with the Treasury Department, made a secured loan to AIG in order to avoid the potentially devastating and destabilizing effects on the economy and the financial system that would have attended the collapse of AIG.

In the Board's judgment and given the fragile economic conditions at the time, an AIG default during this period would have posed unacceptable risks for our economy as well as to the millions of individuals and businesses that were counterparties to AIG, including individuals who were insurance policyholders, state and local governments, workers with 401(k) plans, money market mutual fund holders, and commercial paper investors, as well as banks and investment banks in the United States and worldwide.

With the financial system already teetering on the brink of collapse, the disorderly failure of AIG, the world's largest insurance company, would have undoubtedly led to even greater financial chaos, further contractions in the flow of credit to businesses and consumers, and a far deeper economic slump than the very severe one we are experiencing today.

As detailed in my written testimony, the other conditions required by Section 13(3) were also met for the revolving line of credit and for the loans to the two Maiden Lane facilities.

In particular, the credits were each fully secured at the time they were made. Importantly, the loans are being repaid as AIG winds down and sells its businesses in an orderly fashion. Currently, the revolving line of credit has been reduced from a maximum of $85 billion to $35 billion. The outstanding balance on the loan to Maiden Lane II has been reduced from $19.5 billion to $14.5 billion, and the outstanding balance on the loan to Maiden Lane III has been reduced from $24 billion to about $16 billion.

We expect the Federal Reserve will be fully repaid on each extension of credit involving AIG.

While the conditions for use of Section 13(3) were met, a better option in our view, but an option that was not available to the U.S. Government at the time, would have been for the U.S. Government to have the authority to unwind systemically important non-bank financial firms.

[The prepared statement of Mr. Alvarez follows:]

For release on delivery
10 a.m. EDT
May 26, 2010

Testimony

by

Scott G. Alvarez

General Counsel

Board of Governors of the Federal Reserve System

before the

Congressional Oversight Panel

May 26, 2010

Testimony before the Congressional Oversight Panel
regarding the Federal Reserve's decision
to extend credit under Section 13(3) of the Federal Reserve Act

Chair Warren and Members of the Panel, thank you for the opportunity to discuss the authority, actions and role of the Federal Reserve with regard to the American International Group, Inc. (AIG). The Federal Reserve, in coordination with the Treasury Department (Treasury), extended credit to AIG, beginning in September 2008, in order to avoid the potentially devastating and destabilizing effects on the economy and the financial system that would have attended the collapse of AIG during a period of tremendous economic instability and financial turmoil.

To understand the actions of the Federal Reserve at the time and how those actions justified the use of the extraordinary lending authority provided by section 13(3) of the Federal Reserve Act, it is important to understand the context that motivated the Federal Reserve's actions. During the summer and fall of 2008, the U.S. economy and financial system were confronting substantial challenges. Notably, labor markets were weakening and stresses in financial markets were high and intensifying significantly. Falling home prices and rising mortgage delinquencies had led to major

losses at many financial institutions, strained conditions in financial markets and the slowdown of the broader economy. Tight credit conditions, the ongoing housing contraction, and elevated energy prices were seen as likely to weigh on economic growth for some quarters.

To avoid unacceptably large dislocations in the financial sector, the housing market, and the economy as a whole, the Federal Housing Finance Agency in early September had placed Fannie Mae and Freddie Mac into conservatorship and the Treasury had used its authority, granted by the Congress in July 2008, to make financial support available to these two government-sponsored entities. Then, on September 15, 2008, a little over a week after Fannie and Freddie were placed into conservatorship, Lehman Brothers, one of the largest investment banking firms in the United States, collapsed despite efforts by the Federal Reserve, the Treasury and the Securities and Exchange Commission to find a private sector solution to the firm's liquidity and capital problems.

During the weekend of September 13 and 14, and continuing on Monday, September 15, 2008, AIG was in active negotiations to obtain private sector funding to address its mounting financial difficulties. The failure of Lehman ended any chance of securing a private sector solution for AIG within the time needed to address its critical funding needs. Investors

became extremely concerned about their own financial well being and chose not to use their resources to acquire or assist a struggling firm during this period of economic and financial turmoil. Indeed, there was a widespread pull-back from any risky investment and even from safe, fully collateralized lending by the private sector.

The simultaneous collapse or near collapse of Lehman and AIG, two of the largest financial firms in the United States, both indicates the severity of the financial conditions at the time and contributed to the extraordinarily turbulent conditions in global financial markets. Equity prices dropped sharply, the cost of short-term credit--where available--spiked even further upward, and liquidity dried up in many markets. Losses at a large money market mutual fund caused by Lehman's failure sparked extensive withdrawals from a number of these types of funds. A marked increase in the demand for safe assets--a flight to quality--sent the yield on Treasury bills to virtually zero. By further reducing asset values and potentially restricting the flow of credit to households and businesses, these developments posed a direct threat to economic growth. With the financial system already teetering on the brink of collapse, the disorderly failure of AIG, the world's largest insurance company, would have undoubtedly led to

even greater financial chaos and a far deeper economic slump than the very severe one we have experienced.

Providing credit to AIG was only one of the steps taken by the United States Government during the fall of 2008 to prevent the collapse of the financial system and further damage to the economy. For example, the Federal Reserve established several credit facilities to provide liquidity to broader markets, including money market mutual funds facing heavy redemptions, the commercial paper market, and the markets for student loans, small business loans, credit card loans, and auto loans. To address dollar funding pressures worldwide, we announced a significant expansion of reciprocal currency arrangements with foreign central banks. The extraordinary stresses on the financial system and the economy also encouraged Congress to enact the Emergency Economic Stabilization Act (EESA) on October 3, 2008, to provide Treasury with funds to stabilize the situation and avert what otherwise could have been even more traumatic consequences for our financial markets and for our economy. The Federal Deposit Insurance Corporation, for its part, announced a program to provide deposit insurance without limit for certain transaction accounts at insured depository institutions and to guarantee certain unsecured senior debt of insured depository institutions and their affiliates.

These were all extraordinary government actions taken to address a very serious financial crisis. It was in this context that, on September 16, 2008, the Federal Reserve acted to provide temporary liquidity to AIG under emergency lending authority provided to the Federal Reserve in section 13(3) of the Federal Reserve Act. This authority was granted by Congress during the Great Depression in 1932 when the unavailability of credit severely undermined the economy and resulted in substantial economic stress and extremely high unemployment. It was enacted precisely to allow the Federal Reserve to provide liquidity to individuals and nonbanking entities to relieve financial pressures that might otherwise lead to a financial disaster. This type of lending authority is common among central banks worldwide and is considered an essential tool of central banks for providing liquidity during times of economic and financial stress in order to mitigate the effects of illiquidity and failure on the broader markets and the economy.

Section 13(3) is broad and extraordinary authority that empowers the Board to authorize a Federal Reserve Bank to extend credit to any individual, partnership, or corporation. Consequently, section 13(3) contains a number of important restrictions. In particular, section 13(3) requires that:

(1) the Board find that unusual and exigent circumstances exist;

(2) the loan be authorized by the affirmative vote of not less than five Board members;[1]

(3) the loan be secured to the satisfaction of the Reserve Bank;

(4) the Reserve Bank obtain evidence that the borrower is unable to obtain adequate credit accommodations from other banking institutions; and

(5) the rate of interest on the loan established by the Reserve Bank be reviewed and determined by the Board.

As is evident from its terms, section 13(3) provides extraordinary authority, and that is how the Federal Reserve has treated it. Prior to the recent financial crisis, the Federal Reserve had not lent funds under section 13(3) since the 1930s and had only authorized the use of this authority during two brief periods during the late 1960s. As I will explain, each of the conditions established by section 13(3) was met in the case of the credit extended by the Federal Reserve to AIG.

Revolving Credit Facility. AIG is a very large and widely diversified financial services company that is not regulated by the Federal Reserve. In September 2008, literally millions of individuals and businesses had, and

[1] Fewer than five members may approve a loan under section 13(3) if there are fewer than five Board members in office at the time, or in situations where a financial emergency requires immediate action before five Board members can be contacted.

today continue to have, exposure to AIG in some form. These individuals and businesses include insurance policy holders, state and local governments, workers with 401(k) plans, money market mutual funds and other commercial paper investors, as well as banks and investment banks in this country and around the world.

On September 16, 2008, after AIG's private funding efforts failed, the Board, with its five members voting to approve, and with the full support of the Treasury, authorized the New York Reserve Bank to set up a revolving credit facility for AIG (Revolving Credit Facility), under which the company could borrow on a secured basis up to $85 billion in order to meet its obligations as they became due. In the Board's judgment and given the fragile economic conditions at the time, an AIG default resulting from its inability to meet these obligations would have posed unacceptable risks for our economy. In addition to the direct adverse effects on the extensive range of AIG's counterparties, there was a real risk that the destabilizing consequences of a default would spread unpredictably across broad swaths of the financial markets and financial system. At this time, a loan from the Federal Reserve was the only mechanism available to the government to forestall a potentially catastrophic default by a systemically important financial company.

The Revolving Credit Facility was a short-term credit facility created to allow for the orderly unwinding of AIG. The credit is secured by a pledge of assets of AIG and its primary non-regulated subsidiaries, including all or a substantial part of AIG's ownership interest in its regulated U.S. and foreign subsidiaries. The proceeds of the sales of certain of these assets will repay the outstanding principal, interest, and fees under the Facility. The initial interest rate charged on the Facility was comparable to the rate being negotiated by private lenders with AIG during mid- September and was approved by the Board. Moreover, given AIG's failure to secure financing from private sources, it was evident that the company could not obtain adequate credit accommodations other than from the Federal Reserve. Thus, the establishment of the Revolving Credit Facility satisfied all of the legal requirements of section 13(3).

As a condition for the credit, the Federal Reserve required that AIG provide the U.S. Government preferred securities convertible into approximately 79 percent of the voting shares of AIG, substantially diluting the interests of AIG's existing shareholders. The Federal Reserve also worked with AIG to replace its management.

Securities Lending Facility. Although the Revolving Credit Facility helped AIG satisfy its immediate liquidity needs, the credit markets

continued to deteriorate through the fall of 2008. AIG faced increasing and pressing liquidity strains. An important source of these liquidity drains was the securities lending activities conducted by AIG on behalf of several of its insurance subsidiaries. The cash collateral received by AIG in connection with these securities lending arrangements was invested in residential mortgage-backed securities (RMBS) that, because of the market conditions in the fall of 2008, were largely illiquid. As payments came due under the securities lending agreements and other investors pulled away from AIG, AIG was unable to sell the RMBS and was forced to find other sources of liquidity.

On October 6, 2008, all five Board members voted to authorize the New York Reserve Bank to lend up to $37.8 billion to AIG secured by the investment grade debt securities previously lent by AIG's insurance subsidiary to third parties (the Securities Lending Facility). The proceeds of the loan allowed AIG to return cash collateral to the securities lending counterparties as those counterparties returned the borrowed securities to AIG.

The interest rate on the Reserve Bank loan, approved by the Board, was 100 basis points above the repo rate on the relevant collateral type. Unusual and exigent circumstances continued to exist, both at AIG and in

financial markets generally, and AIG continued to be unable to access the private credit markets. Thus, credit extended under the Securities Lending Facility fully complied with each of the requirements in section 13(3). The maximum amount actually drawn by AIG under this facility was about $20.5 billion.

The November 2008 Restructuring. Market conditions continued to deteriorate and liquidity pressures on AIG did not abate even with access to these Federal Reserve credit facilities. The severe market turbulence in the fall of 2008 made it difficult for the company to quickly sell its businesses to raise funds. In addition, the size and terms of AIG's borrowings, liquidity drains, and other factors led the credit ratings agencies to consider a downgrade of the company's credit ratings. A further downgrade in the ratings of AIG would have resulted in substantial new liquidity demands, due in part to increased collateral calls and other contractual obligations that would be triggered by a ratings downgrade.

To address these pressures, in November 2008, the Federal Reserve and the Treasury restructured the government's financial assistance to AIG. A key part of the restructuring efforts was Treasury's investment of $40 billion in preferred stock of AIG under the authority contained in EESA. All of the proceeds of Treasury's investment were used to repay outstanding

balances under the Revolving Credit Facility and the maximum amount available under the Facility was reduced from $85 billion to $60 billion. Accordingly, the investment both increased AIG's capital and reduced its leverage.

For its part, the Board approved new loans under section 13(3) to two special purpose vehicles, Maiden Lane II LLC (ML II) and Maiden Lane III LLC (ML III). ML II was designed to restructure and replace the Securities Lending Facility that had been extended to address AIG's securities lending program. The Board authorized the New York Reserve Bank to extend credit to ML II to partially fund the acquisition, at then-current market prices, of the RMBS held in connection with the subsidiaries' securities lending program. Under this facility, the Reserve Bank extended about $19.5 billion in credit to ML II and AIG provided $1 billion in subordinated financing to ML II. ML II then acquired for an aggregate price of about $20.5 billion RMBS with a par value of about $39.3 billion. AIG's insurance subsidiaries used the proceeds to repay the Securities Lending Facility in full. The effect of this restructuring was to end AIG's securities lending program with its continued need to draw on the Securities Lending Facility and to fix (and thereby limit) the amount of debt AIG could incur as

a result of its securities lending program at the fair market value of the collateral supporting that program.

The second significant source of liquidity drain was a portfolio of credit default swaps (CDS) written by the Financial Products division of AIG. Under these contracts, AIG was required to post collateral to counterparties that had purchased CDS protection from AIG on the value of certain multi-sector collateralized debt obligations (CDOs) comprised largely of RMBS. As the market value of the CDOs declined and as the rating of AIG declined, AIG was required to post additional collateral to ensure its ability to perform its obligation.

The Board authorized the Reserve Bank to extend credit to ML III to partially fund the purchase of the CDOs and to terminate the CDS contracts. AIG provided $5 billion in subordinated financing to ML III and the Reserve Bank loaned about $24.3 billion to ML III. These funds were used by ML III to acquire CDOs with a par value of about $62 billion for a purchase price of about $29 billion. The purchase of the CDOs from the counterparties enabled AIG to terminate the CDS and the accompanying liquidity drains from the ongoing requirement to post collateral. The cost to AIG was forfeiture of collateral it had already posted against the CDS and the posting of an additional $5 billion in subordinated financing to ML III;

for the Federal Reserve, ML III provided CDOs with a par value of $62 billion as security against a loan of about $24 billion.

In the case of both of the Maiden Lane loans, all the requirements for lending under section 13(3) were satisfied. At the time of these loans, the financial markets in general and AIG in particular continued to experience unprecedented stresses and AIG continued to be unable to raise funds in those markets.[2] Five members of the Board voted to authorize the loans and the interest rates on the loans. Each loan is secured by all of the assets held by the respective Maiden Lane entity. At the time of each of the loans, the market value of the assets securing the loans, as determined by an independent valuation expert, exceeded the amount lent, and in each case, the assets are being liquidated in an orderly manner over time to repay the loans. In the case of ML II, the Reserve Bank also is entitled to 5/6ths of any residual proceeds remaining after repayment of principal and interest on the Federal Reserve loan and the AIG subordinated financing; and, in the case of ML III, the Reserve Bank is entitled to 2/3ds of any residual proceeds from the liquidation of the CDO collateral.

---

[2] As part of the November restructuring, the Board also reduced the interest rate and undrawn funds fee on the Revolving Credit Facility and extended the Facility's maturity from two to five years.

The March 2009 Restructuring. Although the November restructuring helped address AIG's imminent capital and liquidity needs, financial and economic conditions continued to worsen during the fourth quarter of 2008 and in early 2009 and AIG continued to face strong liquidity and capital pressures. In this context, in early March 2009, the Treasury modified its existing preferred stock investment to make it more like common equity and created a new preferred equity capital facility that allowed AIG to draw up to a maximum amount of $29.8 billion.

At the same time, the Board authorized the New York Reserve Bank to accept non-controlling preferred equity interests in AIG's two major foreign life insurance subsidiaries, the American International Assurance Company (AIA) and the American Life Insurance Company (ALICO), as partial repayment of outstanding balances owed on the Revolving Credit Facility. These equity interests were valued in the aggregate at about $25 billion. Like other lending banks, the Reserve Banks may take reasonably necessary measures to ensure satisfaction of an outstanding debt, including accepting collateral as repayment in satisfaction of the debt. In connection with this restructuring, the maximum amount available under

that Facility was reduced by the value of the preferred equity interests received, from $60 billion to $35 billion.[3]

Role of the Board

In addition to authorizing the New York Reserve Bank's creation of the credit facilities for AIG under section 13(3), the Board oversees the Reserve Bank's ongoing administration of those facilities. During the few days between when the Federal Reserve first learned of the extent of AIG's liquidity crisis and when the Revolving Credit Facility was authorized, Board staff joined staff of the Reserve Bank in analyzing AIG's financial problems and the potential damage to the financial markets from a failure of the company. Since the creation of the Revolving Credit Facility, a team of Board staff has regularly reviewed developments affecting AIG with the team of Reserve Bank staff who are primarily responsible for assuring compliance with the terms of the credit agreements, monitoring AIG's liquidity and financial condition, and reviewing the company's divestiture program. The Board staff team updates Board members and senior agency staff about important AIG developments. Board staff also consults with

[3] The Board also authorized new section 13(3) loans that would be secured by cash flows from AIG's domestic life insurance companies. AIG has announced that it will not implement this authorization.

Treasury officials who are responsible for overseeing Treasury's investments in AIG.

Repayment of Credit Facilities

The Federal Reserve anticipates that the loans under the Revolving Credit Facility, including interest and commitment fees under the modified terms of the Facility, will be fully repaid. AIG has already made significant progress in its plans to sell assets to repay the Facility. Importantly, AIG announced in March 2010 agreements to sell AIA and ALICO to Prudential plc and MetLife, Inc., respectively, for aggregate consideration of about $51 billion. The proceeds of these sales will be used first to redeem the Federal Reserve's preferred interests in AIA and ALICO, along with accrued dividends. The remaining amounts will be used to pay down outstanding balances under the Revolving Credit Facility.

Similarly, based on analyses by experienced third party advisors, we anticipate that the proceeds of the liquidation of the RMBS and CDOs held by ML II and ML III, respectively, will be sufficient to fully repay principal and interest on the Federal Reserve loans to those entities. The extended maturities of the Federal Reserve loans provide an opportunity to dispose of the assets of each entity in an orderly manner over time and to collect interest on the assets prior to their sale, other disposition, or maturity.

Moreover, AIG has a $1 billion subordinated position in ML II and $5 billion subordinated position in ML III, which are available to absorb first any loss that ultimately may be incurred by ML II or ML III, respectively.

Public Availability of Information on AIG Credit Facilities

The Board and the New York Reserve Bank have made available to the public on our websites a substantial amount of information describing the Federal Reserve's actions regarding AIG. Information available to the public includes balance sheet information that is updated weekly to show the repayment and outstanding balance of each credit extended to AIG and the Maiden Lane facilities as well as monthly transparency reports that describe recent developments and financial information relating to the AIG facilities. The fair value of the collateral held by the Maiden Lane facilities is determined quarterly in accordance with GAAP and reported on the weekly balance sheet with the loan amounts. In addition, the New York Reserve Bank recently posted on its website a detailed listing of the assets of ML II and ML III as of March 2010.

In March 2009, AIG, with the support of the Federal Reserve, disclosed the names of, and amounts paid to, the counterparties that sold CDOs to ML III as well as the counterparties to the securities borrowing facility that resulted in the establishment of ML II. Moreover, these Federal

Reserve websites contain reports describing the justification for and the terms of each facility, the agreements with third party advisors to the Federal Reserve, and each report filed with Congress under EESA regarding AIG and the Maiden Lane facilities. These disclosures are part of the Federal Reserve's commitment to provide the public with as much information on our emergency lending facilities as possible, consistent with the need to protect sensitive commercial and financial information and to ensure that the facilities can achieve their goals.

Lessons Learned

Chairman Bernanke has testified that nothing made him angrier during the crisis than the irresponsible decisions at AIG that put our entire financial system and economy at grave risk and left the government with no good options. While the Federal Reserve responded with the only tool available to it, a better option in our view would be a resolution regime that allows the U.S. government to unwind systemically important nonbank financial firms. Had such a regime been in place in September 2008, the U.S. government would have been able to act swiftly and with flexibility to resolve AIG and to impose losses as appropriate on AIG's shareholders and creditors. The resolver would also have been authorized to abrogate contracts and restructure compensation at the firm.

AIG also illustrates the dangers of a system that allows systemically important financial firms to operate without strong consolidated supervision of the entire entity. A consolidated supervisor of systemically important financial firms is needed to understand, and require the firm to address, risk exposures throughout the entire organization. The consolidated supervisor must be empowered to require the firm to adopt enhanced capital, liquidity, risk management and other standards that address both the risks the firm assumes and the risks it poses to the financial system.

We are encouraged that Congress is near completion of important landmark legislation that effectively addresses both of these concerns. I appreciate the opportunity to testify before the Panel today.

Chair WARREN. Mr. Alvarez, I'm going to have to stop you there, but your entire statement will be made part of the record.

Mr. ALVAREZ. Thank you very much.

Ms. WARREN Thank you very much. I made a mistake. Before we go to Mr. Baxter, I should have paused to note the absence of Panel Member Richard Neiman.

All of us who serve on this panel do so in addition to our other responsibilities and for Mr. Neiman those responsibilities include serving as the Superintendent of Banks for the State of New York.

Mr. Neiman felt that it would not be appropriate for him to be involved in our Oversight Report on AIG because this report will include an examination of AIG's relationship with its financial counterparties and a number of those counterparties are regulated by the State of New York Banking Department.

We miss his good counsel, but we understand that he is working to protect the integrity of the process.

So my apologies for not mentioning that at the end of our last statement. We miss Mr. Neiman and will be glad when he can rejoin us on subsequent reports.

With that, Mr. Baxter, could I ask you to give your opening remarks?

STATEMENT OF THOMAS C. BAXTER, JR., GENERAL COUNSEL AND EXECUTIVE VICE PRESIDENT OF THE LEGAL GROUP, FEDERAL RESERVE BANK OF NEW YORK

Mr. BAXTER. Chair Warren and Members of the Panel, thank you for the opportunity to testify about the role of the Federal Reserve Bank of New York with respect to American International Group or AIG.

Since September of 2008, the Federal Reserve has provided liquidity assistance to AIG in the form of an $85 billion revolving credit facility. Then, as market and economic circumstances changed and as we developed a deeper understanding of AIG's unique and complex problems, we restructured that facility in a number of ways.

Throughout this process, our goals have remained the same: to protect the financial system by stabilizing AIG and to prevent a loss to the taxpayer.

Today, we are positioned to begin thinking of the day, hopefully not too far from now, when we will be fully repaid principal and interest and have no further role as a creditor of AIG.

Many Federal Reserve and Treasury officials have testified about this general subject matter, including me. Today, I will focus on the crisis management decision faced by policymakers on September 16th, 2008. In my nearly 30 years as a Federal Reserve lawyer, I have been privileged to work on a number of different crises, including the Iranian Hostage Crisis, the Thrift Crisis, the so-called 1987 Market Break, the failure of the Bank of Credit and Commerce International, the near bankruptcy of Solomon Brothers, the private sector rescue of Long-Term Capital Management, and the terrorist attacks of September 11th, which stand in a category all their own.

My experience across three decades gives me a perspective on the context in which Federal Reserve policymakers needed to make

their decision concerning AIG. You cannot understand the decision without an appreciation of the crisis context.

AIG came before Federal Reserve policymakers in the midst of the greatest financial crisis we have experienced since our Great Depression. In testimony on January 27th, 2010, before the House Committee on Government Oversight, Secretary Geithner described the policy choice as "whether to rescue AIG by putting billions of taxpayer dollars at risk or to let AIG fail and accept potentially catastrophic damage to the economy."

On the morning of September 16th, 2008, there were no other realistic options. Congress had provided the Federal Reserve with the ability to lend to a non-bank in exigent and unusual circumstances, provided the putative borrower had no other credit resources.

If ever there was a situation where the circumstances were exigent and unusual, this was it, and the evidence that AIG had no alternative source of private sector credit was simply indisputable.

Secretary Geithner also outlined some of the key crisis management features. He said that "action was required. The world was watching and the Government did not have the luxury of time." He spoke metaphorically of the Federal Reserve as a kind of fire station and the decision was to put out the fire before it spread.

On September 16th, 2008, to pick up the Secretary's fire station metaphor, we had several major fires burning. The flames ignited in the U.S. financial system with the conservatorships of Fannie and Freddie, were burning fiercely when the Lehman fire ball exploded. When AIG came for a decision the day after Lehman's bankruptcy, as Mr. Alvarez has pointed out, many neighborhoods were on fire and burning embers filled the air.

This is the principal reason why the Federal Reserve needed to take action with AIG. In the unique time and context of September of 2008, it would have been unconscionable to allow another major blaze when you had a reasonable alternative. Our alternative was the revolving credit facility.

Had the problems of AIG unfolded more slowly and apart from a broad market crisis, policymakers might have pursued additional information and solutions. They could have asked for more granular information about AIG creditors. They could have dispatched the Federal Reserve's lawyers to explore a prepackaged bankruptcy or perhaps even asked us to begin contacting the largest creditors to see if they would consider some kind of voluntary restructuring of AIG debt, but these tasks would have consumed considerable time and, given the actual situation on September 16th, would have meant the immediate default of AIG and certain bankruptcy with all of its systemic consequences.

Chair WARREN. Mr. Baxter, I'm going to have to stop you there, but your entire remarks will be part of the record.

Mr. BAXTER. Thank you.

Chair WARREN. Thank you. Ms. Dahlgren.

STATEMENT OF SARAH DAHLGREN, EXECUTIVE VICE PRESIDENT, SPECIAL INVESTMENTS MANAGEMENT AND AIG MONITORING, FEDERAL RESERVE BANK OF NEW YORK

Ms. DAHLGREN. Good morning, Chair Warren and Members of the Panel. Thank you for inviting me to appear here today.

As the executive vice president of the Federal Reserve Bank of New York responsible for the management of the Federal Reserve's work to stabilize AIG, I welcome the opportunity to share with you some thoughts on those efforts.

As my friend and colleague Tom Baxter just explained, beginning on September 16th, 2008, policymakers made the courageous choice to provide AIG with the liquidity that enabled its survival.

As a result of that decision and the actions taken by the Federal Reserve and Treasury, we avoided the catastrophic consequences of a trillion dollar conglomerate's bankruptcy.

As the Congressional Budget Office noted in its May 2010 report, "If the Federal Reserve had not strategically provided credit and enhanced liquidity, the financial crisis probably would have been deeper and more protracted and the damages to the rest of the economy more severe."

Going forward from September 16th, as we learned more about AIG and as Congress provided the Treasury and the Federal Reserve with additional tools to stabilize the company through the passage of EESA, we took steps to restructure AIG's debt so as to stop the increasing liquidity drain on the company. We altered the terms of our revolving credit facility and entered into the much-discussed and analyzed Maiden Lane II and Maiden Lane III transactions.

We were motivated by two goals: financial stability and protecting the American taxpayers. Both of those goals required AIG to remain a going concern and AIG could not remain a going concern unless it retained an investment grade credit rating.

Some have questioned our focus on AIG's credit rating, but that focus is easy to explain when you consider the nature of AIG's business. Financial firms like AIG are particularly dependent on the confidence of their customers. Customer confidence in an insurance company is based on reputation and credit ratings. Parents will not put their child's future at risk by purchasing a life insurance policy from a poorly-rated company. A municipality will not trust its teachers' retirement monies to a company with questionable credit, and a homeowner will not purchase a property insurance policy from a company unless the homeowner is confident the company will be able to pay a claim.

No amount of liquidity can save an insurance company whose customers are fleeing. We needed to maintain AIG's credit rating so that it could retain its customers and the value of its businesses.

Two of those businesses, AIA and Alico, are currently under contract for sale for $51 billion. The cash proceeds of that sale and the cash AIG generates as it monetizes the non-cash proceeds of that sale will go directly to paying down AIG's loans from the Federal Reserve. Those proceeds would not be available if we had not ensured that AIA and Alico remained going concerns.

We fully expect to recover our principal and interest on the loans we made to the Maiden Lane II and III LLCs and on the revolving credit facility, and we are not alone in our expectations. The Congressional Budget Office estimates that the Federal Reserve will earn over $12 billion in interest over the life of the loans made to AIG under the revolving credit facility and that the losses on the

facility will be negligible because the Federal Reserve is fully collateralized.

The CBO also estimates that the Fed will gain two billion each from its investments in the Maiden Lane II and III LLCs and notes that it expects positive returns because the Federal Reserve bought the Maiden Lane II and III assets at fair value. To date, the Maiden Lane II and III LLCs have repaid approximately 13.1 billion of the loans made to them by the Federal Reserve.

What we set out to do on September 16th, 2008, stabilize AIG and protect the American taxpayer, we are doing. We are accomplishing our goals.

I thank you again for inviting me to appear here today, and I look forward to answering your questions.

[The joint prepared statement of Mr. Baxter and Ms. Dahlgren follows:]

Joint Written Testimony of

Thomas C. Baxter,

Executive Vice President and General Counsel, and

Sarah Dahlgren,

Executive Vice President, Special Investments Management,

Federal Reserve Bank of New York

before the

Congressional Oversight Panel

regarding

The Federal Reserve Bank of New York's Involvement with AIG

May 26, 2010

Chair Warren and Members of the Panel, thank you for giving us the opportunity to testify here today regarding the Federal Reserve Bank of New York's ("New York Fed") involvement with AIG.

I. The Decision to Lend to AIG

On the morning of September 16, 2008, it became clear to Federal Reserve and Treasury policymakers that AIG, then one of the world's largest insurance and financial firms, was facing a potentially fatal liquidity crisis. AIG's crisis was coming amidst the collapse of the housing market, within weeks of the receiverships of Fannie Mae and Freddie Mac, and within 24 hours of the bankruptcy of Lehman Brothers. Confidence in the financial system was exceptionally fragile, and financial firms were taking dramatic and unusual measures to protect their balance sheets. Money market funds, long viewed as a safe investment by millions of Americans, were experiencing massive withdrawals. The run on these funds, in turn, severely disrupted the commercial paper market, a vital source of funding for American businesses. Securitization markets started to seize up, especially those that relied upon instruments backed by consumer loans. Banks sharply curtailed their lending. A full fledged panic had started and was spreading rapidly; the financial system was facing the threat of collapse.

In light of the circumstances at the time, a bankruptcy filing by AIG would have had disastrous consequences. Federal Reserve Chairman Bernanke has stated that it could well have "resulted in a 1930's-style global financial and economic meltdown, with catastrophic implications for production, income, and jobs." Because of the decisions made that morning, we can never really know.

Let us be clear, though, about the risks that the policymakers did know. Policymakers knew that AIG's largest creditors were other financial firms and that those firms clearly would have been directly impacted by an AIG bankruptcy filing. But the gravest risks were not the direct exposure of other financial firms to AIG. The gravest risks related to the indirect consequences of a bankruptcy of AIG, indirect consequences that would impact millions of Americans.

AIG's role as one of the world's largest and storied insurance companies meant that its failure likely would have had a contagion effect, causing damage as it spread throughout the insurance industry. Policy holders would be hurt. Municipalities, who were already reeling from a lack of financing options for their building projects, would have seen their financial protection disappear. Workers whose 401(k) plans had purchased $40 billion of insurance from AIG against the risk that their stable value funds would decline in value would see that insurance disappear. Pension plans that had placed funds in AIG guaranteed investment contracts, or GICs, which function much like deposits in a bank, would have experienced significant losses, losses that would be passed along to retirees or to others whose aspirations to be retirees would surely have been changed.

And these indirect consequences of an AIG bankruptcy would not have stopped at the U.S. border. AIG was global in scope. It conducted its operations in more than 130 countries, and across various parts of the financial industry, insurance as well as banking. The damage from an AIG filing would have been felt from the farms of Iowa to the streets of San Francisco to the far off corners of the world. The unplanned and chaotic bankruptcy of this trillion dollar

financial conglomerate (especially a day after Lehman's filing) would have been a global catastrophe.

That catastrophe did not happen.

More than a year and a half later, it is easy to forget the level of panic and fear that gripped the world during the week of September 16, 2008. A bankruptcy of AIG would have fueled the fear, much as gasoline fuels a fire. And let us not forget what Federal Reserve and Treasury officials have said many times in testimony –we did not have the necessary tools, such as legal authority for a special resolution regime, with which to limit the damage of an AIG collapse.

We also did not have the luxury of time. AIG needed liquidity and it needed it that day. In the early days of the intervention, when we knew precious little about AIG, but knew that it needed billions of dollars, we were truly facing a binary choice to either let AIG file for bankruptcy or to provide it with liquidity. It is worth noting that this choice fell to the Federal Reserve because Congress had equipped it with an ability to lend to a non bank like AIG in extraordinary and exigent circumstances. Given AIG's situation on September 16, 2008, and given what had transpired over the preceding days and months, how could we responsibly not have lent pursuant to our statutory authority?

With authorization from the Board of Governors under Section 13(3) of the Federal Reserve Act, the Federal Reserve Bank of New York had the ability to provide liquidity to AIG by making a fully secured loan. The decision to activate the authority and lend was clearly justified on the merits but was difficult because of the collateral consequence, the moral hazard

resulting from AIG's rescue. Within hours of the policy determination, the Federal Reserve took over the term sheet originally created by a private sector consortium of commercial banks. In the aftermath of Lehman's bankruptcy, the consortium was no longer prepared to lend to AIG. On the evening of September 16th, we advanced $14 billion in credit to AIG through a fully collateralized lending, and announced the term sheet for what would become an $85 billion revolving credit facility with AIG ("Fed Facility").[1]

Some have asked why the Federal Reserve did not see the threat that AIG posed to the financial system before September 16th. The short answer is that AIG had hundreds of regulators, none of which was the Federal Reserve. The Federal Reserve had no regulatory authority over the firm--no authority over its capital, no authority over its liquidity, and no oversight over its control functions. The Federal Reserve was not engaged in supervision of AIG. It did not have the legal authority to do so. These roles and responsibilities remained with state insurance regulators, and with the comprehensive consolidated supervisor, the Office of Thrift Supervision. Throughout the weekend of September 13th and 14th we were assured by those regulators that a private sector consortium of commercial banks had a solution to AIG's liquidity problems, and we had no basis to question those assurances. But then Lehman filed for bankruptcy protection and the private sector consortium unequivocally stated that they were no longer prepared to lend to AIG.

---

[1] The Fed Facility was (and remains) secured by a pledge of a substantial portion of AIG's assets, including ownership interests in the company's domestic and foreign insurance subsidiaries. As additional compensation for the Fed Facility, AIG agreed to issue to a trust for the benefit of the Treasury, preferred stock convertible into 79 percent of AIG's outstanding common stock.

The AIG situation is both different and similar to that of Long-Term Capital Management ("LTCM"), a hedge fund that nearly collapsed in the fall of 1998. In the LTCM situation, the Federal Reserve called together a private sector consortium made up of LTCM's major counterparties, who agreed to rescue LTCM by investing about $3.6 billion in new equity, in return for a 90 percent equity stake in LTCM's portfolio along with operational control. The counterparties made this decision after the Federal Reserve encouraged them to recognize their self-interest in saving LTCM. The consortium invested in LTCM because its members came to believe that the Federal Reserve staff was right. Several years later, when the investors received back all of their capital with interest, they came to see that the Federal Reserve was right. The market conditions in September 2008 presented a very different situation to AIG's counterparties who, in the aftermath of Lehman's failure, found themselves facing liquidity concerns that compelled them to maintain cash on their balance sheets rather than lend to AIG. Moreover, the unprecedented size of AIG's liquidity need – ultimately more than $150 billion – could not have been met by the private sector. There is, however, one very important similarity. We believe that we will receive full payment of principal and interest from AIG, much like the consortium did in LTCM.

Still others have wondered why Lehman went bankrupt, while the Federal Reserve extended credit to AIG that prevented its default. The answer is that AIG presented a very different case. AIG had enough high-quality collateral to permit the Federal Reserve to extend a secured loan to provide liquidity to the firm. On September 16th, our focus was on providing liquidity so that AIG could meet its obligations and avoid default. To be clear, we were <u>not</u> making an investment in AIG; we were making a fully secured loan. We were not assuming

management responsibility for the company; we were a lender to the company. The recently released Volukas Report shows in a thorough, exhaustive manner that an effective solution to Lehman required a strong merger partner that could provide much needed capital to ensure a going concern. While Federal Reserve and Treasury officials tried very hard to find that merger partner for Lehman, in the end we did not succeed as we had succeeded in March of 2008, when we brought in JPMorgan Chase to acquire Bear Stearns.

As a liquidity provider, we did not consider conditioning our lending to AIG on a requirement that the company obtain concessions from some of its major creditors. Conditioning our lending on AIG coercing certain creditors to agree to reduce the amounts due and owing from AIG would have been to ensure failure. The tactic would have undercut our primary goal in providing AIG with necessary liquidity -- enabling AIG to pay creditors, maintain consumer, regulator, and counterparty confidence, and avoid default. A default would have triggered AIG's bankruptcy, with all of the systemic risk that bankruptcy would have entailed. While these tactics have been used in certain sovereign debt restructurings, they can be used there only because sovereigns cannot go bankrupt, and only with months of pre-planning.

Any attempt to condition our lending would have created further uncertainty in a time of panic as to which of AIG's counterparties would get paid and which would be forced to take substantial losses. One of our objectives was to calm market participants, and uncertainty (and the allegations of favoritism that surely would have followed) does not do that – it fuels fear. Would the conditions extend only to AIG's Credit Default Swap ("CDS") counterparties, or might the Federal government make value judgments as to other AIG contracts? Would senior unsecured debt holders be forced to take concessions? And most importantly, would a creditor

who was pressed for a discount simply refuse and declare a default? Conditional lending would have heightened the risk of an AIG default, which is what we were trying to – and did – avoid.

The default risk would have been exacerbated by the credit rating downgrade that almost certainly would have followed any effort by AIG to coerce creditor concessions. AIG's failure to pay all of its contractual obligations in full would likely constitute a selective default resulting in a downgrade. That downgrade not only would have triggered potential terminations and collateral calls at AIG's Financial Products unit ("AIG FP"), but also would have resulted in substantial value destruction at AIG's insurance companies. Large annuity distributors likely would have stopped selling AIG products, replacing them with better-rated, more stable competitors. High-end life insurance sales would have decreased significantly, and remaining sales would have been vulnerable to adverse selection. Withdrawals and surrenders among existing customers would have increased, depleting cash reserves and creating pressure for asset sales at depressed levels. As a result of a downgrade, many of AIG's insurance companies may have been unable to write new business, and state and foreign insurance regulators may have begun seizing AIG insurance company assets in their respective jurisdictions. Conditional lending would not have allowed AIG to remain a going concern, but rather would have pushed it into bankruptcy.

II. Continuing Pressures on AIG

By the end of September 2008, AIG had drawn $61 billion from the Fed Facility. While successful in providing AIG with the liquidity it needed to avoid default and bankruptcy in the short term, over the longer term AIG's borrowings from the Fed Facility were perceived by some

to be potentially unsustainable. The company continued to experience pressing liquidity needs that necessitated rapid draws on the Fed Facility and concerns that AIG's needs might well exceed the facility's capacity. Even greater concerns arose out of the continued downgrade risk. The probability of a ratings downgrade was considered high unless the Federal Reserve took further action because the aggregate size of AIG's draws on the Fed Facility was greater than rating agency expectations -- the rating agencies felt that AIG had too much debt-- and AIG's expected third quarter losses, which were to be announced on November 10, 2008, far exceeded analyst estimates.

As discussed in Vice Chairman Kohn's testimony of March 5, 2009, in early October 2008, the Board of Governors approved an additional credit facility (the "Securities Borrowing Facility") that permitted the New York Fed to lend to certain AIG domestic insurance subsidiaries up to $37.8 billion in order to allow them to return the cash collateral they received from their securities borrowing counterparties. Additionally, toward the end of October, four AIG affiliates began participating in the Federal Reserve's Commercial Paper Funding Facility (CPFF) on the same terms and conditions as other participants. The CPFF is a generally available program that involves the purchase, through a special purpose vehicle with financing from the Federal Reserve, of three-month unsecured and asset-backed commercial paper directly from eligible issuers.

Notwithstanding AIG's access to these additional Federal Reserve credit facilities, AIG remained extremely vulnerable to the ongoing and intensifying financial crisis. Falling asset values generated both substantial losses on its balance sheet and increases in required payments to AIG's counterparties under the terms of its credit protection contracts. The liquidity crisis was

not driven solely by AIG's need to meet collateral calls on its CDS; AIG also faced severe liquidity pressures arising out of its losses on residential mortgage backed securities ("RMBS") in which its domestic life insurance companies had invested as part of its securities lending program. These factors undermined market confidence in AIG and again put its investment-grade credit rating at risk.

To address AIG's untenable debt burden, the Federal Reserve decided to reduce AIG's debt by transferring RMBS and CDO exposures from AIG's balance sheet to the balance sheets of the two Federal Reserve Limited Liability Companies ("LLCs"), Maiden Lane II and Maiden Lane III. The LLCs acquired these assets by paying to AIG the cash proceeds of certain loans and capital contributions made to the LLCs by the Federal Reserve and AIG respectively. On November 10, 2008, the Federal Reserve Board and the Treasury announced this restructuring of the government's financial support 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. The details of this restructuring have already been the focus of an examination by the Treasury Special Inspector General for the Troubled Asset Relief Program. They have also been the focus of testimony before a number of committees in Congress, including Secretary Geithner and Thomas Baxter's January 27, 2010 testimony before the House Oversight and Government Reform Committees. A summary of the salient facts, however, follows.

As part of the November 2008 restructuring, Treasury invested $40 billion in newly issued Senior Preferred Stock of AIG under its TARP authority.[2] In connection with that investment, the Federal Reserve modified the terms of the Fed Facility to be more sustainable: The maturity of the Fed Facility was extended to five years (due 2013), the maximum amount available was reduced from $85 billion to $60 billion, and the interest rate and commitment fees were reduced. The Fed Facility remained secured by substantially all of AIG's assets, and the company continued to be required to apply proceeds of asset sales to permanently repay any outstanding balances under the facility.

At the same time, the Board approved the establishment of an additional lending facility that would provide a permanent solution to the AIG securities lending program's losses and liquidity drains, thus eliminating the need for the Securities Borrowing Facility. Under the new facility, the New York Fed extended approximately $19.5 billion in secured, non-recourse credit to a special purpose limited liability company, Maiden Lane II, in which AIG would hold a $1 billion first-loss position. Maiden Lane II then purchased, at market prices, RMBS with a par value of $39.3 billion from certain AIG domestic insurance company subsidiaries. This facility allowed AIG to terminate its domestic securities lending program and to repay fully all outstanding amounts under the Securities Borrowing Facility, which was then terminated.

The Federal Reserve also took steps to help address the drain of liquidity on AIG arising from potential collateral calls associated with credit default swap contracts written by AIG FP on multi-sector CDOs. The New York Fed made a secured, non-recourse loan in the amount of $24.3 billion to another special purpose limited liability company, Maiden Lane III. Maiden

[2] In April 2009, Treasury restructured this investment and provided an additional preferred stock facility of $29.8 billion, of which only $7.5 billion has been drawn.

Lane III then purchased, at market prices, multi-sector collateralized debt obligations with a par value of approximately $62 billion from credit default swap counterparties of AIG FP in return for the agreement of the counterparties to terminate the credit default swaps. AIG provided $5 billion in equity to Maiden Lane III to absorb any potential future losses on the CDOs held by Maiden Lane III. The Federal Reserve loans to Maiden Lane II and III have a term of six years and are secured by the entire portfolio of each LLC.

III. Ongoing Investment Management of the Maiden Lane II and Maiden Lane III Portfolios

The Panel has asked us to discuss the New York Fed's "strategy for divesting its AIG holdings." We must emphasize that the New York Fed did not ever decide to invest in AIG. We cannot make such an investment. Our role has always been that of lender, although we are a lender that re-structured our original Fed Facility to accommodate AIG's changing circumstances. The New York Fed is the managing member of Maiden Lane II and Maiden Lane III, and, as set forth above, has control rights over the RMBS and CDOs that were acquired by these LLCs. BlackRock Financial Management Inc., an investment manager, has been retained to serve as the New York Fed's agent in managing the RMBS and the CDOs. The management objective for both is maximization of long-term cash flows to pay the New York Fed's Senior Loans to the LLCs (subject to certain fees, costs, and reserves that are senior to the Senior Loans), and refraining from investment actions that would disturb general financial market conditions. Distribution of all cash flows realized by the Maiden Lane II and Maiden Lane III occurs on a monthly basis.

Cash proceeds from the assets may be invested solely in U.S. Treasury or agency securities that have a remaining maturity of one year or less, U.S. 2a-7 government money

market funds, reverse repurchase agreements collateralized by U.S. Treasury and agency securities, and dollar denominated deposits. However, in the case of Maiden Lane III, a broader range of assets may be acquired as part of a portfolio liquidation of one or more CDOs held in the Maiden Lane III portfolio.

The Maiden Lane II and Maiden Lane III assets continue to generate substantial proceeds, which are distributed monthly to pay down the New York Fed's Senior Loans to the respective Maiden Lane LLCs. While the New York Fed may direct its investment manager to sell Maiden Lane II and Maiden Lane III assets into the market at any time, as a practical matter, the value maximizing strategy has been largely to hold the assets to maturity while collecting interest income, and principal repayments. Currently, the hold-to-maturity expected proceeds of each LLC's portfolio are greater than the LLC's debt to the New York Fed. As of May 20, 2010, the balance on the New York Fed's Senior Loan to Maiden Lane II was $14.9 billion (inclusive of accrued interest), while the total asset value was $15.8 billion. The balance on the New York Fed's Senior Loan to Maiden Lane III was $16.6 billion (inclusive of accrued interest), while the total asset value was $23.4 billion. In sum, the LLCs have repaid approximately $13.1 billion of the loans made to them by the Federal Reserve. Based on the current performance of both portfolios, as well as our analysis of forecasts provided by our investment advisor, it is anticipated that the proceeds from both portfolios will exceed the principal and interest due on the New York Fed's Senior Loans to both Maiden Lane II and Maiden Lane III.

We expect to recover our principal and interest on the loans to the LLCs, and on the Fed Facility. The funds necessary to repay the balance of the Fed Facility will ultimately come from

the cash proceeds of the AIA and ALICO transactions, cash AIG generates as it monetizes the non-cash sales proceeds of the AIA and ALICO transactions, the divestiture of certain non-core assets, and profit derived from AIG's core operating businesses. That said, our goal was never to make money – it was to avoid the systemic consequences that would have resulted from an AIG default and bankruptcy and to foster financial stability.

IV. Conclusion

In all that the Federal Reserve has done, we have been motivated by two goals: to foster financial stability and to protect the U.S. taxpayer. Had we not acted to prevent an AIG failure, the financial crisis would have been substantially worse and even greater economic damage and suffering would have occurred. The decision to lend to AIG was a difficult one because addressing the systemic issues required us to provide liquidity to a non-banking company we did not supervise whose management had made poor business decisions. Still, our understanding of the consequences of an AIG failure left us no real choice.

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

Chair WARREN. Thank you, Ms. Dahlgren. Mr. Finn.

STATEMENT OF MICHAEL E. FINN, NORTHEAST REGIONAL DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. FINN. Chair Warren, Members of the Congressional Oversight Panel, thank you for the opportunity to testify today about the OTS Supervision of AIG.

I am Michael Finn, regional director for the OTS Northeast Region.

From January 2004 to August 2004, I served as OTS assistant managing director in Washington, D.C., for the newly-formed unit called Complex and International Organizations. This unit had responsibility for developing programs to coordinate the supervision of internationally active OTS-regulated holding companies, including AIG, that were subject to the European Union's Conglomerate Directive.

After my departure from Washington in August of 2004, the OTS continued to manage and supervise AIG from Washington until July of 2008 when the responsibility was transferred to the OTS Northeast Region where I reside today.

My responsibility for AIG supervision ended two months later, in September of 2008, when the Federal Government made its ownership investment in AIG. Although the OTS no longer supervises the AIG parent company, the agency continues to supervise AIG's thrift subsidiary, AIG Federal Savings Bank, which operates with $1.1 billion in assets today.

My testimony includes details about the legislative history of OTS supervision of savings and loan holding companies, OTS supervision of AIG specifically, and OTS's recommendations for holding company regulation in the future.

In the time I have this morning, I'd like to just touch on a few points about AIG and its collapse. First, the legal framework for OTS authority to regulate holding companies was designed to ensure the safety and soundness of the underlying thrift institution, not primarily to protect holding companies from their problems.

Although the consensus has developed that the United States needs a systemic risk regulator, the OTS never had that authority. To measure OTS's performance as a systemic risk regulator would be to apply a yardstick that never existed.

The supervision—that supervisory authority will not exist unless Congress establishes it. The OTS strongly supports the proposals in Congress to establish a systemic risk regulator.

AIG Financial Products is the second point. It was a subsidiary of AIG that originated the credit default swaps that were part of AIG's problems. It was operating long before OTS had any responsibility for AIG. AIG Financial Products began its operations in 1990. OTS became the regulator of AIG after the company applied for and received a federal savings bank charter in 1999. The bank, AIG Federal Savings Bank, opened for business in the year 2000.

The third point is credit default swaps were and continue to be today unregulated products that lack transparency. As you know, Congress is considering proposals to require regulation of such derivative products and to improve transparency. The OTS strongly

supports federal regulation of derivatives and a greater transparency across this market.

A fourth point. AIG Financial Products never had any business dealings with the OTS-regulated AIG Federal Savings Bank and had no relation beyond sharing the same corporate parent. Despite AIG's near failure, the OTS-regulated savings bank today continues to operate as a well-capitalized thrift.

The last point I would like to make today is that, based on our experiences with AIG, the OTS recommends the establishment of a federal insurance regulator for holding companies that are predominantly engaged in insurance activities, whether or not they be deemed systemic. We think it is prudent to align regulatory oversight with each holding company enterprise's primary activities and to ensure clear authority to supervise risk across the consolidated insurance entity.

Thank you again for having me here today, and I'm happy to respond to questions.

[The prepared statement of Mr. Finn follows:]

Embargoed until
Presented on May 26, 2010

Statement of

Michael E. Finn
Northeast Region Director, Office of Thrift Supervision

regarding

American International Group

before the

Congressional Oversight Panel

May 26, 2010

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W.
Washington, DC 20552
202-906-6288

Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Statement of Michael E. Finn
Northeast Region Director, Office of Thrift Supervision
On American International Group
Before the
Congressional Oversight Panel

May 26, 2010

I. Introduction

Chair Warren and members of the Congressional Oversight Panel, thank you for the opportunity to testify today on OTS supervision of American International Group, or AIG.

I am Michael Finn, Regional Director of the OTS Northeast Region. From January 2004 to August 2004, I served as OTS Assistant Managing Director in Washington, D.C., for the newly formed Complex and International Organizations (CIO) unit with responsibility for developing programs for coordinating the supervision of internationally active OTS-regulated holding companies subject to the European Union's Conglomerate Directive, including AIG. The CIO unit continued to manage the supervision of AIG from Washington after my departure until July 2008, when responsibility for CIO was transferred to the OTS Northeast Region, where I was serving as Regional Director. My responsibility for AIG supervision ended two months later, when the federal government invested in AIG in September 2008. The Northeast Region continues to supervise AIG's thrift subsidiary, AIG Federal Savings Bank (AIG FSB), which has $1.1 billion in total assets.

In my testimony today, I will discuss the legislative history of OTS supervision of savings and loan holding companies (SLHCs), the OTS program for supervising holding companies, the history of AIG, OTS supervision of AIG and OTS recommendations for holding company regulation in the future.

Before I begin that discussion, I would like to clarify four points about AIG's collapse.

First, AIG Financial Products, or AIGFP – the subsidiary of AIG that originated the credit default swaps (DCS) that were central to AIG's problems – was operating long before the OTS became AIG's holding company supervisor in 2000.

Second, credit default swaps were, and continue to be, unregulated and lacking in transparency, although Congress is considering proposals to require regulation of such derivative products and to improve transparency.

Third, AIG Financial Products never had business dealings with the OTS-regulated AIG FSB and had no relation to it beyond sharing the same corporate parent.

Fourth, the legal framework for OTS authority to regulate holding companies was not primarily designed to protect holding companies from problems, but to ensure the safety and soundness of the underlying thrift institutions, to assess the impact of the holding company activities on the thrift and to prevent holding company actions from harming the thrift and its depositors. Although a consensus has developed that the United States needs a systemic risk regulator to assess the impact of systemically important and interrelated companies on the economy, the OTS has never had that authority or those aspirations. That supervisory authority will not exist unless Congress establishes it. The OTS strongly supports proposals in Congress to establish a systemic risk regulator.

II. Legislative History

The statutory approach to savings and loan holding companies has always been premised on preserving the safety and soundness of the subsidiary thrift. Congress passed the first SLHC legislation, known as the Spence Act, in 1959.[1] Although largely

[1] Pub. L. 86-374, 73 Stat. 691 (1959).

intended as "stopgap legislation," the Spence Act contained provisions prohibiting savings associations from investing in, or in any way having an interest in, the securities of the holding company or its subsidiaries.[2] Similarly, savings associations were prohibited from extending credit to their holding companies or their subsidiaries.[3]

Seven years after enactment of the Spence Act, Congress revisited SLHC regulation by enacting the Savings and Loan Holding Company Amendments of 1967[4], which came to be known as the Savings and Loan Holding Company Act (SLHCA).[5] Unlike the Spence Act, which was limited in its scope, the SLHCA provided a comprehensive statutory framework for the registration, examination and regulation of SLHCs. Among other things, this comprehensive law was designed to preserve the safety and soundness of the subsidiary thrift by protecting holding company subsidiary institutions from overreaching by affiliates in a holding company structure. In the Senate Banking Committee hearings for this legislation, Federal Home Loan Bank Board Chairman Horne noted that with most business enterprises, there is no public concern how a parent company chooses to use its subsidiary, "[b]ut when one of those subsidiaries has the bulk of its liabilities in the form of savings entrusted to it by the public and when those liabilities are insured by a public agency, then there is a very strong reason for public concern over the purposes which that company is made to serve and over dealings of any sort that are not conducted at arm's length."[6]

Congress next amended the SLHCA as part of the Competitive Equality Banking Act of 1987 (CEBA).[7] The amendments did not alter the fundamental purpose of the SLHCA—to protect the safety and soundness of the subsidiary thrift.

Two years after the enactment of CEBA, Congress again amended the SLHCA as part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989

---

[2] *Id.*
[3] *Id.*
[4] Pub. L. 90-225 (1968).
[5] The SLHCA is now section 10 of the Home Owners' Loan Act. 12 U.S.C. 1467a.
[6] Savings and Loan Holding Companies: Hearings on S. 1542 Before the Senate Committee on Banking and Currency," 90th Cong., 1st Sess. at 27 (1967) (Statement of John E. Horne).
[7] Pub. L. 100-86, 100 Stat. 552 (1987).

(FIRREA).[8] The FIRREA amendments were premised on preserving the safety and soundness of the subsidiary institution. For example, FIRREA provided the OTS with an expedited enforcement remedy against holding companies whose activities endangered the financial stability or safety and soundness of their subsidiary thrift.[9] Savings institutions were generally made subject to Sections 23A, 23B and 22(h) of the Federal Reserve Act, in the same manner and to the same extent as those sections apply to Federal Reserve member banks.[10]

Ten years after FIRREA, Congress passed the Gramm-Leach-Bliley Act of 1999 (GLBA).[11] The GLBA facilitates affiliations among banks, securities firms and insurance companies. So long as certain conditions are met, a bank holding company can qualify as a financial company and engage in a wide variety of services that are financial in nature.[12]

In the GLBA, Congress instituted special provisions with respect to the OTS and the Board of Governors of the Federal Reserve System (Board) supervision of functionally regulated subsidiaries of holding companies, such as insurance companies. Generally, these provisions require coordination with the functional regulator and require the OTS and the Board to predicate certain actions on the safety and soundness of the subsidiary depository institution. The GLBA also amended the SLHCA to prohibit new unitary SLHCs from engaging in nonfinancial activities or affiliating with nonfinancial organizations.[13] Existing unitary holding companies were "grandfathered." The restrictions, however, continued to allow financial activities to be conducted by the savings and loan holding company, to the same extent as a bank holding company, including insurance activities.

---

[8] Pub. L. 100-73, 103 Stat. 183 (1989).
[9] 12 U.S.C. 1467a(p)(1).
[10] 12 U.S.C. 1468
[11] Pub. L. 106-102, 113 Stat. 1338.
[12] 12 U.S.C. 1843(l)(1).
[13] *Id.* at § 401.

III. OTS Holding Company Supervision Program

AIG's chief line of business was insurance. The range of other OTS-supervised holding companies is diverse, including some large publicly held insurance companies, large and small mutual insurance companies, privately held companies and fraternal organizations. Collectively, these holding companies own insurance subsidiaries in almost every state, offering insurance and banking products to U.S. consumers. Some have insurance operations in foreign countries as well. These holding companies provide products across the sectors of the insurance industry, including life insurance, annuities, title and property and casualty insurance for consumers and businesses of all sizes. Along with their savings association subsidiaries, these holding companies are able to offer a full range of financial products.

OTS also regulates approximately 39 other holding companies that engage in insurance activities to a lesser degree, but are not considered predominantly insurance companies.

Once a company acquires or charters a thrift institution, as a SLHC it is subject to regulatory examination and monitoring by the OTS. As the primary federal regulator of savings and loan insurance holding companies, the OTS has the authority to examine each holding company, including its subsidiaries, subject to certain obligations under the GLBA to coordinate with the functional regulator[14]. We commonly refer to this overall entity as the holding company enterprise. In its examination and supervision of the enterprise, OTS uses a risk-focused approach that considers the combined risk profile of the holding company, its financial health and stability, and the interdependence of entities within the structure.

The primary objective of a risk-focused examination of a holding company predominantly engaged in insurance activities is to identify and examine the areas of the business that pose the greatest degree of risk to the condition of the overall enterprise and

[14] Pub.L. 106-102, 113 Stat. 1338.

to the thrift. The initial scope of the examination targets the areas that have higher than normal risk characteristics. Employing this approach requires examiners to use judgment in determining the level of review, testing and analysis necessary to assess the condition of the enterprise. Accordingly, the scope of each examination is specifically tailored to the risk associated with the enterprise and it is determined on a case-by-case basis. It may also change from year-to-year as the OTS sets different areas for targeted review.

The examination goal is consistent across all types of holding company enterprises; however, the level of review and amount of resources needed to assess a complex structure, such as a holding company engaged in extensive insurance activities, is far greater than what would be required for a less complex holding company.

Coordination with Other Regulators

Consultation with other regulators is essential to OTS's supervision of SLHCs. OTS seeks to achieve the legislative goal of reducing duplication by sharing information and working closely with other state and federal regulators. In conducting its review of an insurance holding company enterprise, the OTS relies on state insurance regulators and foreign regulators for information and findings regarding the entity for which they are functionally responsible. To limit regulatory duplication, the OTS has entered into regulatory cooperation agreements with all but two state insurance regulators, as well as other jurisdictions overseas.

As a first source, OTS examiners use readily available information about an insurance company in the holding company enterprise by obtaining and reviewing reports the company submits to its primary regulator, information that it reports publicly and externally audited financial statements.

OTS may also request examination information directly from the company if the insurance regulator cannot provide it. It is important to note that OTS may only seek information directly from the company if that information meets certain conditions. Specifically, the information can only be requested if it is needed to assess: (1) a material

risk to a thrift or holding company; (2) compliance with a federal law that OTS has specific authority to enforce against the functionally-regulated entity, or (3) the systems for monitoring and controlling the financial and operational risks that may threaten the safety and soundness of a thrift.

Examination Components

Examination of holding companies is an important part of OTS's supervisory program. OTS examiners assess the condition of the holding company enterprise and help ensure that the operations of the holding company do not harm the thrift affiliate.

In carrying out its regulatory function regarding holding companies, the OTS evaluates four components, collectively known by the acronym "CORE."

The "C" in the CORE rating stands for "Capital." In its review of a SLHC's capital adequacy, the OTS considers the risk inherent in the enterprise's activities and the ability of capital to absorb unanticipated losses, support the level and composition of debt of the parent company and subsidiaries, and support business plans and strategies.

"O" is for "Organizational Structure." This component involves identifying the organizational structure and ownership, and assessing any changes. This part of the examination also includes an assessment of: (1) lines of business and activities, and the inherent risks they pose; (2) concentrations of risk; and (3) the nature and volume of intra-group transactions and significant intercompany relationships.

"R" represents "Risk Management," which involves the ability of the board and executive management to identify, measure, monitor and control risk within the holding company enterprise. Managing risk is fundamental to the success of any business venture. OTS expects holding companies to have adequate risk management practices, including strong corporate governance and a system of internal controls. Such risk management practices should be commensurate with the size and complexity of the holding company enterprise.

"E" represents "Earnings/Liquidity," which involves the overall financial performance of the consolidated holding company enterprise, including the quality of consolidated earnings, profitability and liquidity. This includes the holding company's earnings trends and cash flow, as well as the relative contributions and dividend payout ratios of significant subsidiaries, and the current and prospective effects on subsidiaries, including the thrift.

Once OTS examiners have completed their review of the CORE components, they develop a composite rating, which is the overall assessment of the holding company enterprise, as reflected by consolidated risk management and consolidated financial strength. Examiners exercise judgment in determining the relative importance of each CORE component to the safe and sound operation of the holding company.

IV. History of AIG

AIG is a large international conglomerate that operates in 130 countries worldwide. As of year-end 2007 – the last full year before the federal government's investment in AIG – the combined assets of the AIG group were $1 trillion. The AIG group's primary business is insurance. AIG's core business segments fall under four general categories (*e.g.*, General Insurance, Life Insurance and Retirement Services, Financial Services and Asset Management). AIG's core business of insurance is functionally regulated by U.S. state regulators, with the lead role assumed by the New York and Pennsylvania departments of insurance, and by foreign regulators throughout the 130 countries in which AIG operates.

It is important to note that AIG's crisis was caused by liquidity problems, not capital inadequacy. AIG's liquidity was impaired as a result of two of AIG's business lines: (1) AIGFP's "super senior" credit default swaps associated with collateralized debt obligations (CDO), backed primarily by U.S. subprime mortgage securities and (2) AIG's securities lending commitments. Although much of AIG's liquidity problems were the

result of the collateral call requirements on the CDS transactions, the cash requirements of the company's securities lending program also were a significant factor.

AIG's securities lending activities began prior to 2000. Its securities lending portfolio is owned pro-rata by its participating, regulated insurance companies. At its highest point, the portfolio's $90 billion in assets comprised approximately nine percent of the group's total assets. AIG Securities Lending Corp. (AIG SLC), a registered broker-dealer in the U.S., managed the much larger, domestic piece of the securities lending program as agent for the insurance companies in accordance with investment agreements approved by the insurance companies and their functional regulators.

The securities lending program was designed to provide the opportunity to earn an incremental yield on the securities housed in the investment portfolios of AIG's insurance entities. These entities, through AIG SLC, loaned their securities to various third parties, in return for cash collateral, most of which AIG was obligated to repay or roll over every two weeks, on average. While a typical securities lending program reinvests its cash in short duration investments, such as treasuries and commercial paper, AIG's insurance entities invested much of their cash collateral in AAA-rated residential mortgage-backed securities with longer durations.

Similar to the declines in market value of AIGFP's credit default swaps, AIG's residential mortgage-backed security investments declined sharply with the turmoil in the housing and mortgage markets. Eventually, this created a tremendous shortfall in the program's assets relative to its liabilities. Requirements by the securities lending program's counterparties to meet margin requirements and return the cash AIG had received as collateral then placed tremendous stress on AIG's liquidity.

AIGFP had been in operation since the early 1990s and operated independently from AIG's regulated insurance entities and insured depository institution. AIGFP's

$100 billion in assets comprised approximately 10 percent of the AIG group's total assets of $1 trillion.

AIGFP's CDS portfolio was largely originated in the 2003-to-2005 period and was facilitated by AIG's full and unconditional guarantee (extended to all AIGFP transactions since its creation), which enabled AIGFP to assume the AIG parent's AAA rating for market transactions and counterparty negotiations.

AIGFP's CDS provided credit protection to counterparties on designated portfolios of loans or debt securities. AIGFP provided such credit protection on a "second loss" basis, under which it repeatedly reported and disclosed that its payment obligations would arise only after credit losses in the designated portfolio exceeded a specified threshold amount or level of "first losses." Also known as "super senior," AIGFP provided protection on the layer of credit risk senior to the AAA risk layer. The AIGFP CDS were considered to be on the safest portion of the security from a credit perspective.

AIGFP made an internal decision to stop origination of these derivatives in December 2005, based on the company's general observation that mortgage underwriting standards were declining for loans packaged for securitization. At this time, however, AIGFP already had $80 billion of CDS obligations and commitments. The housing market began to unravel starting with subprime defaults in 2007, triggering a chain of events that eventually led to government intervention in AIG.

V. OTS Supervision of AIG

The OTS granted a federal savings bank charter to AIG in 1999, and the bank opened for business in 2000. The OTS continues to be the primary federal regulator for the $1.1 billion insured depository institution – AIG FSB – and the OTS was the consolidated regulator for the savings and loan holding company. In January 2007, the OTS was informed that its holding company supervision was deemed to have

"equivalency status" by the Coordinator under the European Union's Financial Conglomerates Directive. It is important to point out that this designation bestowed no additional authority or powers on the OTS for supervising AIG. Any limitations on existing authority and power in U.S. law continued to prevail.

On September 16, 2008, the Federal Reserve Bank of New York extended an $85 billion loan to AIG and the government took an 80 percent ownership stake in AIG. On the closure of this transaction, the OTS no longer supervised the AIG holding company because by operation of law, AIG was no longer a savings and loan holding company, as defined by federal statute.

OTS supervision of the AIG holding company included annual examinations of the holding company, targeted reviews of its subsidiaries, reports on the findings of those supervisory activities and follow-up with AIG's management and Board of Directors to address OTS concerns cited in the reports.

OTS actions show increasing supervisory criticism of AIG's risk management, financial reporting and corporate governance, including its oversight of AIGFP. The criticisms culminated in a Supervisory Letter in March 2008 that downgraded AIG's holding company rating.

A key element of OTS's role as AIG's consolidated regulator was to coordinate with the company's other regulators in the U.S. and abroad. Approximately 85 percent of AIG, as measured by allocated capital, was contained within entities regulated or licensed by other supervisors.

A multitude of regulators in more than 100 countries were involved in supervising pieces of the AIG corporate family. The OTS established relationships with the most relevant regulators for AIG, executed information sharing agreements where appropriate, and requested regulators' assessments and concerns for the segment of the organization that each one regulated.

In 2006, the OTS began to convene annual supervisory college meetings with foreign supervisory agencies and U.S. state insurance regulators. During the part of the meetings devoted to presentations from the company, supervisors had opportunities to question the company about supervisory concerns and risk issues. Another part of the meeting contained a "supervisors-only" session, providing a venue for participants to ask questions of each other and to discuss issues of common concern regarding AIG. Also during the college meetings, the OTS arranged one-on-one side meetings with foreign regulators for in-depth discussions about significant risks in their home jurisdictions.

Beginning in 2004, the OTS conducted several targeted, risk-focused reviews of various lines of business at AIG, including AIGFP, and made numerous recommendations to AIG's senior management and the Board of Directors with respect to risk management oversight, financial reporting transparency and corporate governance. The findings, recommendations and corrective action points of the 2005 examination were communicated in a report to the AIG Board in March 2006. With respect to AIGFP, OTS identified and reported to AIG's board weaknesses in AIGFP's documentation of complex structures transactions, in policies and procedures regarding accounting, in stress testing, in communication of risk tolerances, and in the company's outline of lines of authority, credit risk management and measurement.

Following another targeted review of AIGFP in early 2007, OTS recommended that the company revisit its financial modeling assumptions in light of deteriorating sub-prime market conditions. AIG relied too heavily on such models and shortcomings in modeling of credit default swap products camouflaged some of their risk. Until June 2007, the results of the AIGFP models indicated that the risk of loss was a remote possibility, even under worst-case scenarios. The model used market-derived assumptions that were generally acceptable to the rating agencies, AIG and its external auditor.

As previously discussed, the OTS's primary focus regarding AIG was on AIG's thrift institution, AIG Federal Savings Bank. OTS took a formal enforcement action against AIG FSB in June 2007 in the form of a Supervisory Agreement for its failure to manage and effectively control loan origination services outsourced to its affiliate, Wilmington Finance, Inc. The Agreement required AIG FSB to identify and provide remedies for borrowers who were at risk of losing their homes because of the thrift's loan origination and lending practices. OTS also required AIG to establish a $128 million reserve to cover costs associated with providing affordable loans to borrowers and to reimburse borrowers who had paid excessive loan origination fees.

In September 2008, when problems at the AIG holding company were mounting, the OTS took action to ensure that depositors at the federal savings bank and the federal deposit insurance fund were not placed at risk. The OTS precluded AIG FSB from engaging in transactions with affiliates without OTS knowledge and lack of objection; restricted capital distributions; required maintenance of minimum liquidity and borrowing capacity sensitive to the unfolding situation; and required retention of counsel to advise the board in matters involving corporate reorganization and related risks.

Approximately six months after OTS's March 2008 downgrade of AIG's examination rating, the credit rating agencies also downgraded AIG on September 15, 2008. That precipitated calls that required AIGFP to post significant amounts of collateral for which it had insufficient funds or borrowing capacity. The holding company capital was frozen and AIGFP could not meet the calls.

VI. Recommendations

Based on lessons learned from the collapse of AIG and the broader financial crisis, the OTS has three recommendations for regulatory reform.

Systemic Risk Regulator

The OTS strongly endorses efforts by Congress to establish a single systemic risk regulator with broad authority, including regular monitoring, over companies that if, due to the size or interconnected nature of their activities, their actions, or their failure would pose a risk to the financial stability of the country. Such a regulator should be able to access funds, which would present options for the orderly resolution of problems at these institutions. The systemic risk regulator should have the ability and the responsibility for monitoring all data about markets and companies, including but not limited to companies involved in banking, securities and insurance.

Regulation of Credit Default Swaps

Credit default swaps are financial products that are not regulated by any authority. Without a prudential derivatives regulator, standard market regulation or central clearinghouse, these products lack transparency and pose serious challenges and risks. The OTS strongly supports efforts to regulate CDS.

We have also learned there is a need for consistency and transparency in CDS contracts. The complexity of CDS contracts masked risks and weaknesses in the program that led to one type of CDS performing extremely poorly. The current regulatory means of measuring off-balance sheet risks do not fully capture the inherent risks of CDS. The OTS believes standardization of CDS would provide more transparency to market participants and regulators.

Supervision of Holding Companies Predominantly Engaged in Insurance

The OTS recommends that Congress enhance the consolidated supervision of holding companies that are predominantly engaged in insurance activities. Such a holding company should be supervised by a federal regulator that concentrates on the core activity and related risks in the primary business of the enterprise. We think it is

prudent to align the regulatory authority with the holding company enterprise's primary activities.

The authority to supervise such a consolidated holding company could be housed within a federal insurance regulator, if Congress chose to create one. We believe that, at a minimum, a federal consolidated regulator should be established for holding companies predominantly engaged in insurance activities.

A fundamental requirement for prudent risk management of a holding company is effective oversight and enforcement authority over the entire organization. A holding company regulator should have authority to monitor and exercise full enforcement authority over non-functionally regulated affiliates and to implement information-sharing arrangements between entities in the holding company structure and their functional regulators. The regulator should have the authority to impose capital requirements, restrict activities and otherwise regulate the operations of the holding company and the non-functionally regulated affiliates.

VII. Closing

Thank you again for the opportunity to share OTS's recommendations for a stronger framework for systemic risk regulation, derivative products and insurance holding company supervision. We look forward to working with you on these important issues in the future. I am happy to respond to your questions.

Chair WARREN. Thank you, Mr. Finn. Mr. Willumstad is the only non-government official on this panel. We appreciate your being here because you have something important to say about that very same time period that we're focused on.

Your opening remarks, sir.

STATEMENT OF ROBERT WILLUMSTAD, FORMER CHAIRMAN AND CHIEF EXECUTIVE OFFICER, AMERICAN INTERNATIONAL GROUP, INC.

Mr. WILLUMSTAD. Thank you. Chair Warren and Members of the Congressional Oversight Panel, thank you for the opportunity to meet with you this morning.

My name is Robert Willumstad, and from June 16 through September 16, 2008, I served as Chief Executive Officer of American International Group.

In June 2008, when the Board asked me to replace Martin Sullivan as CEO, I was initially reluctant to do so. However, the Board ultimately persuaded me to accept this responsibility and I felt that my experience in the financial services industry, including my time as president and chief operating officer of Citigroup, put me in the position to successfully lead AIG in a difficult period.

On my first day as CEO, I publicly announced I would present my long-term strategic plan for AIG in 90 days. This was an ambitious time frame for a strategic review of a company that in 2007 had one trillion in assets, a 110 billion in revenue, and which employed more than a 100,000 people in more than 100 countries and included a diverse array of businesses operating under scores of different regulatory regimes.

To meet that schedule, the AIG team worked tirelessly and the plan began to come together. While we were formulating the plan, I took immediate actions. The markets declined further and it became apparent that if the decline continued and AIG were again downgraded by the rating agencies, AIG could potentially face a liquidity problem.

The week after I became CEO, I retained a preeminent financial services firm, Blackrock, to provide an outsider's view of AIG's financial products exposure to mortgage-backed securities. I met with the rating agencies in July and they told me they would not review AIG's ratings until after I announced our strategic plan which was then scheduled for September 25th.

Even so, to be prudent, we immediately put in place a number of additional measures to protect AIG in the event of a liquidity problem. We worked through July and August to further strengthen AIG's balance sheet should a crisis arise. We identified non-strategic businesses, retained financial advisors, and began the process of selling those businesses to raise cash.

To conserve cash, we stopped discussions relating to a number of acquisitions. We developed and implemented an aggressive plan to further reduce expenses. We were negotiating a transaction with Berkshire Hathaway that would have protected billions of dollars of AIG's liquidity. We were working with JPMorgan and other banks to obtain additional credit lines. These were precautionary steps.

Through the first week of September we believed AIG could weather the difficulties in the financial markets and we believed we'd be able to announce and implement a new strategic plan on September 25th.

In late July and again on September 9th, I met with the President of the Federal Reserve Bank of New York to apprise him of the situation and discuss ways in which AIG and the Federal Reserve might work together in the event that a liquidity problem did arise.

With the market melting down during the week of September 8th, the counterparties with whom we had been negotiating became unwilling to complete those deals. In addition, as the markets spiraled downward with Lehman and others under increasing pressure, the rating agencies indicated they would no longer wait to review AIG's ratings until the investor meeting on September 25th.

AIG was caught in a vicious circle. The potential for downgrades from the rating agencies and the market fears caused AIG counterparties on a securities lending program and other transactions, not just those related to the credit default swaps, to require AIG to post additional collateral or demand the return of cash or investments, further increasing the need for liquidity.

We worked around the clock during the week of September 8th to take measures that would provide AIG the liquidity needed to make it through the crisis. We worked with potential private investors and new lenders. With the assistance of the New York and Pennsylvania Departments of Insurance and the Governor of New York, we were able to make available as much as 20 billion of additional liquidity but the private markets, even with the help of New York and Pennsylvania, simply could not provide enough liquidity.

On September 9th, I met again with Tim Geithner and during the rest of the week I stayed in contact with the Federal Reserve and the Treasury Department. On Tuesday, September 16, 2008, AIG was preparing for the unthinkable: bankruptcy.

That afternoon, we met again with representatives of the Federal Reserve Bank of New York and the Treasury Department. The regulators said they would provide the necessary liquidity because an AIG bankruptcy would have massive negative effects on the stability of the entire financial system.

The terms of the offer were non-negotiable. After a long and detailed debate and with the advice of counsel and financial advisors, the AIG Board of Directors accepted the plan offered by the Federal Reserve and Treasury Department as the best available option. As part of that plan, I was informed by Secretary Paulson that I would be terminated as CEO. Though I would have liked to have continued to work for AIG and its shareholders, I complied with this requirement two days later.

Due to my departure from the company, I do not have any knowledge of AIG's subsequent business activities or of the manner in which AIG utilized the funds provided by the Government.

I'm happy to answer questions, any additional questions the Panel may have.

[The prepared statement of Mr. Willumstad follows:]

WRITTEN STATEMENT OF ROBERT B. WILLUMSTAD
FORMER CHIEF EXECUTIVE OFFICER OF THE AMERICAN INTERNATIONAL GROUP
BEFORE THE
CONGRESSIONAL OVERSIGHT PANEL
May 26, 2010

Chair Warren, and members of the Congressional Oversight Panel, thank you for the opportunity to meet with you this morning.

My name is Robert B. Willumstad, and from June 16 to September 16, 2008, I served as the Chief Executive Officer of the American International Group (AIG). I assumed the role of CEO of AIG at a time of unprecedented turmoil in the global financial markets. By early September 2008, the U.S. housing market was contracting, two of the nation's largest investment banks—Bear Stearns and Lehman Brothers—had failed, and other major financial institutions, including Citigroup, UBS, and Morgan Stanley, were suffering record losses. Against this backdrop, during the second week of September 2008, AIG faced a liquidity crisis which ultimately required the Company to seek assistance from the United States Treasury and the Federal Reserve. I stepped down as CEO of AIG on September 16, 2008, at the request of former Treasury Secretary Henry Paulson, and do not have any knowledge of the manner in which AIG utilized the funds provided by the government.

On October 7, 2008, I testified before the House Committee on Oversight and Government Reform regarding the events leading up to the U.S. Government rescue of AIG. I would like to take this opportunity to direct the Panel to my previous written testimony from that hearing, which addresses the events leading up to the government intervention, as well as my interactions with officials from the Federal Reserve Bank of New York and the Treasury Department.

I am happy to answer any additional questions the Panel may have.

STATEMENT OF ROBERT B. WILLUMSTAD
BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
OCTOBER 7, 2008

Good morning Chairman Waxman, Mr. Davis and Members of the Committee. I am glad to help the Committee in any way that I can.

I want to begin by saying that AIG's problems never threatened its policyholders. AIG has been a great company for more than thirty years and remains a great company today. AIG's franchises around the world in insurance and financial services are unparalleled. Its entrepreneurial culture and the dedication and talent of AIG's 100,000 employees are unmatched.

I became CEO of AIG a little more than three months ago, at a time when the financial markets around the world were already in crisis. Before becoming CEO, I had been non-executive Chairman of AIG's board of directors for a roughly a year and a half. But, today I am going to focus my comments on the period when I was CEO.

The crisis that required AIG to seek assistance from the Federal Reserve is not limited to AIG. It is a market wide crisis of confidence that has affected the entire financial industry and the American and global economy. In June 2008, when I became CEO, the decline in the U.S. housing market had been under way for months. Though most homeowners were still making their mortgage payments, there was an unprecedented and unexpected breakdown in the market for mortgage backed securities which were held by many banks and other financial institutions, including AIG. As a result, "mark to market" accounting rules – the interpretation of which I understand the SEC is now revisiting – forced Citigroup, Merrill Lynch, UBS, Morgan Stanley and other financial institutions, including AIG, to book tens of billions of dollars

in accounting losses, despite the fact that most of the underlying securities were not in default. Those accounting losses in turn forced many of the affected companies to raise capital in the public markets or from sovereign wealth funds in China, the Middle East and elsewhere. Bear Stearns failed in March, being acquired by JP MorganChase with significant government assistance. Banks and brokerage stocks here and abroad had declined significantly.

The unforeseen and extreme market conditions that were destroying billions in shareholder value at other companies hit AIG also. By the end of the second quarter of 2008, AIG had booked $50 billion of unrealized losses on credit default swaps and on declines in the value of mortgage related securities held in its investment portfolio. AIG was downgraded by the major rating agencies in early May. AIG's stock price fell from a high in 2007 of $72 per share to $26 per share in June 2008.

These events occurred despite extensive actions by AIG's Board and Martin Sullivan before I became CEO. In May 2008, AIG raised $20 billion in new capital. AIG brought in new management at its Financial Products division, the source of much of AIG's exposure to the faltering mortgage backed securities market. AIG had also begun a search process to bring in a new Chief Financial Officer from outside of AIG, seeking to add another talented executive with deep experience in the capital markets.

In June 2008, the Board asked me to replace Martin Sullivan as CEO. I was initially reluctant to do so. However, the Board ultimately persuaded me to accept this responsibility and I felt that my experience in the financial services industry, including my time as President and Chief Operating Officer of Citigroup, put me in a position to successfully lead AIG in a difficult period. On my first day as CEO, I publicly announced that I would present my long-term strategic plan for AIG in ninety days. This was an ambitious time-frame for a

strategic review of a company that in 2007 had $1 trillion in assets and $110 billion in revenue, and which employs more than 100,000 people in more than 100 countries and includes a diverse array of businesses operating under scores of different regulatory regimes. To meet that schedule, the AIG team worked tirelessly, and the plan began to come together.

While we were formulating the plan, I also took immediate actions. The markets declined further, and it became apparent that if the decline continued and AIG were again downgraded by the rating agencies, AIG could potentially face a liquidity problem. A week after I became CEO, I retained a pre-eminent financial services firm, BlackRock, to provide an outsider's view of AIG Financial Products' exposure to mortgage backed securities. I met with the rating agencies in July, and they told me that they would not review AIG's ratings until after I announced our strategic plans, which was then scheduled for September 25. Even so, to be prudent, we immediately put in place a number of additional measures to further protect AIG in the event of a liquidity problem. We worked through July and August to further strengthen AIG's balance sheet should a crisis arise. We identified non-strategic businesses, retained financial advisors and began the process of selling those businesses to raise cash. To conserve cash, we stopped discussions relating to a number of acquisitions. We developed and implemented an aggressive plan to further reduce expenses. We were negotiating a transaction with Berkshire Hathaway that would have protected billions of dollars of AIG's liquidity. We were working with JP MorganChase and other banks to obtain additional credit lines. These were precautionary steps. Through the first week of September, we believed AIG could weather the difficulties in the financial markets, and we believed we would be able to announce and implement the new strategic plan on September 25.

In late July, and again on September 9, I met with the President of the Federal Reserve Bank of New York to apprise him of the situation and discuss ways in which AIG and the Federal Reserve might work together in the event that a liquidity problem did arise.

With the market melting down during the week of September 8, the counterparties with whom we had been negotiating became unwilling to complete those deals. In addition, as the markets spiraled downward, with Lehman and others under increasing pressure, the rating agencies indicated they would no longer wait to review AIG's ratings until the investor meeting on September 25.

AIG was caught in a vicious circle. The rating agencies were considering a downgrade in large part because of market driven liquidity concerns. But it was a downgrade by the ratings agencies – or the threat of one – that would trigger a liquidity issue. The potential for a downgrade and the market's fears caused AIG counterparties on its securities lending program and on many other transactions – not just those related to the credit default swaps – to require AIG to post additional collateral or to demand the return of cash or investments, further increasing the need for liquidity.

We worked around the clock during the week of September 8 to take measures that would provide AIG the liquidity needed to make it through the crisis. We worked with potential private investors and new lenders. With assistance from the New York and Pennsylvania departments of insurance and the Governor of New York we were able to make available as much as $20 billion of additional liquidity. But the private markets, even with the help of New York and Pennsylvania, simply could not provide enough liquidity. On September 9, I met again with the Federal Reserve Bank of New York, and during the rest of the week I stayed in contact with the Federal Reserve and the Treasury Department.

On Tuesday, September 16, 2008, AIG was preparing for the unthinkable: bankruptcy. That afternoon, we met again with representatives of the Federal Reserve Bank of New York and the Treasury Department. The regulators said that they would provide the necessary liquidity, because an AIG bankruptcy would have massive negative effects on the stability of the entire financial system. The terms of the offer were non-negotiable. After a long and detailed debate, and with the advice of counsel and our financial advisors, the AIG Board of Directors accepted the plan offered by the Federal Reserve and the Treasury Department as the best available option. As part of that plan, I was asked by the Treasury Department and the Federal Reserve to step down as CEO. Though I would have liked to continue to work for AIG and its shareholders, I complied with this requirement two days later.

Let me explain what I believe were the major elements that led AIG to September 16. Fundamentally, AIG was affected by an unexpected and unprecedented market-wide crisis of confidence and the resulting seizure of the credit markets. This impacted AIG in many ways, including through the complex financial company AIG operated: AIG Financial Products or FP for short. FP wrote a large number of instruments called "credit default swaps" – essentially a kind of insurance on a bond. Over time, FP had written this insurance-like swap on bonds with a face value of approximately $500 billion. Approximately $70 billion of those swaps were on bonds that AIG referred to as "multi-sector" bonds, backed by student loans, credit card receivables and residential mortgages. AIG's multi-sector credit default swaps were almost all written before the end of 2005, when the housing market was still strong. Moreover, AIG only wrote these swaps on what are referred to as "super senior" bonds. That means that AIG only covered the safest bonds possible and had a built in cushion to further protect AIG from losses. They were viewed as extremely safe – better than AAA. Through June 30, 2007, these credit

default swaps were carried on AIG's books at "par value." That means that AIG had analyzed them and did not expect to lose any money on them.

However, when the market for the underlying bonds froze toward the end of 2007, accounting rules required AIG to "mark to market" the value of its swaps. But the market was not functioning. The way the accounting rules were applied in this unprecedented situation forced AIG to recognize tens of billions of dollars in accounting losses in the fourth quarter of 2007 and the first two quarters of 2008, even though, as far as I am aware, AIG has made very few payments on any of the credit default swaps it wrote and the vast majority of the securities underlying the swaps are still paying and are still rated investment grade or better by the rating agencies.

In my view it was largely as a result of these unrealized mark to market losses that the rating agencies downgraded AIG's credit rating. The downgrade and the low accounting valuations on the bonds required AIG to post billions of dollars of additional collateral to its credit default swap counterparties as security for AIG's promise to pay if the underlying securities did not. In the unprecedented market wide crisis of the week of September 8, fears of a further downgrade and the frozen credit markets fed into the crisis of confidence that led AIG to need the liquidity ultimately provided by the Federal Reserve plan.

Looking back on my time as CEO, I don't believe AIG could have done anything differently. The market seizure was an unprecedented global catastrophe. We took every step we could to protect AIG's balance sheet and its liquidity. We and our advisors explored every avenue to protect AIG's shareholders. There was no private market solution to AIG's situation – just as there was no private market solution for Bear Stearns, Fannie Mae, Freddie Mac, Washington Mutual, or Lehman Brothers. The freezing of the mortgage backed securities

market, the "mark to market" losses that decimated AIG's book equity, the resulting downgrades by the rating agencies and the collateral posting requirements that arose after the downgrades were beyond our control. I regret the pain that events in the market have caused to AIG's employees and its shareholders. I am grateful that the Treasury and the Federal Reserve – and most importantly the American people – offered their assistance to preserve both a vital part of the financial system and a great American institution.

Chair WARREN. Thank you, Mr. Willumstad. Thank you all again for being here.

I'd like to start with my questions. Ms. Dahlgren, I've read the joint testimony that you and Mr. Baxter submitted and it starts with September 16 and the crisis that you faced with AIG, but what I'd like to do is—I note in your testimony you say you knew precious little about AIG on September 16. I think those are the words in the testimony.

When did the Federal Reserve Bank of New York understand that AIG posed some kind of threat to the economy? When did that occur?

Ms. DAHLGREN. Going into the weekend of Lehman Brothers, on that Friday before the weekend——

Chair WARREN. I'm sorry. Let me just back up because I want to make sure, maybe my question's not clear.

Was there no sense that AIG posed a threat before the weekend of Lehman Brothers, before September 14?

Ms. DAHLGREN. We understood—my position prior to taking on responsibility for the AIG Monitoring Team was in the Bank Supervision Group. We had, through discussions, been looking at the exposures to a broad set of counterparties of the institutions that, at that time, we supervised.

We had a sense that there were things going on with AIG through those discussions but for the institutions that we supervised, AIG was not one of the top 10 exposures for those——

Chair WARREN. So you didn't even think AIG was on the top 10 list of those that might be in serious financial trouble as of two days before it collapsed or faced imminent collapse?

Ms. DAHLGREN. As it related to the institutions that we were supervising at the time, it was not the threat that you're describing.

Chair WARREN. All right. So there were—and you hadn't heard—you collectively, the Federal Reserve Bank of New York had not heard from Mr. Willumstad at that point about any challenges facing AIG?

Ms. DAHLGREN. I personally was not involved in that conversation.

Chair WARREN. Well, do you know if others at the Federal Reserve Bank of New York were? Mr. Baxter, feel free to join in.

Mr. BAXTER. During Lehman weekend, which began——

Chair WARREN. I'm still trying to get back before Lehman weekend. I want to find out whether or not—what kind of assessment of a problem there was before the 14th of September.

Mr. BAXTER. Well, as Mr. Willumstad said, it began the week of September 8th which was the week that led up to what we at the Fed and the Treasury refer to as Lehman weekend.

Chair WARREN. So the first inkling you had that AIG might pose a serious problem was a week before it faced collapse?

Mr. BAXTER. Well, with respect to your question, you asked what you had, and I'll answer from my own personal participation in this matter. My awareness of AIG's problems began on or about September 12th.

Chair WARREN. Okay. On or about September 12th.

Mr. BAXTER. Which when——

Chair WARREN. Do you know——

Mr. BAXTER [continuing]. Lehman weekend began.

Chair WARREN. Do you know about the awareness of others, such as the president of the Federal Reserve Bank of New York or others within the organization?

Mr. BAXTER. I know that President Geithner was also concerned on September 12th because he had asked some of the staff to begin——

Chair WARREN. But you don't know about——

Mr. BAXTER [continuing]. Looking at the AIG situation.

Chair WARREN [continuing]. The concerns prior to September 12th?

Mr. BAXTER. I'm not aware of any concerns.

Chair WARREN. You're not aware of any phone calls that Mr. Willumstad made or others made?

Mr. BAXTER. I'm aware that Mr. Willumstad testified today and in his prior appearance that there was a meeting in July which I was not present for and that he also had contact with President Geithner earlier in the week of Lehman.

Chair WARREN. But you never verified any of that——

Mr. BAXTER. I did not.

Chair WARREN [continuing]. Through the Federal Reserve Board? Okay. You've described this binary choice, either it must be bankruptcy and collapse, as you describe it, or a 100 percent bailout.

Mr. Willumstad said they were preparing papers for bankruptcy. When did you consult bankruptcy counsel to discuss alternatives for AIG? Either one of you.

Mr. BAXTER. And I'm the one who should answer that question. If I can back up because you need to have some context for an understanding of the answer to that question?

Over the course of Lehman weekend, we were working aggressively at the Fed in New York and also in Washington to try to find a solution for Lehman Brothers and, over the course of that weekend, we had called together a number of large financial institutions. Some of those financial institutions were involved in providing what was to be a private sector solution to AIG's liquidity problems.

Chair WARREN. Okay. So AIG, at least from the point of view of the Fed, the Fed now knew that there was a serious problem with AIG, but believed there was going to be a private bailout.

Was the Fed a party to the negotiations over this private bailout?

Mr. BAXTER. In the course of the discussions about Lehman Brothers, several of the senior officers of the so-called private sector consortium had said when Lehman came up—when AIG came up, that they were working on a solution to AIG's liquidity problems. So those who were in the room at the time and heard those words, and I was one of those people, were mindful that there was a solution being fashioned for AIG's liquidity problems.

Chair WARREN. So let me just—you switched that to the passive voice. My question was the active voice.

Was the Federal Reserve Bank involved in those negotiations for a private solution?

Mr. BAXTER. We were not involved in the negotiations. We were mindful that they were going on——

Chair WARREN. All right. So your——

Mr. BAXTER [continuing]. Because there were conversations in our presence about those negotiations.

Chair WARREN. So your plan was that the private—the creditors, others, would take care of AIG, and did you have a Plan B in place in case that failed?

Mr. BAXTER. Let me add to that, in addition, we had been informed by the insurance departments in New York and Pennsylvania, as well as by representatives of the Office of Thrift Supervision, that the private sector solution to AIG's liquidity problems was not only underway but there was confidence that it would come to pass.

Chair WARREN. So I take it that means there was no Plan B?

Mr. BAXTER. Well, some would say that the Federal Reserve became the Plan B.

Chair WARREN. I've got that part.

Mr. BAXTER. Now, you asked me, Chair Warren, and I want to be responsive to your question——

Chair WARREN. Sure.

Mr. BAXTER [continuing]. About when we involved bankruptcy counsel. Bankruptcy counsel, and I'm speaking about Davis Polk, had been engaged by the private sector consortium, along with Morgan Stanley, to work on the terms of that private sector solution.

Chair WARREN. I'm sorry. Were they engaged as bankruptcy counsel?

Mr. BAXTER. They were engaged to—not as bankruptcy counsel but engaged to——

Chair WARREN. They were engaged by creditors, is that right? Lenders to AIG?

Mr. BAXTER. By JPMorgan Chase——

Chair WARREN. Right. And wouldn't the last——

Mr. BAXTER [continuing]. Specifically.

Chair WARREN [continuing]. Thing they would have wanted would have been bankruptcy?

Mr. BAXTER. Well, I'm trying again to be responsive to your question. Davis Polk was working on the private sector solution. Davis Polk is a firm not only with banking expertise but also bankruptcy expertise.

Chair WARREN. Did you ask them for bankruptcy advice?

Mr. BAXTER. And at a later point, when we had engaged Davis Polk to take over and to work with the Fed on coming up with the revolving credit facility, among the professionals from Davis Polk who served us were not only banking experts and lending experts in the form of Brad Smith but also a bankruptcy expert who is Marshall Huebner.

Chair WARREN. So let me make sure I understand this. So there were creditors, about to be creditors of AIG and, so far as you know, potential counterparties or counterparties to the counterparties who were trying to negotiate an arrangement with AIG and when that failed, and you used their lawyer in order to advise the Federal Reserve on what path to take forward?

Mr. BAXTER. Well, the way I would answer that is, first, there were multiple creditors, 100,000 employees, and 106 million Amer-

ican policyholders who would be impacted if AIG should file for bankruptcy. So we were mindful of those situations.

When we turned to Davis Polk, we had a matter of hours to deal with this decision of either lend to AIG to resolve its liquidity problems, avoid the catastrophic systemic consequences and the implications for literally hundreds of millions of Americans, that was one choice, or the alternative was AIG was going to file for bankruptcy.

Chair WARREN. So let me ask just one more and then I will stop on this about bankruptcy, but Mr. Willumstad said that obviously AIG was talking with attorneys about the possibility of bankruptcy.

Did you talk with the attorneys that AIG was talking with about the advice they were receiving on bankruptcy and as an alternative?

Mr. BAXTER. We were talking to lawyers representing AIG at Sullivan and Cromwell, at Weil Gotshal. We were also talking to the lawyers we had newly retained at Davis Polk to get our own advice.

Chair WARREN. So the answer is yes, you did, you talked with AIG's bankruptcy lawyers to seek their views on whether bankruptcy or a negotiated arrangement was possible?

Mr. BAXTER. I wouldn't limit it, Chair Warren, to bankruptcy. I mean, we were in open dialogue with the lawyers.

Chair WARREN. Fair enough. On many fronts.

Mr. BAXTER. On many fronts.

Chair WARREN. Bankruptcy was certainly one of the things you discussed with AIG's lawyers?

Mr. BAXTER. We understood that AIG's Board had been assembled on September 16 and that Board was going to consider the options as they appeared on the——

Chair WARREN. I'm sorry, Mr. Baxter. That wasn't my question. My question was did you speak with AIG's lawyers about their advice about the possibility of bankruptcy or a negotiated settlement?

Mr. BAXTER. And I personally spoke to lawyers at Sullivan and Cromwell about the board meeting that AIG was going to have and the decisions taken at that board meeting.

Now one of those potential decisions, Chair Warren, could have been to file for bankruptcy. So to be clear, I had conversations with Sullivan and Cromwell lawyers about the board meeting and what might happen at that board meeting, including this prospect of a bankruptcy filing.

Chair WARREN. All right. Thank you. Mr. McWatters.

Mr. MCWATTERS. Thank you. Let me follow up on that a bit.

Mr. Willumstad, when did you first advise the President of the New York Fed or someone else at the New York Fed regarding the problems at AIG?

There's a book by Andrew Ross Sorkin, "Too Big to Fail," that says that President Geithner received an early warning.

Mr. WILLUMSTAD. I want to put in context my conversations with Mr. Geithner. When I took over in the middle of June, I started in terms of preparation for a solution to the company's problems. They were basically to deleverage and de-risk the company and as I kind of dug into a lot of the financial issues related to doing that, the securities lending program actually concerned me.

The securities lending program, if there were a failure of confidence in AIG and AIG had had significant losses in the three previous quarters, I felt that we were really facing potentially a liquidity crisis and I went to see him on the basis of just good risk management and planning. I didn't anticipate that we would have to use it, but I knew when and if a real crisis came about, it would be very hard in a short period of time for a very complex company like AIG, with the losses it was having, to raise capital in the private markets.

So on July 29th, I went to see Tim Geithner and I explained to him what I had been doing at AIG and gave him a sense that I was just doing good risk management planning and that since the Fed had made the Fed window available to—after Bear Stearns to Lehman and Goldman Sachs and Morgan Stanley, institutions that they traditionally had not regulated, would it be possible, if need be, could the Fed make its Fed window available in a time of crisis to AIG.

We had a meaningful conversation. We talked a lot about issues and concerns. He indicated to me that he thought if there were a formal allowance by the Fed to allow AIG to go to the Fed window that it would in fact exacerbate what I was trying to avoid, which would have been the prospective run on the bank which is what the securities lending program effectively would have been if all of the lenders wanted their cash back.

So I took that under advisement. He asked me to keep him apprised of how things were going and I left. So that was my first encounter with him on AIG's issues.

Mr. MCWATTERS. You know, I assume that the CEO of a publicly-traded company does not have a discussion with the President of the New York Fed unless something fairly serious is happening.

So is it fair to say that on July 29th, 2008, that the President of the New York Fed knew that AIG had serious issues?

Mr. WILLUMSTAD. Again, I want to position this properly. I would not have described to him that AIG was facing serious issues. I tried to explain to him that a series of events—and again AIG's credit default spreads were widening. We had, as I said, suffered multi-billion dollar losses for several quarters. It's not unreasonable to be concerned about what the longer-term prospects of AIG would be in terms of the environment that we were operating in and we certainly anticipated that we would have further losses.

Mr. MCWATTERS. Okay. Mr. Alvarez, Mr. Baxter, in the view of the Federal Reserve Bank, in the view of the Federal Reserve Bank of New York, is AIG today a solvent entity?

Mr. ALVAREZ. So AIG does not have negative net worth.

It has a positive cash capital. It is meeting the demand for loans as they come due.

Mr. MCWATTERS. Okay.

Mr. ALVAREZ. So it does meet the traditional definition of solvency. It is repaying the Federal Reserve from the liquidation of assets in the Maiden Lane II and III facilities and also from the sale of its companies to repay the revolving line of credit.

Mr. MCWATTERS. Okay. So may I assume from that, and please correct me if I'm wrong, that AIG will not need any additional TARP funds?

Mr. ALVAREZ. So the question you're asking there is whether we can predict in the future what might happen there. I'm not able to do that.

Mr. MCWATTERS. Just what you think.

Mr. ALVAREZ. I think right now they are on a path of sustainability, a path of repayment. That is the goal of the management of AIG. They're working very hard in that direction and they are accomplishing the goals that we've set out for repayment of the facilities to the Federal Reserve.

Mr. MCWATTERS. Okay. So I gather your answer is you're not sure, it might, but hopefully will not?

Mr. ALVAREZ. No, I have no expectation that they will need additional funds. They certainly have not requested additional funds from the Federal Reserve. Our line of credit is set right now at a maximum amount of $35 billion.

They have not drawn that full amount and, as I mentioned, they're repaying the loan.

Mr. MCWATTERS. Okay, okay. I think my time is up.

Chair WARREN. Thank you. Mr. Silvers.

Mr. SILVERS. Mr. Baxter, is it correct in your judgment that the critical—that in light of what I think many have commented is the critical sort of characteristic of successful central banking and bank regulation, that there should be consistency over time, is it correct then to view the critical decisions in relation to the structuring of the rescue of AIG to have been those decisions that we were discussing a few moments ago, the decisions made over what you referred to as Lehman weekend and the few days that followed?

Mr. BAXTER. First, Mr. Silvers, I would rather be right than consistent, and let me embellish on this.

We made, as I pointed out in my opening statement, decisions in the context of an incredible crisis to provide liquidity assistance to AIG, and in furtherance of that decision to provide liquidity assistance to AIG in order to avoid the systemic consequences of failure to the American people, we would do it through a revolving credit facility along the lines of a term sheet that had been fashioned by the private sector consortium that was going to do that loan until Lehman failed on September 15th.

When we got to know AIG better and while we got to experience the deepening crisis through the last two weeks of September and into October and, of course, everyone here will remember another significant development in early October was the enactment by the Congress of the Emergency Economic Stabilization Act, as we faced additional problems in our economy and as we got to know AIG, an institution that we never supervised, but as we got to know AIG, we started to think about ways that we could structure our credit assistance to AIG to better accomplish our objectives, which were to foster financial stability by stabilizing AIG and protect the taxpayers, and that led to Maiden Lane II and Maiden Lane III in November and it led to the additional transactions with AIA and Alico in March of 2009, as Ms. Dahlgren has pointed out.

Mr. SILVERS. What I was getting at really was not that you didn't make some changes in the structure of the rescue going forward but, rather, that—because there's been some criticism about

not going back and re-examining the fundamental decision to ensure that the counterparties were paid 100 percent.

There's been some criticism of that not going back later in November and, you know, this panel has heard in the course of our work leading up to this hearing the assertion that really—that there's a consistency that's a fundamental value in these processes. Obviously getting it right is, as well, and that as a result, you kind of locked in on things, on fundamental decisions in September.

Now this is—I just want to confirm that that's the right way to think about this because it's central to how we as a panel look at what decisions mattered and I think, in a sense, either that question of the 100 percent making whole is either opened later or it's not and if it's not opened later, then we have to look at the context it was made in September. Do you disagree?

Mr. BAXTER. Well, I think you have to evaluate the decisions made on September 16 in light of the time available and the context made.

Mr. SILVERS. Absolutely.

Mr. BAXTER. Then if we go to later points in time and let's take November 10th of 2008 as an example, when we restructured Maiden Lane III and we acquired into the vehicle at fair value the CDOs from a number of counter-parties, if you look at that decision today, and there's information in the joint statement by Ms. Dahlgren and I on this very issue, the CDOs are now worth between six and seven billion more than the loan balance.

Mr. SILVERS. Mr. Baxter, can I stop you right there?

I want to look——

Mr. BAXTER. That's a savings to the American taxpayer.

Mr. SILVERS. I want to look then—I want to take your point and go back to September, to those circumstances, and the morning of September 16, all right, and by the morning, I don't mean what most of us think of as the morning but I mean about two o'clock in the morning. All right.

It's my understanding that that is when the Federal Reserve Bank of New York learned that the private consortium was not prepared to fund, is that correct?

Mr. BAXTER. I have to tell you that I did not arrive at the New York Fed until seven in the morning. I had been at the New York Fed through the weekend and went home to sleep Monday night. I arrived at seven in the morning. I don't know of my own knowledge what happened at two.

My belief, as I sit here before you, is that——

Mr. SILVERS. Yes.

Mr. BAXTER [continuing]. The final confirmation with the private sector consortium, that they would not lend, they would not go forward with their term sheet—that occurred around that time, seven in the morning, on September 16.

Mr. SILVERS. All right. You or Ms. Dahlgren or Mr. Alvarez, you may not know the answer to this question, based on what you just said, but exactly who delivered that information and to whom?

Mr. ALVAREZ. I do not know the answer to that question.

Mr. BAXTER. I know because I was at a conference call that took place at eight in the morning and by eight in the morning on Sep-

tember 16, 2008, we knew that the private sector consortium was not going to go forward.

Mr. SILVERS. But it seemed—but you do not—you're saying you do not know who delivered that information and to whom?

Mr. BAXTER. I believe the information was delivered by Mr. Huebner.

Mr. SILVERS. And who is that?

Mr. BAXTER. Mr. Huebner is the Davis Polk lawyer that I mentioned earlier in an answer to the chair's question.

Mr. SILVERS. And this was a lawyer whom at that moment was representing the private sector lending consortium, correct?

Mr. BAXTER. Yes, and was in the process of being reassigned to work on a new consortium.

Mr. SILVERS. A lawyer with clients with potentially conflicting interests at that moment.

Mr. BAXTER. And the conflicts were all waived, Mr. Silvers.

Mr. SILVERS. Who were the two—am I correct in understanding that the leaders of this private sector lending consortium were JPMorgan Chase and Goldman Sachs?

Mr. BAXTER. That's correct.

Mr. SILVERS. And who were the other participants?

Mr. BAXTER. I don't think they had gotten far enough to figure out who they were going to syndicate the loan to, but there was certainly going to be a syndicate given the size, $75 billion.

Mr. SILVERS. So when you talk about a private sector lending group, during this period over the weekend when, as I think has been said several times this morning, there was a belief that such a lending consortium was coming together, it was a consortium of two? I mean, who else did you think was going to be in on something that you appeared to be counting on?

Mr. BAXTER. My understanding was there would be others. I don't know who Goldman Sachs and JPMorgan Chase intended to reach out to. The belief that this consortium was going to go forward was based in my mind on words that I heard from the chief executive officers of both of those institutions, on information coming to us by the state insurance departments, and the OTS, and confirmation from our own people that due diligence was being done by private sector representatives of this consortium on this liquidity facility.

Mr. SILVERS. The chair has been kind enough to not interrupt me. I want to ask one more question.

When Mr. Huebner contacted the Federal Reserve Bank of New York on behalf of JPMorgan Chase and Goldman Sachs and said, sorry, fellows, no money from us, was there any further communication with those institutions about that decision?

Mr. BAXTER. And I can only speak for myself. I had no communication with those institutions about that decision.

Mr. SILVERS. To your knowledge, Mr. Baxter or Mr. Alvarez, Ms. Dahlgren, did anyone else?

Ms. DAHLGREN. Not to my knowledge.

Mr. ALVAREZ. Not to my knowledge.

Mr. SILVERS. Mr. Baxter, you talked about your long experience in dealing with the number of financial crises on behalf of the Fed-

eral Reserve Bank of New York and in a certain sense on behalf of the public.

In your experience in those contexts, is—when you're trying to—when you're pulling together the private sector to solve a problem that they've created of the type that AIG represented, is it typical to accept no as an answer?

Mr. BAXTER. Well, I started out by saying there was nothing typical about the crisis——

Mr. SILVERS. Understood.

Mr. BAXTER [continuing]. We were experiencing in September of 2008.

Mr. SILVERS. But still, you have a lot of history with failing financial institutions that represent systemic risks. You gave a long list of them.

Is accepting no what the Fed does?

Mr. BAXTER. What is typical of a crisis situation in my experience, and I should always add that my experience has always been as a lawyer, so I always had the easy job in crisis situations of advising on the law, not having to make the substantive policy call, but let me say that the difficult decision in a crisis is to act on the basis of imperfect information and to act in sufficient time as to remedy the problem before you because you can always find a reason to wait. You can always find some basis to get more information, but the best crisis decision-makers are the ones who can act quickly.

Mr. SILVERS. I wasn't suggesting waiting.

Mr. ALVAREZ. Could I add?

Chair WARREN. We are very much over but 15 seconds, Mr. Alvarez.

Mr. ALVAREZ. Thank you. I think it should not be understated how at the time folks were hoarding their cash, moving away from investments. The Federal Reserve has often been able to talk people into understanding risks and have them move forward. This was an unusual time. There was very strong pressure against what we were saying.

We had no legal authority to force anyone to take actions they did not want to take and at this time in this economic circumstance, they did not want to provide assistance to a struggling firm. So there was nothing more that we could do, other than use the statutory authority Congress had already given to us.

Mr. SILVERS. You all have been very kind and responsive to my questions. Thank you.

Chair WARREN. Professor Troske.

Dr. TROSKE. Thank you. I guess I have a question for Mr. Baxter or Ms. Dahlgren.

You made the statement that—Mr. Alvarez, you made the statement that it appears that the Maiden Lane vehicles are going to in the end—GAO expects you to turn a profit from this, is that correct?

Mr. ALVAREZ. I think it would be——

Dr. TROSKE. A substantial profit, a fairly——

Ms. DAHLGREN. Yes, and again that was the Congressional Budget Office.

Dr. TROSKE. Okay. Excuse me. CBO. So then is it—presumably had the private sector created this vehicle themselves, they themselves would be sitting on a profit right now.

So to the extent that they're profit-maximizing enterprises and would like to make profit whenever possible, can we conclude that they made a mistake?

Mr. ALVAREZ. So, of course, they made an assessment at the time about what was more important to them, having cash then, going into a very difficult and troubled time where they weren't sure what the value of the assets would be, or selling the assets to the Maiden Lane facilities.

The Federal Reserve has the luxury of being able to provide credit over an extended period of time to bridge from the difficult times to a better time and allow the asset value to come back. So they made an estimation. Whether it's a mistake or not is——

Dr. TROSKE. So I guess my question is ex post. After the fact, would they have been better off using the money to fund this? Because in one of your testimonies you indicate that, you know, with Long-Term Capital Management you had to pull them in kicking and screaming, but in the end, they came out the other side better off and there's—I mean, the Federal Reserve was actually founded as a result of private sector individuals intervening, JP Morgan intervening in a financial crisis, and I guess one of the things I'm struggling with throughout this is these private sector individuals are supposed to be sophisticated investors who I recognize were under a lot of pressure and there's a lot of uncertainty. There's no question about that. There was a lot of uncertainty and perhaps the Fed was better able to deal with that uncertainty.

But it seems like in the past dealings, they had succeeded when they listened to you.

Mr. ALVAREZ. And at this time they valued cash and reducing their exposure to AIG more than they valued the CDOs that they sold to us.

Dr. TROSKE. I guess, Mr. Baxter, you mentioned that, you know, you didn't have the luxury of time. What would you have done if you had the luxury of time?

Mr. BAXTER. Time and tools. First, with respect to time, had we known of the liquidity problems being experienced by AIG at an earlier point and let's say we had effective systemic risk supervision which hopefully we will have if the congressional legislation passes that's before the Congress right now, but let's say we had that kind of vision and we could see the problems emerging at AIG in, say, a year in advance, then you could have taken steps to provide for liquidity for AIG at that earlier point in time.

So that's one thing you could do, if you had the vision of the systemic risk off the bow at sufficient time so that you could steer the ship in a way that would avoid hitting the proverbial iceberg. That's one thing.

Another thing would be to have a special resolution regime, such as also before the Congress right now, that would enable us to effect an orderly wind-down of a systemically significant financial institution like AIG.

So another thing is to have additional tools in the toolbox so that you could bring those tools to bear on a systemically-significant or-

ganization like AIG and deal with some of the fundamental problems that we had and we saw on September 16, addressing problems that we saw in AIG Financial Products and the linkage to the parent through the parent guarantee.

If you had powers to deal with that, and hopefully in the new special resolution regime we will have those powers, then you could have additional choices. We didn't have them on September 16.

Dr. TROSKE. And so if tomorrow an AIG arises, tomorrow or two days from now, three days from now, would you do anything differently? Do you have the ability to do anything differently if another AIG—I mean, have you put in—given the current state of the world, has the Fed changed processes, something along those lines, that if another AIG arose very quickly, you would do the same thing, something different? Do you know how you'd handle it if that occurred?

Mr. BAXTER. Well, the difficulty today is, and I'll come back to the point I made earlier, that the Federal Reserve did not supervise AIG in any way. So it is possible tomorrow for an institution that we don't supervise to also present a problem similar to the problem presented by AIG.

Hopefully, though, whoever the supervisor is for that institution, as a result of some of the lessons learned during this financial crisis, has been focused on capital, focused on liquidity, focused on risk management, and is taking the steps needed to identify problems like we found in AIG in sufficient time to resolve them.

Dr. TROSKE. I think I'm out of time.

Chair WARREN. Mr. Finn, when did the OTS first understand that AIG was in some serious difficulty?

Mr. FINN. AIG had been experiencing an adverse market reaction probably from back in the December time frame when they——

Chair WARREN. December of 2007?

Mr. FINN. December of 2007. I believe it was that time frame when they reported that there were material deficiencies in their valuation of credit default swaps and there became increasing market concern about their practices.

Chair WARREN. So that was the first clue that the OTS had that there was something wrong, was December of 2007?

Mr. FINN. That was, I think, the first time that the market——

Chair WARREN. No. I'm asking the OTS. I can read the market. I want to know about the OTS.

Mr. FINN. Yes. Well, that heightened the concern because we had done work throughout the course of that year looking at AIGFP, the financial products division, valuation practices. We became concerned that they were not where they needed to be with regard to the market values.

Part of that is counterparties were seeking collateral based on their own valuation analysis of the collateral that backed those positions.

Chair WARREN. So you thought there were at least signs that there was significant trouble with AIG throughout or some large part of 2007?

Mr. FINN. So the troubles, I guess I'm alluding to here, are in the valuation practices in assessing the values of the underlying assets.

Chair WARREN. Right.

Mr. FINN. The CDOs behind the credit default swaps.

Chair WARREN. Right.

Mr. FINN. The liquidity concerns grew much more later into 2008 and really the focus there became more not so much on the value of the CDOs, that was part of it, but more the focus on the stability of AIG as a group. They did a capital raise in the May time frame, raising roughly $20 billion to satisfy the market concerns and for a time that was satisfying in terms of reducing the likelihood of a downgrade, but the events of the summer continued to progress and the market concerns continued to grow at AIG as well as many other firms.

Chair WARREN. So you had valuation concerns and then liquidity concerns as we start moving into the spring/summer of 2008?

Mr. FINN. I would say the liquidity was much more in the summer.

Chair WARREN. In the summer of 2008?

Mr. FINN. Yes.

Chair WARREN. Okay. And what did the OTS do about it?

Mr. FINN. At that time we had people onsite looking at their contingency planning. As part of our supervisory work from the latter end of the year that I had mentioned, we issued a supervisory letter to the parent company that downgraded the firm to a less than satisfactory rating, is the way that we describe it in our holding company supervision, and we directed them to undertake a series of corrective actions.

Chair WARREN. So I just want to ask you. Now is this only for the financial—for the thrift, not for the larger——

Mr. FINN. No. This is directly to the AIG parent. So again, March of 2008 we downgraded the institution, the holding company, and issued a series of corrective actions that required them to work on those issues that we had identified later in 2007.

Chair WARREN. Right. Now you say in your written testimony, I've gone through your written testimony, you talk about not having the regulatory tools that you needed during this time period, is that right? That you didn't have large enough supervisory powers, is that right?

Mr. FINN. There are, I would say, two aspects here. The supervision framework for thrift holding companies, as well as bank holding company regulation, is governed by GLBA which requires a respect for functional supervision.

So we did not have the authority to go in and examine insurance companies that were regulated by other regulators. We did not have the authority to directly supervise the activities that were unregulated, like credit default swaps.

Chair WARREN. So then let me understand because actually our staff pulled out the OTS, your, Holding Company Handbook and it directs your examiners to conduct, and I'm quoting here, "comprehensive assessment from the perspective of the consolidated regulator at the parent top tier organization within the conglomerate."

Now, I presume that means you do this on a regular basis and if I'm understanding your written testimony correctly, you're saying the reason you couldn't do this in the case of AIG is because

it was primarily an insurance company, is that—am I understanding this correctly?

Mr. FINN. I guess I'm trying to describe the difference. If it was purely a banking firm that was owned by a thrift holding company, we would regulate both—we would regulate the entire entity on a consolidated basis.

In an organization——

Chair WARREN. And that's what this language would refer to?

Mr. FINN. Correct. Well, no. It does require the OTS taking a view as a consolidated supervisor from the top down, but when there are diversified financial services companies, there are a multitude of regulators.

In a situation like AIG, those regulators are both domestic and foreign. We would not have the ability to go examine the individual regulated entities that are underneath that. So we would rely on information coming from the respective insurers.

Chair WARREN. So knowing that there were some difficulties, knowing that you did not have the capacity to see into AIG the way you could see into a bank holding company, when did you sound the alarm about what you knew you couldn't see?

Mr. FINN. Discussions were going on with the firm again throughout the——

Chair WARREN. Publicly or with other regulators. When did you make it clear that there was a problem here, that there was no one regulating this behemoth company?

Mr. FINN. We at staff level, OTS staff that had done work on AIG had conversations during the—I guess it was the July/August time frame.

Chair WARREN. July/August of 2008?

Mr. FINN. July/August of 2008.

Chair WARREN. With whom? With the Treasury?

Mr. FINN. No, not with the Treasury.

Chair WARREN. With the Federal Reserve Bank of New York?

Mr. FINN. With the Federal Reserve at the staff level.

Chair WARREN. So you were telling the Federal Reserve Bank of New York about this problem in July?

Mr. FINN. There was an inquiry by an individual, I think it was an examining officer, that, you know, has relationships with other counterparties of AIG as to what was happening at AIG with regard to the credit default swaps.

We arranged for a meeting in August, the early part of August, August 11th.

Chair WARREN. This is a meeting with the Federal Reserve Bank of New York?

Mr. FINN. On the staff to staff level, yes.

Chair WARREN. In August of 2008?

Mr. FINN. August of 2008.

Chair WARREN. To raise your concerns about AIG and what it was that you could not see?

Mr. FINN. What we shared with them were our views with regard to the liquidity situation and the capital situation at AIG because again the market across—the whole market at that time was becoming increasingly stressed.

Chair WARREN. Right. And if you'll permit me just one more so I can just wrap this up?

Mr. FINN. Sure.

Chair WARREN. And that is, were you or anyone at OTS a party to the negotiations of this private bailout that was being arranged through JPMorgan Chase and Goldman Sachs?

Mr. FINN. We had no involvement.

Chair WARREN. Did you have any knowledge of it?

Mr. FINN. We were informed at several points over the course of that weekend.

Chair WARREN. That weekend, meaning September 14 to 15?

Mr. FINN. The Lehman weekend, yes.

Chair WARREN. Yes.

Mr. FINN. So we knew that the Board was meeting with AIG over the weekend late through Sunday night to try to arrange a private transaction.

Chair WARREN. Okay. So you were the principal regulator, but you were not party to the discussions, you simply knew that they were occurring and believed there was going to be a private bailout?

Mr. FINN. We—again, up through Sunday night, AIG was still working on a private solution. We got word late Sunday night that that fell through.

Chair WARREN. And from whom did you get—did you receive word?

Mr. FINN. From the regulatory contact at AIG.

Chair WARREN. All right. So the—your contact at AIG called you and said that the deal's off. Do you remember when that was?

Mr. FINN. It was probably around 11 p.m. that Sunday.

Chair WARREN. On Sunday night?

Mr. FINN. Again, Lehman, I think, if not, announced—was preparing to announce right at that time.

Chair WARREN. Fair enough. And the call went to whom in your organization?

Mr. FINN. That call came to me——

Chair WARREN. Came to you.

Mr. FINN [continuing]. From the regulatory counsel.

Chair WARREN. Okay. Thank you very much. Mr. McWatters.

Mr. MCWATTERS. Thank you. Mr. Alvarez, Mr. Baxter, when the private sector bailout attempt broke down, was there any attempt to, let's say, get the Secretary of Treasury, the President of the New York Fed involved in this process, to actually walk into the room and say, okay, guys, you're at an impasse here, you must have two or three points, let's see if we can resolve those? Was that attempt made or did that happen?

Mr. BAXTER. First, with respect to Lehman weekend, which began at 6 p.m. on September 12, 2008—and that was a Friday evening—and it began with a meeting of a number of financial institutions, approximately 12, with the Secretary of the Treasury at the time, Hank Paulson, the Chairman of the SEC, and Tim Geithner, and those financial institution representatives, and they were represented at the highest level by their CEO in most cases, continued and stayed at the New York Fed through Saturday and Sunday. So that group was together. They were together for a spe-

cific purpose and that was to work on what was hoped to be the rescue of Lehman Brothers.

Now in the course of those meetings, AIG did come up and in the course of those meetings, we had heard from two of the CEOs that a private sector solution was going to be done.

Events changed dramatically when Lehman filed for bankruptcy shortly after midnight on Sunday, September 14, and when I say changed dramatically, I mean changed dramatically not only for Lehman Brothers, but the implications for the markets and for market participants were such that they were all protecting their balance sheets.

Mr. MCWATTERS. Okay.

Mr. BAXTER. But the sense was it was futile at that point to call them back in to talk about a potential deal they had already rejected.

Mr. MCWATTERS. Or how about a hybrid approach? What if the Secretary of Treasury walked in and said, look, let's split the difference, there will be some government money, there will be some private money? Were those attempts made?

Mr. BAXTER. Again, the problem as we saw it was a liquidity problem at AIG. We at the Fed had a specific tool, Section 13(3) which——

Mr. MCWATTERS. Sure, sure.

Mr. BAXTER [continuing]. My friend and colleague has spoken about this morning——

Mr. MCWATTERS. I understand.

Mr. BAXTER [continuing]. To address that liquidity problem.

Mr. MCWATTERS. But there was no attempt to do a hybrid approach with the Government and the private sector, private/public?

Mr. BAXTER. There was no time and there was—it was also felt that that could be counterproductive, given what we were seeing in the markets at the time.

Mr. ALVAREZ. Mr. McWatters, if I could add quickly here?

Mr. MCWATTERS. Yes.

Mr. ALVAREZ. You know, we didn't like being in this position any more than anybody else likes us having been in that position. We were not anxious. We were not interested. We were not looking to lend to AIG. In fact, that's one of the reasons that we've been calling for a new resolution authority.

It would have changed the dynamic if we had had the kind of authority that is now being considered by the Congress. We could then have been more forceful. We could have taken over the company ourselves and then the—not us, the resolver, would have been able to structure the losses across the creditors and across the shareholders in a better way.

Mr. MCWATTERS. Well, what about a bridge loan, an $85 billion bridge loan for a 180 days with a 180 days to work out a prepackage bankruptcy of AIG, plenty of time to work with all the insurance regulators, put a private sector deal together, but like you said, not let the world fall apart?

Mr. ALVAREZ. We did in fact provide a bridge loan, a two-year loan, for up to $85 billion, $60 billion of which was drawn down within the first two weeks. So it was not—they had a very severe

liquidity need, not just a $5 billion or a $10 billion liquidity need. They had an immediate need within 14 days of roughly $60 billion.

They still—our loan did not prevent the private sector from subsequently coming in and restructuring AIG, making another loan and taking us out of the position. That was always a possibility. Our loan did not remove that possibility.

Mr. MCWATTERS. But after September 16, did you then immediately shift and go into prepackaged bankruptcy mode, hire counsel, fire it up?

Mr. ALVAREZ. That requires the creditors, of which there are thousands for AIG, to come to agreement and be willing to——

Mr. MCWATTERS. I know.

Mr. ALVAREZ [continuing]. Do that and——

Mr. MCWATTERS. I know.

Mr. ALVAREZ [continuing]. That's not an easy task, as you know.

Mr. MCWATTERS. It's not easy, but it's hardly impossible because it happens on a fairly frequent basis.

Mr. BAXTER. And if I may point out that after September 16, my colleagues and I were quite busy with respect to other facilities, market-wide facilities that we had to bring to bear to deal with other market problems, like the problems in the commercial paper market, the problems that we were seeing with money market mutual funds.

So the experience we were having between September 16 and year-end was we were dealing with a panic, and in dealing with a panic we had to do a number of things with—roll out a number of programs in very short amounts of time to deal with the implications of what we were seeing in the American economy during that period, things like the TALF, the commercial paper funding facility.

Mr. MCWATTERS. Sure. I understand that.

Mr. BAXTER. Money market mutual funding facility. We were rolling them out as quickly as we could.

Mr. MCWATTERS. No. I also understand if you hire the right counsel, the right accounting firm, you turn them lose, interesting stuff can happen on a pre-pack. They might very well have been able to put one together.

Let me shift a little bit to a question concerning the credit default swaps, and did the New York Fed press AIG not to release the names of the counterparties, Mr. Baxter?

Mr. BAXTER. We did not.

Mr. MCWATTERS. At all?

Mr. BAXTER. There was never an intention to disclose the names of AIG customers and that's what the counter-parties were.

Mr. MCWATTERS. Right.

Mr. BAXTER. These were customers of AIG. AIG never had an intention to disclose the names of those customers. What we were doing is we were commenting on AIG's securities disclosures. AIG continues to be a public company today. It was a public company then. It had its own disclosure obligations.

So when we looked at AIG's draft disclosures on transactions we were doing with AIG, we had two purposes in mind. One was to assure accuracy, the other was to protect the taxpayer interest where we saw that interest at stake.

Now, with respect to the counterparty names, there was never an intention to disclose those customer names and that was the starting position and so as we proceeded to deal with common thing on AIG securities disclosures, our perception was always—our perspective was always as I described it: assure accuracy, protect the taxpayer interest but not to conceal or hide.

Mr. MCWATTERS. That may have been your intent, but it's possible it was communicated in a way that was somewhat ambiguous and was construed and implemented in a different way.

Mr. BAXTER. And Panel Member McWatters, I agree with you and one of the things that I take away as a lesson learned for Tom Baxter here is that if we should go through this again, we need to be more mindful of how our actions can be perceived, that our actions were done for the reasons I described, but I understand that it can be perceived as if we're trying to hide and the lesson learned for me personally here is that we need to be mindful of that and perhaps change our behavior as a result of the perception, not the actuality.

Mr. MCWATTERS. Okay. I'm over my time. I have one other question.

Would you release to this panel the copy of the minutes of the New York Fed which has to do with the recommendation by the New York Fed to the Federal Reserve Bank to extend $85 billion of credit?

Mr. BAXTER. If I can ask for a clarification? The way the law reads, and the law is Section 13(3) of the Federal Reserve Act, is the Federal Reserve Board provides authorization to the Federal Reserve Bank of New York to make the loan.

So with respect, I think the issue is the minutes of the Board of Governors deliberation on authorizing the New York Fed to make that $85 billion credit facility available to AIG.

Mr. MCWATTERS. Well, let me ask you this. Was there a recommendation by the New York Fed to the Federal Reserve Board of Governors to extend the $85 billion loan? If there was a recommendation, who made that recommendation? Was it the President alone or was it the Board of the Federal Reserve Bank of New York? If it was the Board of the Federal Reserve Bank of New York, I would like to see the minutes. If it was the President alone, I question whether or not the President had the power to do that, but that's a different issue.

Mr. BAXTER. At eight o'clock on the morning of September 16, 2008, in a conference call at which I was present, Tim Geithner, our President, in conversations with Chairman Bernanke and Secretary Paulson, recommended that the Board of Governors later in the day proceed to meet and authorize an $85 billion credit facility along the lines that we actually did. That took place orally. It took place in my presence. It happened.

But later in the day, for legal reasons, the Board of Governors needed to meet and they needed to authorize in a vote as described by my friend and colleague Mr. Alvarez.

Mr. ALVAREZ. Two quick points here.

Mr. MCWATTERS. But as General Counsel of the New York Fed, does the President of the New York Fed have authority to make that recommendation alone?

Mr. BAXTER. Yes, there is a delegation from the Board of Directors to the President of the New York Fed enabling him to make discount window loans, so that the directors of the New York Fed do not get advance notice of particular lending decisions, and we can make available to you and to the Panel a copy of that delegation on which Mr. Geithner relied to make his oral recommendation to the Board of Governors on September 16 of 2008.

Mr. MCWATTERS. Okay. Fair enough.

Chair WARREN. Mr. Silvers.

Mr. SILVERS. Mr. Baxter, I just want to follow that up and just get to the last step.

All right. So then-New York Fed President Geithner makes a recommendation to the Board of Governors. The Board of Governors votes to authorize the loan. The terms of the loan and the actual entering into the loan through the discount window under 13(3), how were those decisions made as a legal matter?

Mr. BAXTER. As a legal matter, we had a term sheet and the term sheet was the one that was to be used by the private sector consortium. We took that term sheet and worked with it as the basic terms that we were going to request authorization on.

One of them was changed and that is the amount of liquidity assistance went from $75 billion to $85 billion. Another issue for us in the course of the day of September 16 was the equity participation, the 79.9 percent equity stake in AIG. We had to talk through different avenues as to how we could take that.

Mr. SILVERS. Mr. Baxter, I had a much simpler question. What is the legal act that enters into that contract? Who—is that an authority that the President of the New York Fed had? Did the New York Fed's Board do it? Did the Board of Governors of the Federal Reserve System do it? Who had the authority to enter into the loan contract?

Mr. BAXTER. Well, the ultimate revolving credit facility was between the Federal Reserve Bank of New York and AIG, but the New York Fed could only do that, could only enter into a contract with a non-banking organization to make this kind of extraordinary loan if it had expressed authorization from the Board of Governors.

Mr. SILVERS. Did the Board of Governors authorize the details of the loan or did it authorize—did it give you a general authority to enter into a loan?

Mr. ALVAREZ. The Board of Governors, and this is reflected in minutes that I believe——

Mr. SILVERS. Yes.

Mr. ALVAREZ [continuing]. We provided to your staff, authorized an $85 billion revolving credit facility with certain terms that were enumerated in a term sheet that was provided to the Board.

The actual contracts, though, the details about that are negotiated by the New York Reserve Bank and the document, the actual loan document is entered into between the New York Reserve Bank and——

Mr. SILVERS. And Mr. Alvarez or Mr. Baxter, who at the New York Reserve Bank has the authority to enter into that contract?

Mr. BAXTER. The president of the bank.

Mr. SILVERS. Okay. That's what I wanted to understand.

Mr. Alvarez, just to move from the very small to the very large——

Mr. ALVAREZ. Yes.

Mr. SILVERS [continuing]. In the view of the Federal Reserve, is it a bad thing that market participants perceive that OTC derivatives are essentially guaranteed by the Federal Government? Is that a bad thing? Let's hypothesize that people assume that after this sequence of events.

Mr. ALVAREZ. Well, I think it's a little broad to say that we guarantee OTC derivatives. That's an entire market——

Mr. SILVERS. I'm not saying—I'm not saying that—I'm saying hypothesize that such a perception exists among some people. Is that a bad thing that such a perception exists?

Mr. ALVAREZ. I do not want to disagree with you on the idea that too big to fail is a very bad idea. It is an idea that we at the Federal Reserve do not think is the right approach to have entering into a crisis and that's why we're trying very hard to get that changed.

Mr. SILVERS. Understood. But I'm asking in a sense not about an institution but about a market, the OTC derivative markets, and am I fair to extrapolate from your comment that you think that should a person—should market participants believe that an OTC derivative is essentially a safe or safer than, say, an insured bank account, that that's a bad thing, we don't want people thinking that?

Mr. ALVAREZ. Well, we're not—nothing that we have done guaranteed OTC derivatives as a class. We did provide liquidity to AIG which was engaged in that.

Mr. SILVERS. So, Mr. Alvarez, you agree that that would be a bad idea to guarantee OTC derivatives——

Mr. ALVAREZ. Yes.

Mr. SILVERS [continuing]. As a class?

Mr. ALVAREZ. I think it would be a bad idea. I do think—if I could quickly? I do think that there are markets where we think liquidity should be provided to allow the markets to continue to function. For example, the commercial paper market and other markets, money market mutual fund market, things—places where we have provided liquidity.

Mr. SILVERS. Right.

Mr. ALVAREZ. They're different than guaranteeing the instrument.

Mr. SILVERS. Yeah. Well, perhaps it's different. I mean, but let's establish that that would be a problem. Not if.

Mr. Baxter, Ms. Dahlgren, Mr. Alvarez, in each of your testimonies you talked about essentially the contagion effect from AIG's parent and AIG Financial Products to AIG subsidiaries whose obligations are in part guaranteed by state insurance funds.

Does it—and the necessity of rescuing obligations of AIG's parent which include the collateral payment obligations under OTC derivatives contracts, the necessity of doing so to avoid essentially a potential run on or a disintermediation of these guaranteed subsidiaries with, as you pointed out, millions of policyholders and pension funds and the like.

If you take these two statements together, are they not a powerful and profound argument for ensuring that nobody who has that type of guaranteed obligation—an insurance company, a bank, nobody—has a large unguaranteed derivatives business on top of them that would provoke this type of choice in the future?

Mr. ALVAREZ. You are exactly describing the moral hazard that comes with providing credit to an institution like AIG, and it does send the impression that large institutions that are organized in this way are going to receive government assistance. That's something that we think should be—the government should be provided tools so that that does not happen again.

Mr. SILVERS. But, Mr. Alvarez, I'm not describing that. I'm describing the pairing of these large Federal Government-guaranteed obligations, insurance contracts, you know, individual insurance contracts we all hold, bank accounts and the like, the pairing of those obligations with large OTC derivatives books. All right. This is a matter immediately in front of Congress and I just can't see any way of reading the story you all have told, other than as a powerful brief for disaggregating those two businesses as is provided in section 716 of the bill in front of Congress.

Mr. ALVAREZ. So I guess I don't see the connection that you're trying to draw. The connection——

Mr. SILVERS. Mr. Alvarez——

Mr. ALVAREZ. [continuing]. Between AIG and——

Mr. SILVERS [continuing]. Do I need to quote your testimony back to you about the necessity of rescuing these financial—the parties to the OTC contracts in order to save the insurance businesses?

Mr. ALVAREZ. The difficulty I'm trying to connect is between your view of 716 and what happened in AIG. I don't think those two are connected. In AIG there was——

Mr. SILVERS. Should I disregard your testimony and the testimony of your colleagues from the New York Fed that a primary reason for your sense that you had to pay a 100 percent on those contracts was to avoid the collapse of the guaranteed insurance businesses? Is that part of your testimony to be disregarded?

Mr. ALVAREZ. No, sir. But 716 stops insured institutions from engaging in swaps activities. That isn't what caused the contagion in AIG as it relates to its insurance subsidiaries. There were guarantees——

Mr. SILVERS. So you wouldn't have a problem——

Mr. ALVAREZ [continuing]. Of AIG of obligations of the AIG insurance subsidiary.

Mr. SILVERS. So you wouldn't have a problem then——

Mr. ALVAREZ. The swaps would have been prohibited by 716.

Mr. SILVERS. You wouldn't have a problem then with a measure that essentially disaggregated federally-insured financial activities from swaps activities on the scale that AIG was engaged in?

Mr. ALVAREZ. So I think that swaps activities can safely and should be safely done within depository institutions. They——

Mr. SILVERS. Then how do we not end up back in this situation where we have to rescue swap participants and treat their obligations as though they were guaranteed, as though they were better than, you know, the average individuals' guaranteed bank account

in order to avoid having an unraveling and thus a problem with an individual's guaranteed bank account or insurance policy?

Why is it that we are not faced with that exact problem today should another firm be so foolish as to behave in the fashion that AIG did and should regulators choose to look the other way while they did so?

Mr. ALVAREZ. Because swap activities can safely be done and are important as a hedging mechanism for depository institutions.

Mr. SILVERS. I don't see how that statement is at all consistent with your testimony or that of your colleagues.

Mr. ALVAREZ. Perhaps——

Chair WARREN. Perhaps we should stop here. Thank you.

Mr. ALVAREZ. I'm happy to talk with you further about this because this is a very important issue.

Chair WARREN. Thank you. Right. Dr. Troske.

Dr. TROSKE. Thank you. So let me start along a related line and go back to the statement Mr. Baxter made about the importance of consistency.

It has been the case that the Federal Government has stepped in and bailed out institutions, starting with Continental Illinois and Long-Term Capital Management and a variety of institutions.

It's potentially the case that when Lehman Brothers was allowed to fail that was a surprise to the market and they priced that accordingly.

Given that, that the market already figured out, okay, what the Government was doing previously has now ended and we can't expect to be bailed out any more, it's entirely—I want you to speculate on the possibility that had AIG then subsequently been allowed to enter bankruptcy, that the market wouldn't have been all that surprised because you had allowed Lehman Brothers to enter bankruptcy.

What's your reaction to that sort of hypothesis? I'll call it that.

Mr. ALVAREZ. Sure. And others, I'm sure, will have a view on this, but there's several significant differences between what happened with Lehman and what happened with AIG.

One is Lehman—the market had a long time to prepare for Lehman. They knew Lehman was struggling and so there was a longer lead time than I think there was with AIG. Also, Lehman had pretty dramatic effects on the market. There were dramatic effects in the commercial paper market, in the money market mutual fund market, in state and local municipalities that held various kinds of Lehman instruments.

A follow-on failure of AIG 48 hours after Lehman would have been, especially without time to prepare—without the markets being really in a position to understand what would have happened and prepare for that—would have been a tremendously jolting effect.

So I think they were different situations. I don't think the market was as prepared for AIG, and I do think also with the failure of Lehman, things changed. People became more conscious about cash. They became more worried about their own financial condition and the condition of everyone else. There was a real possibility markets would have frozen up very dramatically with the second follow-on failure.

Dr. TROSKE. Okay. Mr. Willumstad, you've sat over there so patiently. I thought——

Mr. WILLUMSTAD. I don't have much choice, do I?

Dr. TROSKE. Yeah. And I guess you're the financial expert and so in reading about this situation, there are a number of questions or things that confuse me as a lowly economist, one of which was in your testimony. You made the statement that the accounting necessity on mark-to-market caused AIG to experience losses, accounting losses without any fundamental change in the profit—in the long run value of the company.

Now, again, we're in a market in which presumably we're dealing with traders that are reasonably sophisticated and reasonably bright people and should be able to see through accounting rules that force you to do something as accounting rules sometimes do. Sometimes they're valuable. Other times they're not, but occasionally they force you to do something that doesn't reflect the true underlying value of the company.

So if the value of the company really hasn't changed any, why can a simple accounting rule cause a problem in the way the market treats the company? Help me try to understand that, drawing from your experience, not simply at AIG.

Mr. WILLUMSTAD. Yeah. I'll try. The mark-to-market accounting, which I think is certainly a valid accounting process, the problem, of course, at the time, there was no market. So we really weren't marking to market. We were marking to some hypothetical formulaic approach and a number of different areas.

Dr. TROSKE. But again, that's something that everybody knew. I mean, presumably anybody could—I could look at that and say, well, there's not really a market here. So they're just making it up.

Mr. WILLUMSTAD. Right.

Dr. TROSKE. Not to be too flip.

Mr. WILLUMSTAD. No. But from an accounting point of view, we were required——

Dr. TROSKE. Yes.

Mr. WILLUMSTAD [continuing]. On that basis to take losses and they were substantial. They were unrealized. There was no sale of securities and in fact the securities at the time, throughout this whole period of time, were still rated AAA or AA and there were virtually no defaults. The securities were being paid and again I understand mark-to-market.

The point I was trying to make is that in temporary market situations, these significant write-downs that the company had to take impaired its capital and on the basis that the securities actually over the long-term maturity of the securities would come back and that was obviously a judgment call, based on different individuals, was a belief that those securities had much more value than the market had given them in this mark to market process. That was my only point. I'm not sure I understand your question beyond that.

Dr. TROSKE. Okay. There's a lot of discussion about lack of access to debt. Can you explain to me why AIG didn't try to raise capital through an equity market?

Mr. WILLUMSTAD. It did. Going back in May of 2008, AIG raised $20 billion of capital which at the time I think was the largest cap-

ital raise ever done. The subsequent losses in the second quarter, which were announced in August, ate into a lot of that and again it wasn't so much an issue of pure capital. This was liquidity that was the crisis that came about and so at probably the recommendation of my lawyers not do this, I would say to clarify some of the things that happened, because I think there's a little mixture of capital-raising and liquidity issues that have gone on here, the private solution that was attempted on Friday, the 12th, the 13th, and the 14th, was an AIG private solution.

The Fed had not entered into any of those discussions. I had reported to the Fed on Saturday evening that we had made some progress towards raising capital from both secured lending facilities as well as new equity investments from private equity participants and that's where the New York State Insurance Commissioner came into play.

But the number we were looking for was getting bigger, mostly in anticipation of what would happen to the markets on the Monday after Lehman Brothers. We started looking for 20, we found 20. The number then escalated by Saturday evening to 40 and I remember going to the Fed and explaining to both Tim Geithner and Secretary Paulson that we thought we could probably raise $30 billion this weekend, but the investors and New York State Insurance Commission would not go ahead unless they would be assured that the company would survive after receiving that money which was only, obviously, sound judgment.

We continued to work all day Sunday with investors and, of course, the news kept getting worse about what was going to happen to the markets on Monday and by Sunday evening at five o'clock, I went back to the Fed and told them that we had essentially failed to raise any capital. The markets had withdrawn any effort and, oh, by the way, the number was getting bigger, as much as $60 billion.

Dr. TROSKE. So let me—you seem to have just said that you had a deal for 20 and then you had a deal for 30.

Mr. WILLUMSTAD. No.

Dr. TROSKE. Okay. That's what I heard you say, so I wanted to make sure, because you seemed to indicate that you could have gotten 30 billion.

Mr. WILLUMSTAD. We believe we could have. The New York State Insurance Commission had released $20 billion of securities which previous to that approval process was not available. Banks had indicated they would lend us $20 billion. These were government securities. So there was no real collateral risk. So we assumed that we could raise $20 billion based on what we got as collateral and from the banks.

The private equity investors that were there Saturday had indicated they'd be willing to put up $10 billion on the assumption that this would be a viable company coming out the end. There was no way of doing that under the circumstances, knowing that the markets were going to be in very serious condition on Monday.

I went to the Fed on Saturday and explained this to them and asked for both a bridge loan and/or a guarantee that I could take back to the lenders and the private equity investors that would give them some assurance that AIG would be viable after they put

up this capital. I was told that was not going to happen. There would be no government solution for AIG, and we went back to work on Sunday trying to find more capital.

On Sunday evening, by this time we concluded that we couldn't raise any capital because we couldn't guarantee——

Dr. TROSKE. So I know I'm running over, but this seems to address some points that have been asked before.

You seem to be suggesting from what you just said that when you went to the New York Fed you had the possibility to put together a partially private/partially public deal that would have allowed you to continue to exist, that you had $30 billion in promises from the private sector, conditional on the New York Fed guaranteeing the survival of the company or providing some additional support. So it didn't have to be all one, you believed you had a deal that would allow both a private and a public component to it, is that correct?

Mr. WILLUMSTAD. I believe that we had a commitment, a verbal commitment, at least under the circumstances, for approximately $30 billion, but without some further guarantees of liquidity from someone, in this case the Fed, we were not going to be able to complete that deal.

Dr. TROSKE. Thank you very much.

Mr. WILLUMSTAD. If I could?

Dr. TROSKE. Yes.

Mr. WILLUMSTAD. Just one more point. It wasn't until Monday morning of the 15th when I received a call from Tim Geithner that the Fed was going to—he actually asked me for permission for JPMorgan and Goldman Sachs to represent or to attempt to work on a "private" solution with a syndicate of banks to provide the capital. That didn't start until 11 o'clock on Monday morning. We were all summoned over to the Fed at 11 o'clock on Monday, the 15th, and that's when there was a discussion and Tim Geithner said at that meeting to everybody, and there were probably 40 people in the room, that there would be no government resources available to AIG and that was that Monday at 11 a.m. and, then, of course, there was no solution.

Dr. TROSKE. Okay. Thank you.

Chair WARREN. I just want to make sure I'm following the timeline here. So the people you were working with, the creditors you were working with over the weekend, who was that? That was not JPMorgan Chase and Goldman Sachs?

Mr. WILLUMSTAD. No, and again——

Chair WARREN. Over the weekend?

Mr. WILLUMSTAD [continuing]. Apples and oranges.

Chair WARREN. I understand that. Who was it?

Mr. WILLUMSTAD. Well, JPMorgan was our advisor to AIG over the weekend. They were acting as AIG's advisor in helping us raise capital. We had a number of private equity investors and we had the New York State Insurance Commission—that was a big help. So that was purely AIG-driven with our advisor, JPMorgan, and Citibank, by the way. Citigroup were also co-managers through that process.

We were talking to large private equity firms and I had had conversation with Warren Buffett, as well, in terms of trying to raise

capital. That was unrelated to what's been referred to as the JPMorgan/Goldman Sachs effort. That didn't start until Monday at 11 a.m.

Chair WARREN. I see, and so when Mr. Baxter is referring to the Lehman weekend, we keep hearing that AIG's going to be taken care of, they've got the money they need, there's going to be adequate funding, it's this private deal you were——

Mr. WILLUMSTAD. That was our effort.

Chair WARREN [continuing]. Working on, that collapsed Sunday night at five o'clock.

Mr. WILLUMSTAD. Well, I informed them that Sunday.

Chair WARREN. Who did you inform?

Mr. WILLUMSTAD. Well, we were summoned back over to the Fed. There were a number of people there. Tim Geithner was there. My recollection is that Secretary Paulson was not in that meeting, but I could be wrong about that.

Chair WARREN. So that's Sunday at five o'clock. It's now clear that that effort has failed. A new effort starts at 11 o'clock on Monday morning but is evidently gone——

Mr. WILLUMSTAD. Well, just again to fill in some of the timeline, after Sunday evening a phone call was received from the Fed and JPMorgan was asked to go back to the Fed on Sunday evening.

Chair WARREN. But you were not?

Mr. WILLUMSTAD. We were not. As a matter of fact, we were—I specifically asked whether we could be there and we were told no, we were not invited, and so I can't tell you exactly what happened Sunday evening, but I did receive this call on Monday morning from Tim Geithner saying that both JPMorgan and Goldman would work on a syndicated private solution with my authorization. Of course, I gave it to them.

Chair WARREN. Yes, and that started at 11 o'clock on Monday and then——

Mr. WILLUMSTAD. So that was a conversation that we had had. Everybody was summoned to the Fed——

Chair WARREN. That's right.

Mr. WILLUMSTAD [continuing]. At 11 on Monday.

Chair WARREN. And that failed then at what time?

Mr. WILLUMSTAD. Well, everybody's timeline is a little different. I had the suspicion Sunday evening—Monday evening that there was going to be no solution and that was just from some of the feedback from some of the people who had attended some of the meetings.

On Tuesday morning, I called Tim Geithner because it was clear in the absence of a private solution on Tuesday we were going to have to file bankruptcy by Wednesday morning.

Chair WARREN. I see. Good. Of course. Please.

Mr. MCWATTERS. It sounds like you had a deal that was fairly close to being struck but it fell apart. What needed to be done or who needed to do what to keep that deal alive, the deal that you were working on over the weekend?

Mr. WILLUMSTAD. Well, again, we had potential people—potentially people willing to put in, in my estimation, as much as $30 billion into AIG, but as I said, no thoughtful person would put

money in if they thought the company would file bankruptcy two or three days later, or a week later, even two weeks later.

So they needed some form of guarantee that the company was viable going forward after they made their investment. It was my judgment that the only person who could give a guarantee like that that would be credible would be the Fed.

Mr. MCWATTERS. What if the Fed, instead of giving a guarantee, instead of making an $85 billion loan, made, let's say, a $30–40 billion loan? Do you think you could have had a deal on those terms?

Mr. WILLUMSTAD. It certainly would have been much more attractive. It's hard to know whether at that time, especially given what was going on over the weekend, that a specific number would have satisfied it.

Remember, all the lenders that were going to put capital in were going to take collateral from AIG. So they would have been secured in the event of some form of bankruptcy.

Mr. MCWATTERS. Right. And the Fed would have also, but since the Fed's loan was not 85, it was 30 or 40, presumably they would take less collateral and leave more collateral for your bank syndicate or your syndicate of lenders.

Okay. Thanks.

Chair WARREN. And I just want to make sure I have this. 11 a.m. Monday meeting, this was a meeting called by the Fed?

Mr. WILLUMSTAD. Yes.

Chair WARREN. All right. And then President Geithner was there. You said you think Secretary Paulson was not, but you're not entirely sure?

Mr. WILLUMSTAD. Secretary Paulson was clearly not there.

Chair WARREN. Clearly not there.

Mr. WILLUMSTAD. I said I don't think he was there Sunday evening.

Chair WARREN. Got it. Okay. Anyone else you remember in this meeting on Monday morning?

Mr. WILLUMSTAD. On——

Chair WARREN. Who was there on the Monday morning at 11 o'clock?

Mr. WILLUMSTAD. Representatives from JPMorgan, a large contingent from Goldman Sachs, including Lloyd Blankfein. There were representatives representing the Fed from Morgan Stanley and, of course, each one of these firms had its assumed number of lawyers with them. I think the lawyers outnumbered the bankers at the time.

Chair WARREN. Not probably for the first time. Okay. Good, good.

Another one, Damon?

Mr. SILVERS. One clarifying thing about this. Did the—was there—and I don't know.

Mr. Baxter, were you at this meeting?

Mr. BAXTER. Not to my recollection.

Mr. SILVERS. All right. So, Mr. Willumstad,—Ms. Dahlgren, were you there?

Ms. DAHLGREN. No, I was not.

Mr. SILVERS. Okay. Mr. Willumstad, did then President Geithner and his team remain for the entirety of the meeting? Were they sort of—were they running that meeting?

Mr. WILLUMSTAD. Well, that's hard to answer. Mr. Geithner stayed, I'd say, for about 10 or 15 minutes. I remember his last words before leaving were that there would be no government assistance and that this had to be a private solution.

The principal representative from Treasury was Dan Jester who was there. He and I actually left the meeting to go call the rating agencies. So I was actually out of the meeting probably for about an hour and by the time we were completed calling the rating agencies, the meeting had broken up and people were coming back to AIG to work on putting together the financial information necessary for a syndicated loan.

Mr. SILVERS. So what time did that meeting end, roughly?

Mr. WILLUMSTAD. I would say about 12:30–1 o'clock, or something.

Mr. SILVERS. And you left that meeting believing that a syndicate was being put together?

Mr. WILLUMSTAD. No, no. I've been in this business a long time. I'm not naive. I believe——

Mr. SILVERS. What did you believe when that meeting ended?

Mr. WILLUMSTAD. No. I believed that JPMorgan and Goldman Sachs were charged with the effort to try and put together a syndicate to come up with X billions of dollars and that effort was undertaken.

Mr. SILVERS. Now, did you—were there any further meetings involving that effort that you were involved in or any phone calls after that meeting ended?

Mr. WILLUMSTAD. No.

Chair WARREN. And, Mr. Baxter, just so I'm sure we have the record clear on this. Based on your earlier experiences, was the Fed in the room for the negotiations over Long-Term Capital Management?

Mr. BAXTER. The negotiations with the creditors of Long-Term Capital Management, to enlighten them of their self-interests in putting $3 billion in capital in, took place on the 10th Floor of our building at 33 Liberty Street.

Chair WARREN. So it's fair to say you were there?

Mr. BAXTER. We were there.

Chair WARREN. You were there. Solomon?

Mr. BAXTER. And Solomon, there were a whole series of discussions.

Chair WARREN. Were you there?

Mr. BAXTER. In some I was.

Chair WARREN. Okay. Or the point is the Fed was there——

Mr. BAXTER. Yes.

Chair WARREN [continuing]. In some form or another? And the sovereign debt crisis?

Mr. BAXTER. Sovereign debt crisis would have been a number of discussions among colleagues of mine at the Fed, yes.

Chair WARREN. So the Fed was there, and Bear Stearns?

Mr. BAXTER. Clearly, we were there for Bear Stearns.

Chair WARREN. Okay. Good. Just making sure we've got it all clear. I think that's it.

Thank you all very much. Thank you for your patience and thank you for your help to the panel.

This panel is excused, and I call the second panel and while they're coming, I will introduce them.

Martin Bienenstock is Partner and Chair of the Business Solutions and Government Department at Dewey & LeBoeuf. Rodney Clark is the Managing Director of Insurance Ratings at Standard & Poor's Credit Rating Agency. Michael Moriarty is Deputy Superintendent for Property and Capital Markets at New York State Insurance Department.

Gentlemen, I want to thank you, all three, for coming here today. We appreciate it, and I'm going to ask you if you would make opening statements, if you could hold your remarks to five minutes. As you can see, we are a lively panel with many questions, and flights back late tonight.

So I'm going to ask to hold your remarks to five minutes, but your entire written remarks will be part of the record.

Mr. Bienenstock, could I start with you, please?

STATEMENT OF MARTIN BIENENSTOCK, PARTNER AND CHAIR OF THE BUSINESS SOLUTIONS AND GOVERNMENT DEPARTMENT, DEWEY & LEBOEUF

Mr. BIENENSTOCK. Yes. Good morning, Chair Warren and Panel Members, Deputy Chair Silvers, Mr. McWatters, and Dr. Troske. Thank you for the opportunity to testify today.

Since I've heard several times that testimony is automatically in the record, I thought at least in part I would try to supplement what I've written by crystallizing some of what I've heard this morning and tying it to the relevant portions of my written testimony.

First, I have no issue with the emergency action taken by the Fed to provide the $85 billion facility on September 15, 2008, and you have more information than I do, but all I can say is from what I have been able to read from a lay person in the public, based on the speed of the meltdown and the exigencies of the situation on the heels of the unrescued Lehman bankruptcy and collapse, I don't know of any alternative, whether there could have been some money from the private sector, I'm not sure at the end of the day would even make a big difference because the $85 billion facility was all secured. So the secured part will be paid back. Hopefully it's over-secured and the Government will get all its money back at a profit, but it was secured with everything AIG had of value, as far as I can tell.

Where I might take issue with some of what has gone before, both this morning and in prior hearings, is the notion that everything was set in stone on September 15 and let me backtrack for just a moment.

The speed and suddenness of the need for the $85 billion facility, while I can tell it's surprising to me, including some in this room, is not surprising to those of us who have been through crises involving trading companies before.

I met with Enron the Friday after Thanksgiving in 2001 and the next week it filed Chapter 11. When you're dealing with a trading company, financial statements and balance sheets don't have much meaning because the next trade changes the assets and liabilities. It also changes the risk profile.

When the market loses confidence in either the trader or there's a pervasive market shift in confidence in a class of securities, such as subprime, the values fall out of bed, the financial statements are worthless, and you're at what I suppose AIG considered one of the highly unlikely occurrences in their computer models.

If there was a fault there, I think it was governance at AIG that didn't recognize the severity of the damage if the unlikely did occur and there was no preparation for that, but each of these are unique situations. It's only the speed of the death spiral that is the same and whatever legislation arises out of this, it's very hard to script the steps that should be taken.

I think you'll find that the most important thing is to have the risks fully understood in advance so people are at least ready to deal with them when they do occur and each one is unique.

Anyway, having advanced the $85 billion facility on September 15, the Maiden Lane II and III deals didn't occur for several months later. Meanwhile, the Fed had a lien on everything of value. AIG had over 30 million customers which were 30 million creditors and the creditors from which it really wanted concessions in the notion of fairness are the creditors who were trading in the businesses creating the harm, primarily the credit default swaps and perhaps the securities lending.

Those came down to the bulk of the exposure being with eight counterparties, the vast bulk being with 16, according to other testimony I've read, including from Mr. Baxter a few months ago.

So the bottom line is there were months to talk to the parties having the most exposure about what concessions they might grant if the Government and AIG would basically, in partnership, take them out.

Now, what we know on the opposite end is the Government took the worst case. They already held $35 billion in securities and the Government paid the full value, the par value remaining. You can't do any worse than was done here. Hopefully the Government will be able to recover much and all of that. Apparently it's over-secured from what I've read in Mr. Millstein's testimony that you'll hear later today. It's currently over-secured.

But at the time, we have to recognize that the tables changed and the essential message I want to give you is this is a process. You don't look at just the end games. Once the loan was made, once AIG was secured, 30 million customers were current as well as its other creditors. AIG wasn't going to file bankruptcy voluntarily and under those circumstances, no one could really file involuntarily because AIG was generally paying its debts as they matured.

[The prepared statement of Mr. Bienenstock follows:]

Testimony of Martin J. Bienenstock[1]
May 26, 2010
Congressional Oversight Panel

Good morning Chair Warren and panel members, Mr. Silvers, Mr. McWatter, and Dr. Troske. Thank you for the opportunity to testify today.

I was asked to address whether in my judgment the rescue of AIG could have incorporated some shared sacrifice by AIG creditors who were otherwise made whole with U.S. taxpayer money loaned or invested under the Troubled Asset Relief Program ("TARP") and by the Federal Reserve Bank of New York ("FRBNY") pursuant to the authorization of the Board of Governors of the Federal Reserve System.

For the reasons I am about to explain, my conclusion is that it was very plausible to have obtained material creditor discounts from some creditor groups as part of that process without undermining its overarching goal of preventing systemic impairment of the financial system and without compromising the Federal Reserve Board's principles. I do not think any material creditor discounts from creditor groups associated with AIG's profitable businesses were remotely practicable. I do not believe any prepackaged chapter 11 plan for AIG was remotely possible within the acutely short time available.

I have done my best to undertake this analysis without using hindsight to engage in Monday morning quarterbacking. Equally important when engaging in this analysis is to appreciate the trauma, extremis, and for those new to the world of distressed companies, the unexpectedly rapid onslaught of the death spiral whereby AIG's traditional lifelines – commercial paper, sale of stock, institutional borrowing and the like – suddenly disappeared. I have great empathy for those involved, and I think it is appropriate to use Monday morning quarterbacking to acknowledge that the mission of avoiding a systemic market collapse was accomplished, and those responsible, including then President of the Federal Reserve Bank of New York, Timothy Geithner, and Federal Reserve Chairman Bernanke deserve much credit for sparing our nation a devastating outcome that likely would have shattered the financial market that was rattled and rendered fragile in the immediate aftermath of Lehman Brothers' unrescued implosion and bankruptcy on September 15, 2008.

Before developing my own analysis, I had the benefit of reading Treasury Secretary Geithner's answers to Chair Warren's questions at the Congressional Oversight Panel's hearing on December 10, 2009. I've also reviewed, among other things, numerous AIG Forms 10-Q and 10-K filed with the Securities and

---

[1] Martin J. Bienenstock is a member of the law firm, Dewey & LeBoeuf LLP, where he is chair of its Business Solutions & Governance Department and a member of its Executive Committee. Mr. Bienenstock also teaches Corporate Reorganization as a lecturer at Harvard Law School and University of Michigan Law School.

Exchange Commission, the report dated November 17, 2009 of the Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP Report"), and the very thoughtful statement dated January 27, 2010 of Mr. Thomas C. Baxter, Jr., Executive Vice President and General Counsel of the Federal Reserve Bank of New York regarding factors affecting efforts to limit payments to AIG counterparties before the Committee on Government Oversight and Reform of the United States House of Representatives.

Finally, I understand that downgrades of AIG by the rating agencies would have exacerbated certain of AIG's problems by triggering requirements for AIG to post additional collateral for the credit default swaps ("CDS") that AIG Financial Products ("AIGFP") had written, and possibly by impairing AIG's other businesses. The impact of downgrades on posting collateral is largely or completely now eliminated by AIGFP's buyout of its CDS exposure held by the counterparties holding most of AIGFP's liability.

The Special Inspector General for the Troubled Asset Relief Program ("SIGTARP") concluded the "negotiating strategy to pursue concessions from counterparties offered little opportunity for success..."[2] The effectiveness of a restructuring depends heavily on the process and strategy used to attain it. The most effective process for AIG would have to yield the desired result consensually, without going into court, let alone through a trial and judgment.

The unique facts bearing on the best process for AIG were that AIG was current on its debt obligations and was granting the Federal Reserve Bank of New York ("FRBNY") a lien against all available assets to secure a revolving loan of up to $85 billion. On September 16, 2008, AIG's state insurance regulators notified AIG that AIG was "no longer permitted to borrow bunds from its insurance company subsidiaries under a revolving credit facility that IAG had maintained with certain of its insurance subsidiaries acting as lenders. Subsequently, the insurance regulators required AIG to repay an outstanding loans under that facility and to terminate it...."[3] These facts give rise to two very significant consequences.

First, no creditor obtaining a judgment for any subsequent default would necessarily be able to collect because the FRBNY's lien would rank higher than any judgment lien and AIG's source of funds from insurance company subsidiaries was cut off. Second, AIG's status as generally paying its debts as they matured, meant that anyone filing an involuntary bankruptcy petition against AIG would be unable to sustain its burden to show that AIG was not generally paying its debts as they became due. On a consolidated basis, AIG had over

---

[2] SIGTARP Report at page 1 under Conclusions and Lessons Learned.
[3] AIG Form 10-Q for Q3 2008, at p. 50.

$800 billion of liabilities,[4] which FRBNY clearly believed could be serviced with the help of the $85 billion facility it extended. The credit default swaps and securities lending liabilities were a small fraction of AIG's liabilities.

Accordingly, AIG was in a position to advise certain creditor groups such as the credit default swap counterparties, as follows:

1. State law recovery actions against AIG would be unlikely to yield any benefits due to the prior lien held by FRBNY;

2. AIG would not voluntarily file bankruptcy;

3. Creditors would be unable to file involuntary petitions in good faith because AIG was generally paying its debts as they became due, even if AIG were not to post additional collateral or pay certain other debts of the entities that caused its losses.[5]

4. If creditors nevertheless filed involuntary bankruptcy petitions against AIG, they would render themselves liable for compensatory and punitive damages if the court found AIG was generally paying its debts as they became due and the creditors had been warned in advance of that fact;[6]

5. FRBNY was saving AIG with taxpayer funds due to the losses sustained by the business divisions transacting business with these creditor groups, and a fundamental principle of workouts is shared sacrifice, especially when creditors are being made better off than they would be if AIG were left to file bankruptcy.

The impact of the foregoing on the creditors, would include:

1. The knowledge that enforcement action would be unlikely to yield recoveries;

2. The knowledge that an involuntary bankruptcy petition would be a 'bet-the-ranch' venture by the creditors because of the risk of suffering compensatory and punitive damages for knowingly bankrupting AIG when it was generally paying its debts as they became due;

3. The knowledge that any creditor enforcement action would be highly publicized and would isolate the creditor in the public as

---

[4] AIG Form 10-K for year ended December 31, 2008, at p. 193.
[5] *See* 11 U.S.C. § 303(h).
[6] *See* 11 U.S.C. § 303(i)(2).

working against the efforts of the United States and its taxpayers to save AIG and the financial system; and

4. The knowledge by some of the creditors that working against the United States would be singularly unwise after the United States either provided them rescue funds or helped them buy a company such as Lehman Brothers for $250 million plus the appraised value of the Manhattan office tower it owned.

The foregoing strategy maximizes forces on creditors to grant debt concessions, while yielding them very few alternatives to granting concessions and no alternatives lacking delay, expense, and uncertainty. Unlike the negotiating strategy that SIGTARP described as having had little opportunity for success, this strategy is not based on bluffing bankruptcy. It is based on straight talk and acknowledging there would be no bankruptcy. Additionally, FRBNY retained an outstanding law firm and attorney for its work. But, the law firm is identified with representing Wall Street institutions such as JP Morgan and it would be awkward for it to devise strategies to obtain concessions from those institutions.

Significantly, the foregoing strategy eliminates or at least answers many of the reasons that ultimately caused FRBNY not to obtain concessions.[7] For instance, all lenders are justified in requiring shared sacrifice. Therefore, FRBNY would not have been using its regulatory status to demand concessions. It could do so in its lender status. Most importantly, FRBNY was not required to bluff about bankruptcy. The correct strategy was the opposite – to show there would be no bankruptcy and no real opportunity for the creditor to do better. The foregoing process is carried out in conference rooms, not in the public.

While the FRBNY might still be concerned about the sanctity of contract, fairness in debtor-creditor relations exists when creditors share the pain, not when taxpayers bail out contracts they did not make. I acknowledge this is often counterintuitive. We all grow up learning to carry out all our promises. In debtor-creditor relations, however, once a debtor cannot carry out one promise to one creditor, it is more fair to break more promises so similarly situated creditors share the pain, rather than having one take all the pain, or worse yet, having innocent taxpayers take all the pain.

I understand there was also a concern about ratings downgrades following any concessions. Intuitively, it should be illogical that AIG would be viewed as a lesser credit risk once it procured concessions from creditors which would reduce the amount AIG needed to borrow from FRBNY and would reduce future debt service expense. To be sure, the ratings protocols may not always appear

[7] SIGTARP Report at pp. 18-19.

logical to the layperson, but given the singular unique aspects of the AIG rescue, it is hard to figure out why the ratings agencies would believe AIG would be less credit worthy without creditor concessions.

The argument exists that creditor concessions could signal that FRBNY may not continue to provide AIG funds to satisfy all debt. The answer to that is that FRBNY has not provided that assurance. Indeed, I received many phone calls in September 2008, asking whether it was safe to buy or hold AIG bonds after FRBNY provided the $85 billion facility. The market clearly understood that FRBNY did not provide any guaranties to creditors for the future. Therefore, it would be illogical for a downgrade to turn on whether AIG already obtained concessions. The risk of a future default is the same or less if prior concessions were granted.

Recent experiences with workouts of the monoline insurance companies help corroborate the likelihood of concessions. I have had limited involvement in those negotiations, but my firm has been very involved on behalf of the insurance companies. In those restructurings, institutional lenders, including French institutions, were similarly owed additional collateral to secure credit default swaps and other derivatives. Consensual discounts were and are being granted in very material amounts. Additionally, there is litigation pending today over whether certain credit default swaps qualify for any priorities in payment afforded insured contracts under state law. Accordingly, there are many uncertainties causing counterparties to grant consensual discounts.

Thank you for allowing me the opportunity to provide this analysis. I am anxious to try to answer any questions.

"

Chair WARREN. Thank you, Mr. Bienenstock. I'm going to stop you there, but that's very helpful. Thank you.

Mr. Clark, I just want to say again how much I appreciate your being here and Standard & Poor's stepping forward to give us some insight into the credit rating process here.

If you could give us your opening remarks.

STATEMENT OF RODNEY CLARK, MANAGING DIRECTOR, INSURANCE RATINGS, STANDARD & POOR'S

Mr. CLARK. Yes. Thank you. Thank you, Chair Warren, Members of the Panel, good morning.

My name is Rodney Clark, and I serve as Managing Director in Standard & Poor's Ratings Services, and from 2005 through 2008 I served as S&P's lead ratings analyst covering AIG.

I'm pleased to appear before you this morning. At the outset, I'd like to take a moment to speak generally about our ratings process and to explain what ratings are and are not intended to convey.

S&P's credit ratings are current opinions on the future credit risk of an entity or a debt obligation. They express our opinion about capacity and willingness of an entity to meet all contractual and financial obligations as they come due.

S&P forms its rating opinions through quantitative and qualitative analyses performed by our rating analysts and after an opinion is formed, S&P publishes the opinion in real time and for free on our website and we generally publish a more detailed narrative about our opinion. This is the process by which S&P arrived at its ratings on AIG.

My written submission includes a table listing our global ratings history on AIG since 1990 and a more detailed description of our rationale for our rating changes. By way of overview, up to 2005, S&P's rating on AIG was AAA, our highest rating, reflecting our view that AIG's capacity to meet its financial commitments was extremely strong. Our opinion began to change starting in March of 2005 and S&P has since lowered its ratings on the company four times.

In February 2008, S&P announced a negative outlook for the company's rating based on the way AIG was determining the fair value of its credit default swaps that it had entered into. AIG CDS guaranteed an array of structured finance securities, including securities backed by sub-prime residential mortgages.

In May 2008, we lowered our rating on AIG further to AA Minus in reaction to the company's announcement of losses, including 5.9 billion related to its CDS portfolio, and we maintained a negative outlook on AIG's rating throughout the summer of 2008.

In August, S&P announced its view that AIG's actual credit-related losses in the CDS area would likely amount to $8 billion with significantly higher mark to market losses. But the market value of AIG's investments and the investments of third parties that had purchased CDS guarantees deteriorated sharply amid the substantial market turbulence in September 2008.

In light of these events, on September 12, 2008, S&P placed its ratings on AIG and all AIG subsidiaries on credit watch with negative implications. On September 15, as AIG's condition continued to deteriorate, S&P lowered its rating further to A Minus in light

of increasing CDS-related losses and its reduced flexibility in meeting the collateral needs.

In our view, were it not for the extension of an $85 billion borrowing facility by the Federal Reserve Bank of New York on September 17, 2008, AIG's creditworthiness would have continued to deteriorate.

Our current rating on AIG, which remains A Minus, includes a five notch uplift to account for Federal Government support. Our current view is that AIG has made significant progress in re-establishing its insurance market presence and in implementing a very challenging restructuring plan. However, we believe AIG remains susceptible to competitive pressures as well as aggressive market pricing.

With respect to the effect of AIG's current financial situation on the creditworthiness of its subsidiaries, we believe those subsidiaries are to some extent insulated by the state insurance laws and regulations. For example, if AIG had been forced into bankruptcy, the bankruptcy would have likely included a relatively small number of AIG's non-insurance subsidiaries, such as AIG Financial Products, with only a marginal impact on AIG's insurance subsidiaries.

Nevertheless, when S&P lowered its credit rating on AIG to A Minus on September 15, we also lowered the ratings on most of the insurance subsidiaries to A Plus, where they remain today.

While AIG's financial problems have no direct effect on the solvency of the insurance subsidiaries, we believe the creditworthiness of those subsidiaries is nevertheless indirectly affected by the decreased likelihood that they could receive additional capital from AIG as well as the reputational risk resulting from the parent company's financial problems and its impact on customers.

You've asked me to explain S&P's ratings treatment of certain distressed exchanges. Our criteria call for consideration of various factors in assessing whether a distressed exchange would be viewed as a selective default, including whether default insolvency or bankruptcy in the near or medium term would be likely without the exchange offer.

Chair WARREN. Mr. Clark, I would ask you just to—just do one sentence. We've all read the report, but we're at five minutes.

Mr. CLARK. Okay. The important line then is every situation is different and any significant discount to the payment of the obligations, other than perhaps the time value of money, could potentially constitute a default under our published criteria.

Thank you for the opportunity to participate.

[The prepared statement of Mr. Clark follows:]

TESTIMONY OF RODNEY CLARK
MANAGING DIRECTOR, RATINGS SERVICES,
STANDARD & POOR'S FINANCIAL SERVICES LLC
BEFORE

THE CONGRESSIONAL OVERSIGHT PANEL
CONGRESS OF THE UNITED STATES

MAY 26, 2010

Chairwoman Warren, members of the panel, good morning. My name is Rodney Clark. I serve as a managing director in Standard & Poor's Ratings Services ("S&P") and, from 2005 through 2008, I served as S&P's lead ratings analyst covering American International Group ("AIG"). I am pleased to appear before you today, and I intend to address three broad topics: (i) the history of S&P's ratings on AIG; (ii) our reasoning in arriving at those rating opinions, particularly those that we published in the period immediately before the government rescue of AIG in the fall of 2008; and (iii) our views with respect to the effect of AIG's troubles on the creditworthiness of its subsidiaries.

At the outset, I would like to take a moment to speak generally about our ratings process and to explain what ratings are and are not intended to convey.

S&P's Credit Ratings

S&P's credit ratings are our current opinions on the future credit risk of an entity or a debt obligation. They express our opinion about the capacity and willingness of an entity to meet all of its contractual and financial obligations as they come due. S&P's ratings do not speak to the market value of a security or the volatility of its price and they are not recommendations to buy, sell or hold a security; they simply provide one of the tools investors can use as they assess risk and differentiate credit quality of obligors and the debt they issue.

S&P forms its rating opinions through quantitative and qualitative analysis performed by rating analysts. These analysts gather information about a particular obligor or debt issue, analyze the information according to our published criteria, form opinions about the information

and then present their findings to a committee of analysts that votes on what ratings to assign. After a rating opinion is formed, S&P publishes the opinion in real-time and for free on its Web site, www.standardandpoors.com. We also generally publish a narrative along with our ratings that provides detailed information about our opinion.

This is the process by which S&P arrived at its ratings on AIG, which I will now address in some detail.

S&P's AIG Rating History

Attached to my written submission is a table listing our global ratings history on AIG since 1990. As the table shows, as of June 1990 S&P's rating on AIG was 'AAA.' This is our highest rating, and it reflected our view at the time that AIG's capacity to meet its financial commitments was extremely strong. Our view took into consideration AIG's internationally diversified business mix, historically superior earnings performance, conservative balance sheet management, and exceptional liquidity characteristics. Our opinion began to change, however, starting in March 2005. Since then, S&P has lowered its rating of the company four times.

Recent Ratings Actions on AIG

S&P downgraded AIG on March 30, 2005, when it lowered AIG's rating from 'AAA' to 'AA+'. Our opinion of AIG had changed in large part due to the company's involvement in a number of questionable financial transactions, and reflected our revised assessment of AIG's management, internal controls, corporate governance and culture. In publishing this rating change, we expressed our view that AIG's globally diversified financial services group was still expected to generate very strong earnings and profits. We also reported that the company had told us that its new management had initiated a rigorous review of internal controls.

In June 2005, we again lowered our rating on AIG — this time to 'AA' — reflecting our revised credit assessment based on significant accounting adjustments that had just been announced by the company. Despite strong overall earnings, we believed that AIG's adjusted financial statements indicated greater volatility and lower profitability than had been previously reported. At that time, we considered AIG's capitalization — that is, its ability to absorb losses — good.

In February 2008, S&P placed a negative outlook on the company based on concerns about the way AIG was determining the fair value of credit default swaps — or "CDS" —it had entered into. As has been widely reported, CDS are essentially guarantees of credit risk on securities or entities. AIG's CDS guaranteed an array of structured finance securities, including securities backed by subprime residential mortgages.

Three months later, in May 2008, we lowered our rating on AIG further to 'AA-'. This rating action was based in large part on our reaction to the company's announcement of an after-tax loss of $7.8 billion, including $5.9 billion in losses related to its CDS portfolio. S&P maintained a negative outlook on AIG throughout the summer of 2008.

In August, following a deal-by-deal credit analysis of AIG's investment and CDS portfolios, S&P reached its view — and stated publicly — that AIG's actual credit-related losses in these areas would likely amount to around $8 billion with significantly higher mark-to-market losses.

As has been well-publicized, AIG's financial condition deteriorated sharply in September 2008 following substantial market disruptions, including government takeovers of Freddie Mac and Fannie Mae, the bankruptcy of Lehman Brothers, and the sale of Merrill Lynch, among other

things. These events led to a sudden drop in the market value of AIG's investments and, more importantly, the investments of third parties that had purchased CDS guarantees from AIG.

In light of these events, on September 12, 2008, S&P placed its ratings of AIG and all AIG subsidiaries on CreditWatch with negative implications. Three days later, on September 15, 2008, as AIG's condition continued to deteriorate, S&P lowered its rating further to 'A-'. As stated in our published reports at the time, our decision to downgrade AIG was based primarily on a combination of AIG's reduced flexibility in meeting collateral needs and its increasing CDS-related losses.

The next day, on September 16, 2008, the Federal Reserve Bank of New York announced that it would extend an $85 billion borrowing facility to AIG. Were it not for this government assistance, we believe that AIG's creditworthiness would have continued to deteriorate. Indeed, our current rating on AIG, which remains at 'A-', includes a five-notch "uplift" to account for federal government support. Thus, without government support, our rating on AIG today would be 'BB'.

S&P's Current Outlook For AIG

On April 1, 2010, S&P affirmed its 'A-' rating on AIG. This rating, as noted, is adjusted to account for the extraordinary government support currently provided to AIG. Our most recent ratings affirmation also reflects an increase in AIG's stand-alone credit profile to 'BB', from 'BB-'. This revised stand-alone rating reflects our view of AIG's continued momentum in reestablishing its multi-line insurance market presence through its Chartis and SunAmerica operations, of good progress in the unwinding of AIG Financial Products Corp., and of the

improved liquidity position of its noninsurance operations. We also believe that AIG's recently announced transactions reflect solid progress in its challenging restructuring plan.

Although we do not expect any increase in government support at this time, in our view, the government's continuing actions with respect to AIG have significantly reduced the risk of further rapid deterioration in the company's creditworthiness. However, while our outlook on the company's stand-alone credit profile is positive, we maintain our negative outlook on the company going forward. This is based in part on our belief that AIG is particularly susceptible to the broad insurance market trends, given its somewhat weakened position, and that pressure on the operating performance of its subsidiaries may build, due to market factors such as aggressive pricing and competitive pressures. Furthermore, the negative outlook reflects uncertainty with regard to legislative risk and its potential impact on the government's ability to continue to provide extraordinary support to AIG, if needed.

If, in our view, AIG's operating performance does not improve to a level approaching historical performance, factoring in the strong but diminished competitive position, we could lower the company's rating one notch. However, if operating performance comes close to historical levels and capitalization remains consistent or improves, we could revise the outlook to stable.

The Relationship Between AIG and its Subsidiaries

With respect to the effect of AIG's current financial situation on the creditworthiness of its subsidiaries, we believe those subsidiaries are to some extent insulated. For example, if AIG had been forced into bankruptcy, the bankruptcy would have likely included a relatively small number of AIG's non insurance subsidiaries — such as AIG Financial Products Corp. — with

only a marginal impact on AIG's insurance subsidiaries. That is because the insurance subsidiaries' capital is generally insulated by state insurance laws and regulations.

Nevertheless, when S&P lowered its credit rating on AIG to 'A-' on September 15, we also lowered the ratings on most of AIG's insurance subsidiaries to 'A+' from 'AA+', where they remain today. While AIG's financial problems have no direct effect on the solvency of its insurance subsidiaries, we believe the creditworthiness of those subsidiaries is nevertheless indirectly affected in two primary respects. First, in our opinion financial pressures at AIG generally make it less likely that AIG will be in a position to provide additional capital to its subsidiaries in the event the subsidiaries suffer investment losses of their own or otherwise require recapitalization. This concern is somewhat muted by AIG's receipt of government support, and because of improved capitalization. For example, we believe the recent announcements of two major divestitures — AIA and ALICO — will, if successfully completed, improve AIG's financial profile, and the overall improvement in the company's full-year 2009 GAAP earnings reflects favorable trends in financial markets that contributed to lower investment losses and the general improvement in mark-to-market results across all segment operations.

The second issue we see affecting the creditworthiness of AIG's insurance subsidiaries relates more generally to overall reputational risk resulting from the parent company's financial problems. For example, it may be more difficult for the subsidiaries to retain and attract new customers where there is uncertainty surrounding the parent company — particularly in light of a dampened demand for insurance and, more significantly, marginal pricing.

As a general matter, S&P believes that AIG's insurance subsidiaries are currently well capitalized to meet their policy obligations. The strength of its subsidiaries is a positive factor in our view of AIG's overall creditworthiness. Our ratings on any particular subsidiary could change in the event of a sale of the subsidiary by AIG. The nature of the change would likely depend on the buyer and the impact of the sale on the subsidiary's competitive position, capital structure, and earnings. It is quite possible that the ratings on some subsidiaries could move in a different direction than others.

Ratings Treatment of a Distressed Exchange

In the invitation to appear today you also asked that I explain S&P's ratings treatment of distressed exchanges, where a company that is in distress settles its obligations at a significant discount so as to avoid insolvency or bankruptcy. Such efforts are usually motivated, at least partially, by the desire to avoid the alternative of a potential conventional default.

As a general matter, the impact on ratings of such exchange offers depends on the facts of a particular situation and how a reviewing rating committee assesses them. Our criteria call for the consideration of various factors in assessing whether a distressed exchange would be viewed as a selective default, including whether default, insolvency, or bankruptcy in the near or medium term would be likely without the exchange offer. To consider an exchange offer as tantamount to default, we generally consider whether: 1) the offer, in our view, implies the investor will receive less value than the promise of the original securities; and 2) the offer, in our view, is distressed, rather than purely opportunistic. Thus, although every situation is different, any discount other than one for the time value of money could potentially constitute a default pursuant to our published ratings criteria.

In the event that we do consider a distressed exchange as a default, we may lower the issuer credit rating and the affected issue ratings to 'CC', and, upon completion of the exchange, ratings may be lowered to 'D' and the issuer credit rating may be lowered to 'SD' (selective default), assuming the issuer continues to honor its other obligations. This is the case even though the investors, technically, may accept the offer voluntarily and no legal default occurs. After that, our practice is to adjust the rating going forward to again focus on conventional default risk.

Conclusion

I thank you for the opportunity to participate in this hearing, and I would be happy to answer any questions you may have.

Table of S&P ratings history for American International Group Inc. since June 1990

Date	Rating/Outlook
26-Jun-1990	AAA/Stable
29-Oct-2004	AAA/Negative
15-Mar-2005	AAA/Watch Neg
30-Mar-2005	AA+/Watch Neg
03-Jun-2005	AA/Negative
10-Nov-2006	AA/Stable
12-Feb-2008	AA/Negative
08-May-2008	AA-/Watch Neg
21-May-2008	AA-/Negative
12-Sep-2008	AA-/Watch Neg
15-Sep-2008	A-/Watch Neg
17-Sep-2008	A-/Watch Dev
03-Oct-2008	A-/Watch Neg
02-Mar-2009	A-/Negative

Chair WARREN. That was impressive. Thank you, Mr. Clark, to be able to take those last pages and put them together in a sentence.

Mr. CLARK. I knew the important line.

Chair WARREN. That's right. Mr. Moriarty, could you give us your opening remarks, please, sir?

STATEMENT OF MICHAEL MORIARTY, DEPUTY SUPERINTENDENT FOR PROPERTY AND CAPITAL MARKETS, NEW YORK STATE INSURANCE DEPARTMENT

Mr. MORIARTY. Surely. Pleased to. Thank you, Chair Warren and other Members of the Congressional Oversight Panel, for the opportunity to present any information the New York Insurance Department can assist in fulfilling your important charge.

There's some broad points I'd like to make. Number one. AIG Financial Holding Company is not regulated by state insurance regulators. The state insurance regulators are charged with regulating the insurance operating entities here in the United States.

In that realm, our job is to make sure that policyholders are treated fairly and that the insurance that they purchase to protect themselves will be paid by the insurance company when legitimate claims are put on the table.

Number two. The AIG crisis was the primary result of the credit default swaps issued by an entity that was, for all intents and purposes, an unregulated derivative shop that traded on the rating of AIG as a whole.

During the crisis, the Fed's main concern was not the collapse of the insurance companies which we don't believe would have happened, but AIG Financial Products had CDS, had futures, had other derivatives with many of the major commercial banks and brokerage firms. The failure to perform on these transactions would have a systemic impact on the worldwide economy, especially since the counter-parties to AIG Financial Products were already reeling from the failure of Lehman, the problems with Bear Stearns, and the extreme distress of the other financial institutions.

The aggressiveness of AIG's bullish outlook on the residential mortgage market did bleed into the insurance companies in the form of the securities lending. When the size of the securities lending program in the life insurance companies became known to the insurance companies in terms of its size, which was probably in the beginning of 2007, we, with other states, worked with AIG to begin to wind down the securities lending in an orderly fashion and did go from a high of $76 billion in the beginning of 2007 down to $58 billion right before the implosion of AIG in September of 2008.

The crisis caused by Financial Products did spook the borrowers of the securities lending program and they would not let the borrowings roll over as they had done in the past and instead required that the AIG return the cash collateral that was provided for them.

AIG had invested a lot of that cash collateral in residential mortgage-backed securities which were underwater and fairly illiquid and would have taken a significant loss at the life insurance companies if those collateral calls were made.

Once the $85 billion federal facility was established by the Fed, AIG did take advantage of that and use some of it, $17 billion worth, to pay back some of the borrowers of the securities, but the remainder of the lending portfolio remained kind of an albatross around AIG as a going concern.

Maiden Lane II was formed in December 2008 to effectively end the lending program at the AIG life insurance companies. Now for the $19.2 billion that was provided by the Federal Government for approximately $39 billion in par value residential mortgage-back securities, again, they are being paid back and by all indications they could make a profit on it.

I think it's important to remember that credit default swaps and securities lendings are different transactions. In a securities lending program, the borrower posts collateral. If you do not return that collateral, they will keep the securities that they borrow. So AIG was going to suffer a loss on the securities lending programs and it's a different transaction than a credit default swap.

Quickly, in response to our oversight of the AIG insurance companies, as all states do, we review insurance financial statements and other ancillary documents that are furnished by our domestic insurance companies. We do on-site examinations and regular meetings with the management.

At the time of the crisis AIG had 71 licensed insurance companies in the United States. Seven of those were domestic property/casualty insurance companies and three of those were life insurance companies.

On Friday we did get the call from the CFO of AIG that a downgrade was imminent and it would have drastic ramifications. A team of New York Insurance Department high-level representatives were sent to the AIG office.

It was during that weekend that the proposal to allow the property and casualty insurers to effectively swap $20 billion of liquid assets with some of the residential mortgage-backed securities were put on the table. I just think it's important to note that there were conditions to this and that there was capital provided by outside investors and that the life insurance companies be put underneath the P&C company, effectively becoming subsidiaries of the P&C companies.

[The prepared statement of Mr. Moriarty follows:]

TESTIMONY

TO THE CONGRESS OF THE UNITED STATES

CONGRESSIONAL OVERSIGHT PANEL

HEARING ON

AMERICAN INTERNATIONAL GROUP

BY DEPUTY SUPERINTENDENT MICHAEL MORIARTY

NEW YORK STATE INSURANCE DEPARTMENT

WEDNESDAY, MAY 26, 2010

DIRKSEN SENATE OFFICE BUILDING ROOM 342

I would like to thank Chair Elizabeth Warren and the other members of the Congressional Oversight Panel for providing the New York Insurance Department the opportunity to testify today at the hearing on the assistance provided to the American International Group.

My name is Michael Moriarty and I am Deputy Superintendent for Property Insurance and Capital Markets. I have been asked by New York Insurance Superintendent James Wrynn to testify on behalf of the Department because the events you are reviewing occurred well before he took office in August 2009.

You have asked me to discuss our regulatory role with AIG's insurance subsidiaries both before and after the rescue of the company in September 2008 and our participation in the rescue and in events since then.

Before I address those questions, I would like to make a couple of broad points that I think are essential context for understanding what happened at AIG. Please note that when I speak of AIG, I am referring to the parent company, which was an international financial services company not regulated by the state insurance departments. I am only discussing AIG's insurance companies when I state that explicitly.

First, the crisis for AIG did not come from its state regulated insurance companies. The primary source of the problem was AIG Financial Products, which had written credit default swaps, derivatives and futures with a notional amount of about $2.7 trillion, including about $440 billion of credit default swaps. Losses on certain credit default swaps and collateral calls by global banks, broker dealers and hedge funds that are counterparties to these credit default swaps were the main source of AIG's problems.

The main reason why the federal government decided to rescue AIG was not because of its insurance companies. Rather, it was because of the systemic risk created by Financial Products. There was systemic risk because of Financial Products' relationships and transactions with virtually every major commercial and investment bank, not only in the U.S., but around the world.

Second, just as AIG was overly aggressive in seeking profits from credit default swaps in its Financial Products unit, it was also overly aggressive in its securities lending program, which was operated centrally by the parent company for its insurance companies. Many insurance companies and other financial institutions use securities lending, but none had the severe problems that AIG had.

State regulators identified the problems in the securities lending program well before the crisis and were working with the company to unwind it in an orderly fashion. It was the crisis caused by collateral calls on the credit default swaps that made a continuation of an orderly reduction impossible. While there is no question that the insurance subsidiaries would have had losses from the program, the losses were manageable and would not have made the insurance subsidiaries as a group insolvent.

Third, the federal rescue of AIG was possible because there were strong operating insurance companies that would enable the federal government and taxpayers to be paid back. The reason why those insurance companies were strong is because state regulation walled them off from non-related activities in the holding company and at Financial Products.

In most industries, the parent company can reach down and use the assets of its subsidiaries. With insurance, that is greatly restricted. State regulation requires that insurance companies maintain healthy reserves for policyholders' claims backed by investments that cannot be used for any other purpose. That is why policyholders were and continued to be protected.

Now, let me turn to your specific questions. The first is the nature of the role of the New York Insurance Department regarding AIG prior to September 18, 2008.

Before the crisis, AIG was a huge, global financial services holding company that did business in 130 countries. At that time, AIG had 71 U.S.-based insurance companies. In addition to those US based insurance entities, AIG had 176 other financial services companies, including non-U.S. insurers.

State insurance departments have the power and authority to act as the primary regulator for the insurance companies domiciled in their state. So the New York Department is primary regulator for only those AIG insurance companies domiciled in New York. At the time of the crisis, the New York Insurance Department was the primary regulator for 10 of AIG's 71 U.S. insurance companies: American Home Assurance Company, American International Insurance Company, AIU Insurance Company, AIG National Insurance Company, Commerce and Industry Insurance Company, Transatlantic Reinsurance Company, American International Life Assurance Company of New York, First SunAmerica Life Insurance Company, United States Life Insurance Company in the City of New York, and Putnam Reinsurance Company. AIG's New York life insurance companies are relatively small. The property insurance companies are much larger. Other states act as primary regulator for the other U.S. insurance companies.

On the whole, prior to September 2008, we were regulating AIG's insurance subsidiaries as we normally regulate insurance companies under New York law, including regular reviews of financial information, on-site examinations and discussions with management.

However, starting in 2006 and 2007, New York and other state regulators began to more closely supervise the securities lending program.

Securities lending is an activity that has been going on for decades without serious problems. Many, if not most, large financial institutions, including commercial banks, investment banks and pension funds, participate in securities lending. Securities lending involves financial institution A lending a stock or bond it owns to financial institution B. In return, B gives A cash or securities worth generally about 102 percent of the value of the security it is borrowing. (In the case of AIG the collateral was cash which AIG then invested in other securities.) A still owns the security and will benefit from any growth in its value. And A invests the cash to gain a small additional amount.

Problems can occur if B decides it wants to return the security it borrowed from A. A is then required to sell its investment to obtain the cash it owes B. Generally, in a big securities lending program, A will have some assets it can easily sell. But if many of the borrowers return the securities and demand cash at the same time, A may not be able to quickly sell enough assets to obtain the cash it needs or may have to sell assets at a loss before they mature.

AIG securities lending was consolidated by the holding company at a special unit it set up and controlled. This special unit was not a licensed insurance company. As with some other holding company activities, securities lending was pursued aggressively rather than prudently. AIG maintained two securities lending pools, one for U.S. companies and one for non-U.S. companies. At its height, the U.S. pool had about $76 billion. The U.S. security lending program consisted of 12 life insurers, three of which were from New York. Those three New York companies contributed about 8% of the total assets in the securities lending pool.

The program was invested almost exclusively in the highest-rated securities. Even the few securities that were not top rated, not triple A, were either double A or single A. Today, with the perfect clarity of hindsight, we all know that those ratings were not aligned with the market value of many mortgage-backed securities, which made up 60 percent of the invested collateral pool.

The New York Department and other state regulators were aware of the potential stresses at the AIG securities lending program and was actively monitoring it and working with the company to deal with those issues. Those efforts were working, but were thwarted by the Financial Products crisis in September 2008.

As early as July 2006, we were engaged in discussions about the securities lending program with AIG. In 2007, we began working with the company to start winding down the program.

Unfortunately, the securities lending program could not be ended quickly because beginning in 2007 some of the residential mortgage securities could not be sold for their full value. At that time there were still few if any defaults, the securities were still paying off. But selling them would have involved taking a loss.

Still, we insisted that the program be wound down and that the holding company provide a guarantee to the life companies to make up for any losses that were incurred as that happened. In fact, at the insistence of state regulators, the holding company provided a guarantee of first $500 million, then $1 billion and finally $5 billion.

In 2008, New York and other states began quarterly meetings with AIG to review the securities lending program. Meanwhile, the program was being wound down in an orderly manner to reduce losses. From its peak of about $76 billion, the U.S. security lending pool had declined by $18 billion, or about 24 percent, to about $58 billion by September 12, 2008.

At that point, the crisis caused by Financial Products caused the equivalent of a run on AIG securities lending. Borrowers that had reliably rolled over their positions from period to period for months began returning the borrowed securities and demanding their cash collateral. From September 12 to September 30, borrowers demanded the return of about $24 billion in cash.

The holding company unit that managed the program had invested the borrowers' cash collateral in mortgage-backed securities that had become hard to sell. To avoid massive losses from sudden forced sales, the federal government, as part of its rescue, provided liquidity to the securities lending program. In the early weeks of the rescue, holding company rescue funds were used to meet the collateral needs of the program. Eventually the Federal Reserve Bank of New York created Maiden Lane II, a fund that purchased the life insurance companies' collateral at market value for cash.

There are two essential points about this. First, without the crisis caused by Financial Products, there is no reason to believe there would have been a sudden increase in demands by borrowers to return securities and retrieve their cash. Instead, we would have continued to work with AIG to unwind its program and believe that any losses would have been manageable.

Second, even with no federal rescue of the securities lending program, our detailed analysis indicates that the AIG life insurance companies would not have been insolvent. Certainly, there would have been losses, with some companies hurt more than others. But we believe that there would have been sufficient assets in the companies and in the parent to maintain the solvency of all the companies. Indeed, before September 12, 2008, the parent company contributed slightly more than $5 billion to the reduction of the securities lending program.

Our involvement with AIG changed substantially on Friday, September 12, 2008. The immediate spark for the crisis was the sudden decision by the credit rating agencies to downgrade AIG without waiting to see the results of its restructuring only two weeks away. The company learned about this decision on or about Friday, September 12. The downgrade would require AIG to post additional collateral against its credit default swaps and against its guaranteed investment contracts. AIG's initial estimates were that it would need about $18 billion in cash to post collateral. While AIG had assets, including its insurance companies, worth many times this amount, the assets were not liquid and could not be used to solve the collateral problem. Thus it appeared initially that the company had a liquidity problem. That is, it was not short of capital, but it was short of cash because it could not turn most of its assets into cash quickly enough.

The Department received a call from AIG's then general counsel and chief financial officer informing us of the company's serious and immediate liquidity problem, and asking for assistance. We had a conference call with AIG leaders Saturday morning and then went over to their office for the remainder of the weekend to provide assistance and be in a position to expedite the consideration of any regulatory actions that might be needed to get through the crisis.

The Department worked with AIG to develop solutions, vet proposals and find transactions that would stabilize AIG while protecting policyholders. As a result, we developed a proposal that the Governor announced on Monday, September 15. This plan would have allowed AIG to temporarily access about $20 billion of excess surplus assets in its property/casualty insurance companies while fully protecting policyholders.

There are some key points that are important to understand. The proposal was just that, a proposal that we agreed to consider. It was never finalized. Agreement was dependent on conditions that would guarantee the protection of policyholders, including a substantial investment from capital providers and a restructuring of the US operations that would essentially make the life insurers subsidiaries of the property/casualty operations. Thus the $20 billion liquidity provided would be one part of a total solution of the company's problems. At the point at which we were discussing this proposal, everyone thought that AIG only had a temporary cash flow problem. When it became clear after a few days that the problem was much bigger, our proposal was dropped and replaced by the government rescue.

I can provide more detail if you like, but the basis of the proposal was that AIG had plenty of assets, but could not turn them into cash quickly enough to meet the demands for collateral. Also, AIG's property insurance companies had excess surplus, that is, surplus above what was legally required to protect policyholders. We were willing to consider allowing the parent company to temporarily borrow more liquid assets such as municipal bonds from its property insurance subsidiaries in exchange for less liquid assets, but only if the less liquid assets were worth more than the municipal bonds.

We were very carefully vetting the assets being purchased by the property insurance companies to ensure they were of high quality. We were also being careful to make sure that the amount of securities remaining in the companies was sufficient to pay all claims, meet statutory risk-based capital requirements and still have billions of dollars in extra surplus.

When it became clear that the company needed more money and that the original plan was not feasible, the Treasury asked two banks to try to form a private syndicate to raise the necessary funds. At that point, the proposal was still an essential part of the rescue. Eventually, it became clear that no commercial private sector rescue was possible. At that point, the Treasury proposed the $85 billion bridge loan and our proposal was no longer needed.

Staff of the Department participated in meetings at AIG over the weekend of September 12 through 14 and then in the meetings at the Federal Reserve that eventually resulted in the rescue. We were involved in meetings and informal discussions about different ideas and provided expertise on insurance issues.

Following the rescue, New York's involvement with the parent company has been substantially reduced. Those issues have been handled by the Federal Reserve. However, the New York Insurance Department co-chaired a 50-state task force created by the National Association of Insurance Commissioners to monitor the financial condition of the insurers, oversee and facilitate the sale of any insurance operations and coordinate state regulatory responses. One of the main purposes of the task force is to protect policyholders by ensuring that insurance operations are purchased by stable, responsible entities capable of operating them successfully. And we will also ensure that the regulatory approval process is efficient and does not hold up transactions.

Did AIG present systemic risk and was a rescue necessary? Yes, but the source of the problem was the risky and unregulated activities engaged in by AIG Financial Products. AIG's insurance companies, even with the problem from securities lending, did not pose systemic risk.

Credit default swaps, which were at the core of AIG's problems, were specifically exempted from federal or state regulation. That meant AIG Financial Products could sell a promise to pay without holding appropriate reserves to guarantee its ability to deliver on that promise. AIG Financial Products sold the swaps to banks and other financial institutions around the world. And some of those financial institutions used the swaps to evade their own capital reserve requirements. Thus, when Financial Products was unable to pay on its promises, that created the risk of substantial losses and other pressures on a broad range of financial institutions and thus, created a potential systemic spread of its problems.

AIG's insurance subsidiaries, however, were required by state regulation to hold reserves to guarantee they would deliver on their promises to policyholders. Thanks to that state regulation, AIG could not touch those insurance subsidiary assets when the bill came due on Financial Products' bad bets. Whatever the AIG insurance companies' losses on securities lending, those losses should not have created serious problems for other financial institutions, which were protected by the fact that they held and could keep the securities they borrowed if AIG could not return the collateral they provided.

Thank you for your time and I am happy to answer any of your questions.

Chair WARREN. Very helpful. Thank you, Mr. Moriarty.

So I want to be clear, if I can, about setting the stage a little bit for this panel. If you've read the testimony from the Fed and we've had multiple meetings now with the Fed, they basically have made the argument that negotiation was simply not possible, and that it was not possible because negotiation under these circumstances, particularly in the case of rapid dissent, is never possible, that ratings downgrades would have triggered multiple cross-defaults and contagion throughout the market, and that the insurance regulators would have seized the insurance companies and therefore destroyed the value of the entity and possibly caused losses to the insured, people around the country.

So the reason we asked this panel to come is that we wanted to probe that claim. That's what we're here about, to just push back on this alternative. So I at least am going to start that. I want to start that, if I can, with you, Mr. Clark.

Following the bailout of a 100 cents on the dollar—because the Fed has described and they describe in their written testimony, it was totally binary. It was either a full bailout with full payment to everyone or it was no help, bankruptcy, and collapse, as they saw the alternatives, and so what I want to ask here is following the Fed bailout, there was still a ratings downgrade, right, of—I think I'm reading—you have some slight readjustment. No?

Mr. CLARK. You're saying following the——

Chair WARREN. The actual bailout.

Mr. CLARK [continuing]. $85 billion, the initial——

Chair WARREN. That's right.

Mr. CLARK. Okay.

Chair Warren: Right. You have some change in how you're rating AIG?

Mr. CLARK. Yes. On September 17, following the change, we actually—we had lowered the rating on the Monday, the 15th, to A Minus. On the Wednesday, we maintained the rating at A Minus. We revised the credit watch, which indicates the direction of possible movement from negative because the trend was clearly negative on Monday to developing on Wednesday, that implied it could go up or down, but we were still sorting out the impact of this facility.

Chair WARREN. Got it. So government help—you had to evaluate it, evaluate what its impact was going to be, its size, the likelihood it would be there in the future, and I would assume from the ratings you gave, it was not guaranteed that it would be there forever; otherwise, it would have gone back up to AAA.

Mr. CLARK. Correct.

Chair WARREN. So you were trying to evaluate that, and as we all know, AIG ultimately paid every creditor 100 cents on the dollar and has continued to do so to this day.

So here's my question. I also read in your testimony that right now AIG gets a five notch improvement because of your assessment of the value of the government assistance.

Mr. CLARK. Right.

Chair WARREN. If AIG had had a negotiated settlement of some kind with government assistance, with private assistance, and with a haircut to the creditors of some dollar amount, would they have

been better off than if they had paid a 100 cents on the dollar or would they have been worse off going forward into the future? What would have been their financial picture? If you can pay less on your debt, are you better off than if you pay a 100 cents on the dollar on your debt?

Mr. CLARK. Right. And it's difficult for me to explain in the hypothetical, but I know in our ratings criteria on distressed exchanges, which we shared with the Panel staff previously, it speaks to the fact that we would consider a distressed payment of less than what is owed to be a default or a selective default——

Chair Warren. Yes.

Mr. CLARK [continuing]. Under our ratings criteria. However, it is true that in many cases following a restructuring, following either a distressed exchange or a series of distressed exchanges, that the credit condition could be better than before the time of the exchange.

Chair WARREN. Okay. Good. That was the part I needed, and then if one combined this distressed negotiation with substantial funding from some combination of private and public sources, what would the credit rating look like going forward?

Mr. CLARK. I can't speak to the hypothetical without knowing the terms, but it is possible that it could have been similar, better, or worse.

Chair WARREN. Okay. So I'll ask it then just the other way and then I'm through, and that is was it a foregone conclusion that their ratings would be completely wiped out if they paid something less than a 100 cents on the dollar, if they had secured both government and private money going forward?

Mr. CLARK. Under the criteria that we use, we look to was the counterparty paid what they were owed, and was it done in a distressed situation, that is, to save the company from insolvency or bankruptcy?

If there was a modest discount, such as relative to interest rates and the time value of money, that would not have necessarily caused a default, but those are factors the rating committee would weigh in determining is the exchange distressed or isn't it in determining what the impact on the ratings would be.

Chair WARREN. Okay. Along with how much money is available going forward, right?

Mr. CLARK. Absolutely.

Chair WARREN. All right. Good. That's helpful. Thank you very much.

Mr. McWatters.

Mr. MCWATTERS. Thank you. Let me follow up on that, Mr. Clark. If there's a distressed exchange at the same time the Government has made commitments, I mean has by this time, by November of 2008, put in so much money that it seems unlikely the Government is going to walk away from that, so at that point in time it's not that AIG needs to do these distressed situations in order to save money for liquidity because it has Uncle Sam providing the liquidity. It's in effect doing the distressed transaction in order to treat the taxpayers more fairly.

I mean, does that resonate with you at all?

Mr. CLARK. I believe so. I'm not sure I'm hearing the question.

Mr. MCWATTERS. Well, the question is we're going to cut a deal. We're going to cut a haircut, but the reason we're cutting a haircut is not to save money for liquidity of AIG because that's been assured by the taxpayers, by the Federal Reserve Bank already putting in $85 billion, it's unlikely they're willing to walk away. We're going to cut a haircut because it's fair to the taxpayers. The taxpayers are putting in the money to take these guys out.

Mr. CLARK. Okay. Now understand the basis for our ratings. We've published a view that the rating, absent the federal support on AIG today, would be BB and suffice it to say a year ago it would have been worse than that. However, it's an A Minus rating with the benefit of the government support. That is based on a view that the support that exists is available to allow the company to meet its financial obligations.

So it is fair to say that our rating committee would look at a situation where AIG has significant funding but isn't able to use it to satisfy its financial obligations in whole, be it for the credit default swaps or other obligations.

We would have to form an opinion, well, will that funding be available to future financial obligations to pay them on time and in whole, and so those are all factors that we'd have to evaluate in determining the appropriate rating.

As it's been to date, the credit facility has been there for essentially all of the financial obligations as needed. If that were not the case, we'd re-evaluate the value of the support in the rating.

Mr. MCWATTERS. Okay. So this is not a simple situation, that if there is one of these distressed exchanges, therefore the wall falls down. Okay.

Mr. Bienenstock, I read your testimony with great interest. You seem to present an elegant alternative to what happened and I think you were about to get into that in your opening remarks. Would you care to elaborate?

Mr. BIENENSTOCK. Sure. Once the Government came forward with the $85 billion facility and secured it with everything of value, so far as I can tell, the dynamics changed. Bankruptcy was now off the table. Everything I've read in the public record so far has been the Fed, et cetera, didn't want to threaten a bluff about bankruptcy but now the strength of AIG would say we're not voluntarily filing and you can't involuntarily file because we have over 30 million creditors and we're paying 99.999 percent of them on time in full.

So what is the remedy now of those creditors you think who, as a matter of equity to the taxpayers, should provide a discount? The remedy is not a lot. They can go at most to state court at the cost of great public notoriety. Some of these entities had government assistance separately. Other of these entities, for instance, purchased Lehman Brothers for $250 million, plus the appraised value of the real estate it received, and then had to acknowledge in its SEC filing a $3.5 billion profit on the purchase.

I'm saying as a matter of common sense I don't think these entities were in a position to say to the U.S. Government no, we won't make some moderate but meaningful concession in exchange for taking us out entirely of these credit default swaps. Remember, that's what was done. They were paid 100 cents, and we could always go or AIG could always go to the rating agency and say, look,

we're only asking for concessions from businesses we're winding down. We're not doing more of this foolishness and as far as all our insurance companies, all ongoing businesses, we have the facility there. It's available for payment in full on time.

Mr. MCWATTERS. Okay. Thank you.

Chair WARREN. Mr. Silvers.

Mr. SILVERS. Mr. Bienenstock, your response just then, when in your view—I mean, let me first get this straight. This is your profession, is it not, giving advice in these types of situations, these highly-pressurized insolvency crises?

Mr. BIENENSTOCK. Yes, Mr. Silvers.

Mr. SILVERS. All right. When are you suggesting that the approach that you just outlined would have best been deployed by the Federal Reserve?

Mr. BIENENSTOCK. Once they—after—the first thing was to stabilize, to provide the $85 billion facility. Then in discussions with those people who should equitably give concessions over the next several weeks, months. They took until November and December to close their deals. So they had plenty of time to do this.

Mr. SILVERS. But essentially as soon as—you're saying as soon as it had been made clear to the markets, in general around the systemic risk issues and the like, that a simple Chapter 11 filing was not happening?

Mr. BIENENSTOCK. Well, yeah. To give you a bit more of a professional response since you said this is my profession——

Mr. SILVERS. Right.

Mr. BIENENSTOCK [continuing]. What I would say to the client is after you've taken care of your lifelines, now who were AIG's lifelines? First, speak to Mr. Clark to explain exactly what's going on, why this will improve creditworthiness going forward and not endanger others, after explaining to employees, customers, et cetera, here's how we're going forward.

Then, once you've got your lifelines intact, once the Government, which is the revolving credit facility lender, knows what you're doing, now's the time to do it.

Mr. SILVERS. All right. Mr. Moriarty——

Mr. MORIARTY. Yes?

Mr. SILVERS [continuing]. You—it has been represented to us, and I think you heard some of it this morning, that absent what the Fed did and precisely the way it did it, there would have been a crisis for the insurance subsidiaries and their ability to maintain their business, pay their obligations, and the like, a crisis that's so serious that it was absolutely necessary to rescue the parent in the manner the parent was rescued in order to avoid such an outcome.

I think there is a kind of implicit analysis made by the Federal Reserve and the Treasury in saying so, that whatever problems might have arisen in the insured subsidiaries, they would have been beyond the ability of the state insurance regulation and guarantee system to manage.

What is your response to both those propositions and specifically what was the view of the New York State Insurance regulators and the—I forget the term of art now, but there's a sort of coordinating body of state insurance regulators.

What was your view during the so-called Lehman weekend around these questions?

Mr. MORIARTY. Sure. I'd like to bifurcate my answer into two parts. We do not believe that the existing policyholders of the AIG property and casualty companies for sure or even the life insurance companies would have suffered any losses should there—would there have been a bankruptcy of the AIG holding company system.

State insurance laws through the McCarran-Ferguson Act clearly give the states the authority to regulate insurance companies and to rehabilitate and liquidate them, which is a different process from a bankruptcy. So we would maintain that the existing policyholders would have been made whole, even if there was a bankruptcy.

The life insurance subsidiaries would have suffered significant losses and the cushion, which we call surplus, which is effectively capital between assets and liabilities, would have taken a severe hit, but we still think it would have been positive.

Now, when we look at AIG as a going concern that would have been a problem. Clearly, the reputational risk of bankruptcy at the holding company level could shake the confidence of the policyholders on the property and casualty side. Much of the business is placed by three big brokers. If they had blacklisted AIG for all intents and purposes as a going concern, they would be gone; the same on the life insurance side. So to the extent that there was a bankruptcy, there would be a concern as to the ability of the AIG companies, the insurance companies to proceed as a going concern.

Now that being said, there are options. There could be sales of the book of business to existing insurance companies. There could be transfers of certain parts of the books to other companies. So, I mean, there could have been some money moved around. There could have been rebranding. I mean, it's hard to speculate, but clearly the bankruptcy would have had a troublesome impact.

Mr. SILVERS. Well, I'm not asking you to speculate but just to remember. Did you all communicate a view that—did your department or did, to your knowledge, other insurance regulators communicate a view to the Federal Reserve or to the Treasury during this period that the parent of AIG had to be rescued in the manner that it was rescued?

Mr. MORIARTY. No, we didn't.

Mr. SILVERS. Did you communicate any view at all to the Fed, the New York Fed or the Treasury?

Mr. MORIARTY. When we were at the Fed, beginning Saturday morning, I think it's clear from Governor Patterson's offer, New York and Pennsylvania at the time, which were the two lead regulators of the property and casualty companies, did see an opportunity to basically lend AIGFP $20 billion in more marketable securities and we would take over the less liquid residential mortgage-backed securities.

We did that again on the premise that, number one, there would be new capital provided in AIG, Inc., by outside investors and, number two, that the life insurance subsidiaries and thus the value of the life insurance subsidiaries would be put underneath the P&C companies.

So we were looking for, I guess you'd call it, a private savings but it had to be a global solution. It had to be part of a solution that would allow AIG to continue making its way through the financial crisis. Anything short of that I think we'd be highly reluctant to let any money come out of the property and casualty insurance companies.

Chair WARREN. Thank you. Professor Troske.

Dr. TROSKE. Thank you. I guess maybe I'll start with you, Mr. Bienenstock, and you can help because one of the things I haven't understood about AIG in particular is the claim, the claim that seems to be made that had AIG entered bankruptcy, they would have simply ceased operating which seems somewhat different than most companies that actually do enter bankruptcy if recent experience of Chrysler and General Motors and a variety of airlines is any example. Companies often do enter bankruptcy and workers get up the next morning, go to work and continue to produce products.

Do you have any sense of why, what's different about AIG in this instance and Chrysler or General Motors or, you know, United Airlines?

Mr. BIENENSTOCK. I think so. The clear distinction is that trading operations can only trade when there's confidence in the marketplace. That's why Enron's trading ceased before it filed its Chapter 11 petition. That's why AIG's would also.

Dr. TROSKE. When you say trading, you mean their securities trading, not their insurance business?

Mr. BIENENSTOCK. Not—no. I'll get to that.

Dr. TROSKE. Okay.

Mr. BIENENSTOCK. The insurance companies are subsidiaries that are ineligible to go into bankruptcy. They could be seized by state regulators or not, but they would not technically be in bankruptcy themselves. They might be in state proceedings, but at the holding company, the various non-insurance operations, the Bankruptcy Code has special provisions for derivatives trading that allows counterparties to terminate and to liquidate. That's the thing that doesn't operate.

The rest of the operations that are, if there are any, more like the airlines, the auto companies, they can continue. I don't think AIG had many of that type of operation.

Dr. TROSKE. Okay. And, Mr. Moriarty, you made the claim, and this is the claim that's often made, and it was a claim that was made of auto companies, of why they shouldn't enter bankruptcy because the warranties all of a sudden, you know, who's going to buy a car from a bankrupt car company because, you know, you got no guarantee that you could—you know, they were going to be around to protect the warranty. Of course, the warranties can often be provided by third party people and do it all the time.

And, so again, when I look at it as an economist, if there's value being produced, somebody's going to produce that value because they want to make a profit in a market-based economy. So if AIG had valuable entities, even if part of the company went bankrupt, somebody's got to be able to step up and continue to provide the services they do, be it maybe under a different name.

Does that seem like a reasonable outcome?

Mr. MORIARTY. I think it is. Again, there are reasons that the state insurance laws wall off the assets and the liabilities of the insurance entities from all the non-insurance entities, simply because the assets are meant to pay the policyholder claims.

AIG, as one of the former panelists indicated, employed over a 100,000 people worldwide. There were less than 500 people employed by AIG FP which arguably brought down or caused severe stress to AIG. AIG clearly had a lot of talent in terms of its core businesses which were property and casualty insurance and life insurance, and those subsidiaries could have been sold, the business could have been taken by other entities.

You know, I think there were options. I think the policyholders, number one, would have been paid and, number two, probably could have gotten new coverage, whether from a company that was sold by AIG or commercial accounts that just went to AIG.

I do think that one of—two other concerns that we were most concerned about with respect to AIG were, number one, that they would lose customers because of the reputational risk and that they would lose good people because of the reputational risk. Those are concerns that, you know, still remain with us.

Dr. TROSKE. But that's no different than any business. I mean, presumably, you know, do you want to fly on an airline that's bankrupt? I mean, when I get on an airplane, I sort of do you depend on the person driving it? I got to think that those concerns may be even more paramount. I think I'm more concerned when I get on an airline than about my life insurance policy.

Mr. MORIARTY. Oh, again, in insurance, it is a promise to pay.

Dr. TROSKE. It is, yes.

Mr. MORIARTY. They don't make widgets and they don't make cars.

Dr. TROSKE. An airline is a promise to get you there alive.

Mr. MORIARTY. Yes, correct, correct.

Dr. TROSKE. Okay.

Mr. MORIARTY. But I understand your point, and I do agree with you.

Dr. TROSKE. So let me—one more question. I'm sorry. Yeah. I remember. Mr. Clark. So we've discussed today about the combination of private sector/public sector, you know, the financial support for AIG.

How would that have been affected had the Federal Government put in less money, private sector put in more? Can you speculate a little? Would that have affected the ultimate rating of AIG in your mind?

Mr. CLARK. No. We'd be looking to the outcome in terms of AIG's sources of liquidity, its ability and willingness to meet its obligations when due, whether that funding was private, public, or a mixture. That wouldn't have affected our rating.

Dr. TROSKE. Okay. Thank you.

Chair WARREN. Thank you. Good. Thank you. Mr. Bienenstock, I think you were in the room to hear Mr. Baxter explain the role of the Fed in the Long-Term Capital Management negotiations, and I think his words were that the Fed explained to the creditors what was in their own best interests in reworking what needed to be done.

Can you talk about what kind of conversation might have occurred with the counterparties to AIG and what was in their own best economic interests? I think you hit this, but I just want to make sure we got this one nailed down.

Mr. BIENENSTOCK. I'm sensitive to the concern of the Fed not to use its regulatory power in a debtor/creditor capacity where they're serving as a lender. So I'll phrase it as to what any 800-pound gorilla lender, such as one of the big banks or, in this case, the Fed, would have said to the other creditors and the answer is we're taking a lien on everything. In this case, it's unique, as I said, because bankruptcy was taken off the table for other reasons.

We're taking a lien on everything. Bankruptcy is not an option. We're willing to do a transaction with you if you make a fair concession for the benefit of all taxpayers because if not for our money, you would have taken a big loss on us for the most part, and what are your options? Your options are to do nothing, in which case we won't do a transaction, you won't have more money from us, we won't buy out your CDO. Your options are to go to state court. We'll argue awhile about whether you're entitled to more collateral and how much more and by that time the underlying dynamics will have changed.

But at the end of the day, you're not going to have a remedy that really gets you value because we're sitting here with an $85 billion lien and you'll be in the newspaper and on the news every night trying to frustrate the United States Government's effort to save the global financial system. Now what would you like to do?

Chair WARREN. Okay. I think we have that. Can I ask you one other that comes out of your testimony, your written testimony, and that is you talk about shared pain, the principle of shared pain and bankruptcy? Can you just elaborate a bit on that?

Mr. BIENENSTOCK. Sure. We all grow up being told that when we make a promise, we keep it. When we give our word, we keep it. And one of the things that makes bankruptcy counterintuitive and, frankly, offensive to a lot of lay persons is that in bankruptcy, if a debtor breaks one promise, takes one creditor and doesn't pay it, but pays its others, that's pretty unfair. So the more fair procedure is to break all its promises and to share the pain equally across all the creditors. That's where bankruptcy is contrary to most of our notions of substantial justice.

So sharing the pain is the way of the creditor being hurt or the lender coming up with innocent taxpayer money, saying it's unfair that we're taking all the pain, you're getting paid 100 cents for a business that couldn't have paid it if we had not come to the rescue. You have to share equally because that's fair.

Chair WARREN. Okay. Thank you very much, Mr. Bienenstock. I'm through.

Mr. McWatters.

Mr. MCWATTERS. Thank you. Mr. Bienenstock, when I was reading your written submission, again I was struck by the elegance of it, rather the simplicity of it, which made me think, well, why wasn't this done, why didn't other people think of this?

Then I got to page four and you say on page four, you say, "Additionally, the Federal Reserve Bank of New York retained an outstanding law firm and attorney for its work, but the law firm is

identified with representing Wall Street institutions, such as JPMorgan, and it would be awkward for it to devise strategies to obtain concessions from those institutions."

Could you help me understand that?

Mr. BIENENSTOCK. Sure. In this case, I think it sounds to me because of the exigencies of time, the law firm that was probably familiar with the situation, other than AIG's own law firms, was the law firm being used by JPMorgan and Goldman Sachs to try to come up with a private solution which I heard earlier, I think, was a Monday, September 15, effort.

Mr. MCWATTERS. Yes.

Mr. BIENENSTOCK. So since they had immersed themselves in the documents, I suppose at least that was one factor why, with waivers granted and full disclosure and all the rest, this was all done properly, I'm sure, that JPMorgan and Goldman Sachs surrendered their counsel effectively to the Federal Reserve Bank of New York.

Those counsel, they are outstanding, as I said, both as a firm and the individual who was leading it, but they are known to represent the Wall Street interests, not that they don't represent others, but they're synonymous in the restructuring industry with representing Wall Street interests.

So it would be awkward, as I said, for them to concentrate on, "well, here's how we might get concessions from counterparties", who are their clients in many other matters.

Mr. MCWATTERS. Well, I assume this is particularly true, given that two weeks from now they will be back representing JPMorgan and JPMorgan may say, "yeah, you're the guy that just came and represented the Fed and came to us and beat us up for a concession."

Mr. BIENENSTOCK. Well, and I want to emphasize this was done, I think the Federal Reserve Bank of New York people said earlier, this was done with full waivers, et cetera. It was done totally properly and it's allowed to be done and it's often done.

In this case, I just think it put counsel in an awkward position and also you've heard there are a lot of explanations. I mean not everyone gives my analysis, certainly, maybe no one did, and there were a lot of explanations that were facile for people to latch on to why you should just pay all the creditors all the time.

Mr. MCWATTERS. Correct. One last question. If, on September 16, I came to you and retained you and said we've just given this entity $85 billion, this entity, AIG, $85 billion, and it's on a 180 days as a bridge. Can you work out a prepackaged bankruptcy of AIG, working with the insurance companies, the rating agencies, and the like, within a 180 days and reach resolution?

Mr. BIENENSTOCK. I would have told you less than a 10 percent likelihood. Let me just amend something I said before.

I did, before today, test with restructuring experts, both business and legal, the idea of getting concessions and I was surprised to find out I got unanimous buy-in to that.

On the prepack, the reason I'm saying less than a 10 percent likelihood is, as a matter of right, any creditor can ask for an examiner. God knows, there was a lot to examine here. I think that's what you're doing. That can take months or years. I would caution you that if you're doing the bankruptcy after the $85 billion re-

volver has been extended, that $85 billion is subject to restructuring in bankruptcy, like all the other debts.

Mr. MCWATTERS. Sure.

Mr. BIENENSTOCK. Prepackage is a term used most technically for making a deal with everyone in advance, going to court and asking for swift approval of the plan. It basically works when you have a small group of sophisticated parties or you're just paying everyone in full.

Here, if the decision had been made to pay everyone in full, then my answer of less than a 10 percent probability would change. I would say if you're going to pay everyone in full in that prepack, then yes, you can, more likely than not you can do it in a 180 days, but if you're not paying everyone in full, I would say the likelihood of dealing with millions of people who have guarantees for their insurance policies, thousands of other types of creditors, including derivative creditors, in six months, it's nearly impossible.

Mr. MCWATTERS. Okay. Well, thank you then, and that helps support your solution that you have in your paper.

Thanks.

Mr. BIENENSTOCK. Thank you.

Chair WARREN. Thank you. Mr. Silvers.

Mr. SILVERS. Mr. Clark, you, like Mr. Moriarty, have been assigned responsibility by our national government for much of what has happened here. By you, I mean your firm and the other credit rating agencies.

I want to offer you the opportunity to, if you dispute what's been said about the rating agencies by our other witnesses, to do so, but I want to also ask you a very specific question about a different way of thinking about the options available, which is, if, rather than rescuing the parent, all right, the Federal Reserve had chosen to make 13(3) lending available to subsidiaries on an as needed basis, would it have been possible to have maintained the same level of credit rating, by your agency and others that was effectuated by rescuing the parent.

And just to make this question a little bit more complicated, do you agree with Mr. Moriarty's assessment that the subs could have handled their problems around securities lending absent the problems of the over-the-counter derivative business at the parent level?

Mr. CLARK. That's complicated.

Mr. SILVERS. That's complicated. Well three distinct questions. One open ended, the second question is, could you have maintained the credit worthiness of the subs directly and let the parent go?

Or, have the parent have go through something like perhaps what Mr. Bienenstock was talking about? And thirdly, is Mr. Moriarty right, that the subs could have handled the securities lending problems without further assistance?

Mr. CLARK. Okay, I'm going to leave the open ended one on the table. But if the New York Fed had lent directly to the subsidiaries, I don't know that they had the authority to do that and I can't really speak to whether that would have helped the subsidiaries to maintain their credit ratings without understanding what the terms would have been.

Mr. SILVERS. Well let's just assume that we're talking about essentially what happened to the parent, a blank check under 13(3). And you can lend to anybody under 13(3), I think that's kind of what we've learned. But let's just—I don't want a legal opinion about whether the Fed had the authority. Let's just assume the Fed opened the spigot to the subs.

Mr. CLARK. Okay.

Mr. SILVERS. Could they have opened the spigot wide enough to maintain the credit rating of the subs?

Mr. CLARK. I presume that they could have. It's much, much more complicated when you look at the fact that by lending to AIG, they're sort of your filter to get money down to the subs. But when you talk about——

Mr. SILVERS. But they're a filter with a giant hole in it called credit default swaps.

Mr. CLARK. Of course, understood. But that was only one of the places that those funds coming from the New York Fed were going.

Mr. SILVERS. Right.

Mr. CLARK. And when you look at the literally hundreds, when you start looking globally, of regulated and unregulated subsidiaries of AIG, I think it would have been very difficult to get money to all of those.

In addition, you had cross guarantees between certain of the subsidiaries, both domestic and foreign, which most often went back to insurance companies regulated in New York or Pennsylvania, not always. It was a very complicated web of relationships really just necessitated by the complex global nature of the group.

Mr. SILVERS. So it was simpler to do it at the parent?

Mr. CLARK. It was much simpler to do it at the parent.

Mr. SILVERS. But you're not saying you couldn't have done it?

Mr. CLARK. I don't know that under their authority they could or could not.

Mr. SILVERS. Well I'm talking about——

Mr. CLARK. It would have complicated the task.

Mr. SILVERS. Right, it would have complicated the task, okay. Do you agree with Mr. Moriarty that the resources were available to the subs to deal with the securities lending problem?

Mr. CLARK. I think it's possible that they could have. I do think though if you look at what happened between September 15 and really the end of the year when the enormity of the financial crisis, the continued investment losses, not only on the securities lending program but on other investment holdings of AIG's insurance companies and many other insurance companies in the industry.

There was a drain there and AIG through its resources from the New York Fed did inject significant capital into the domestic life insurance companies. Could they without the drain of the CDS have handled that themselves given the continued decline of the financial markets, possibly, but it's difficult to say with any certainty.

Mr. SILVERS. One more question. Is it possible, in your opinion, for a major insurance player company to operate with a double B credit rating?

Mr. CLARK. It depends on the businesses that they're in. Assuming they're diverse——

Mr. SILVERS. Assuming a diversified range of businesses, life and property and casualty——

Mr. CLARK. It's possible.

Mr. SILVERS [continuing]. And investments?

Mr. CLARK. It's possible, and we see it in certain areas. Certain areas of insurance are more confidence-sensitive than others. When you look at some of AIG's businesses that were high net worth life insurance and annuities, those are very confidence-sensitive, vulnerable to runs on the bank in a severe stress.

And the large commercial insurance similarly, not a run on the bank risk, but very sophisticated purchasers of insurance who value credit and would be unlikely to purchase or renew business——

Mr. SILVERS. Double B is below the line, isn't it?

Mr. CLARK. Yeah, definitely. In most buyers' views it would be.

Mr. SILVERS. Mr. Moriarty, do you—I couldn't tell if you were agreeing or disagreeing.

Mr. MORIARTY. No, I disagree with my colleague. The commercial side of the business, whether it be on the property side or the high net worth individual are very rating sensitive and do due diligence in terms of the credit worthiness of the insurance companies that they're dealing with.

But for some personal lines, like auto, and homeowners, arguably they can write at the lower levels. But something below investment grade even would be difficult to write any extensive book of business.

Mr. SILVERS. I have one more question.

Chair WARREN. Quick.

Mr. SILVERS. I'll be quick. Mr. Bienenstock, can you help us understand, from your general knowledge of these markets and so forth. JPMorgan Chase and AIG, was there a mutual dependency here of some kind during this period?

Mr. BIENENSTOCK. Well gee, I'm not——

Mr. SILVERS. Do you have any insight into this?

Mr. BIENENSTOCK. I'm not familiar with their contractual relationships.

Mr. SILVERS. Okay, thank you.

Chair WARREN. Thank you. Dr. Troske.

Dr. TROSKE. Thank you. Mr. Moriarty, I guess I'm going to ask a general insurance question. And I'm going to try to put it in as simple terms as possible because I think sometimes we get a little confused by the jargon. AIG was writing credit default swaps, where essentially they were insuring mortgage backed securities.

Mr. MORIARTY. AIG Financial Products——

Dr. TROSKE. Yes, some of them.

Mr. MORIARTY [continuing]. Yes.

Dr. TROSKE. While simultaneously the company was also purchasing mortgage backed securities?

Mr. MORIARTY. Correct.

Dr. TROSKE. So they were actually purchasing products that they were also insuring?

Mr. MORIARTY. Doubling down, yes.

Dr. TROSKE. Yes. I'm no financial expert, nor am I an expert in insurance, but that seems rather odd to me that a company would

both insure something and then expose themselves even further to the risk that they're insuring. Is that usual for insurance companies to double down in this fashion?

Mr. MORIARTY. No it's not, actually. You usually try and make sure that the risk on the asset and the liability side do have some—don't have a high degree of correlation.

When we first looked at these securities lending programs it was uncovered by Texas, which has one of the biggest life insurance companies, and they were doing an examination. And they just noted that this thing was growing exponentially and alerted other states.

At the time, AIG management had come in to the regulators to explain the program. And you know, we expressed concern about two things. Number one, was the size and number two was the fact that they were investing the cash in securities that were longer dated than the liabilities on the securities lending.

So they depended on the counterparties to effectively roll over or else they'd have to liquidate the securities. Then we went into the diversity of these securities which were 60 percent in—over 60 percent in residential mortgage backed securities, which was clearly a high amount.

But they brought up the point, these were all Triple A rated, they were all Double A rated residential mortgage backed securities that were in fact diversified because they came from different originators, the collateral was spaced throughout the country, that basically the mortgages. And there hasn't been a meltdown of the residential mortgage, across the country in the United States, in a long time.

Dr. TROSKE. 15 years.

Mr. MORIARTY. And so again, from their viewpoint, it wasn't an imprudent activity, I gave them more investment yield. But nonetheless, just the sheer size of it and the concentration in the RMBS, that they did, at our behest, begin a significant downsizing of it without reporting big losses.

And they reduced it by 24 percent in a year, from $76 billion down to $58 billion dollars. And we do things that, you know, again absent the issues at FP and the financial crisis, that the securities lending program would have been wound down.

Dr. TROSKE. Let me ask another question too. And it's actually when you're doing this, when you're sort of both insuring and purchasing, and you exacerbate the risk. Because now you've got what's known as a co-variance, the way the two of them move together.

Because typically you only have to worry about the changes, potential changes in one. So it's actually very important if you're doing both to understand how the things you're purchasing are going to vary with the things that you're insuring.

Mr. MORIARTY. No, no, I totally agree with you Dr. Troske. I think one of the issues though is that we regulate the insurance company——

Dr. TROSKE. Right.

Mr. MORIARTY [continuing]. We do not regulate——

Dr. TROSKE. And I'm asking you just as an insurance expert, not as that you should have been overseeing this because I don't want

to imply that. So let me—and Mr. Clark, as Mr. Moriarty indicated that these were all triple A rated securities or double A rated.

But your—when you take, and again I'm going to be real simple here, and this is not particularly what you've come to talk to us about—but when they were coming to you with essentially a box of mortgages and S&P was giving a rating on those mortgages, you were rating the mortgages in a box and then the bank would go out and sell them to somebody.

But what AIG now had is they had—they were insuring a box over here and they were buying a box over here. You're not evaluating how those two boxes are going to move together which is a key point for AIG if they're both insuring and buying. You're not evaluating the co-variance between those two investments, are you? Well, your triple A—just tell me about the likelihood of loss from these mortgages I own not——

Mr. CLARK. Let me separate out what I can and can't answer.

Dr. TROSKE. Okay.

Mr. CLARK. First of all, I'm an analyst in our insurance ratings practice——

Dr. TROSKE. Right.

Mr. CLARK. [continuing]. Responsible for AIG.

Dr. TROSKE. Okay.

Mr. CLARK. So I can't speak to how the rating were arrived at and structured financially.

Dr. TROSKE. Fine.

Mr. CLARK. I can speak to the analysis we did on AIG's securities lending and its CDS portfolios.

Dr. TROSKE. Okay, that would be great.

Mr. CLARK. And we were, throughout 2008, analyzing those portfolios and making projections, which we updated publicly to the market throughout the year as to our expectation as to losses that the firm would likely see on those portfolios both. We were looking at both and we were combining the analytics.

What we saw, however, was that in the fall of 2008, and very much to Mr. Moriarty's point that we'd seen housing declines before, but one on a nationwide scale of this depth of magnitude, that was really outside of our assumptions and the assumptions of many in the market.

It was quite unprecedented. So we did find that the performance of both of those portfolios, although we modeled them together, looked at the exposure together, the eventual losses did exceed what our expectations were.

Dr. TROSKE. Okay, thank you.

Chair WARREN. Good. Thank you very much. I want to thank all three panelists, Mr. Bienenstock, Mr. Clark, and Mr. Moriarty. We appreciate your taking the time to be here with us today. This has been very helpful to the panel and will be very helpful to our report.

We're going to call a recess for this panel for half an hour. We'll start again at a quarter of two. And our first witness at that point will be Clifford Gallant. Thank you.

[Whereupon, at 1:14 p.m., a recess was taken.]

Chair WARREN. This hearing is back in session. I want to welcome Mr. Gallant, the Managing Director of Property and Casualty

Insurance of Keefe, Bruyette, and Woods. Mr. Gallant is an equity research analyst who covers the insurance industry and he's here to share his thoughts on AIG's current financial outlook.

We appreciate your being here today and I'd like you to make opening remarks if you would and limit them to five minutes.

Mr. GALLANT. Okay, thank you for the opportunity.

Chair WARREN. Thank you Mr. Gallant.

STATEMENT OF CLIFFORD GALLANT, MANAGING DIRECTOR, PROPERTY & CASUALTY INSURANCE RESEARCH, KEEFE, BRUYETTE & WOODS

Mr. GALLANT. Yes, on April 27th we published a report on AIG where we downgraded the shares to an Underperform. We put a $6.00 price target on the stock and at the time that was considered somewhat controversial, at the time the stock was trading in the mid–40's, it's still in the low 30's.

However, we didn't view our conclusion that there was not a lot of common equity value in the stock to be all that profound. In fact, we view it to be somewhat self-evident. And by that I think there are two main realities of the company.

One is that it's still dependent on government aide. And I think the evidence of that is in the first quarter that there was further access of government credit lines. The FRBNY loan went from $23.4 billion to $28.9 billion through April. And the Series F, U.S. Treasury-owned securities went from $5.3 to $7.4 billion.

Secondly, when we do any type of sum of the parts analysis, or try a valuation of the company it's just, it's hard to come up with a positive number. And I think that's a somewhat obvious reality of the current financial position of the company.

I think that investors do need to understand a few key points. One, there is a great franchise beneath this company. The insurance operations have a fantastic global footprint.

And I would say that the current management team has done a very good job with the company in terms of stabilizing it, you know to stem the loss of people and of clients. A lot of credit needs to go to them for dealing with what is obviously a difficult situation.

That said, I think in terms of valuing the stock there are some things that people have to be aware of. One, is a book value is not a normal book value calculation, right. The debt to equity is something like seven to one. That's a ratio that most insurance—no other insurance company is at and could not normally operate at.

If the U.S. Government were to be replaced with just normal private creditors, I don't think that they could conduct business. The only reason it does happen is because it is the U.S. Government that is the backer.

The earnings that the company is producing do not accrue to the common shareholder in the normal fashion, because there is a preferred shareholder for its stockholder in the Series E stock.

That dividend has not been paid, but if they financially get to the point where they can pay that, I assume that that's where the money's got to go. They can't accrue to the common shareholder. So again, you can't use a normal P/E ratio here to value AIG.

And there are a number of book value concerns with the company. I think if we were to have a public offering of the shares on

a large scale, I think investors would want a discount to book value for several reasons.

One, concerns over the quality of property and casualty reserves, valuation of things, like the ILFC, aircraft leasing business. And I think one thing you need to keep in mind as well is that the peer group, the property and casualty life insurance companies today on the market, several of them have redundant capital positions.

They're buying back stock, have leasing reserves and yet they're all trading below book value. Something like 85/90 percent of book. I got to assume that AIG would trade at a discount to those, those peers.

And finally, I think just as the systemic risk fades, I think the treatment of AIG is likely to change. I believe that you know, since September of 2008 as a result of systemic fears, the taxpayer has had to take some losses on AIG, has had to be very generous towards its treatment of AIG.

You know, debt has been restructured, top debt was changed into this non-cumulative form. And those things were necessary, needed to be done to keep the company going. But I have to believe as that systemic risk fades, that it's less likely to happen.

I think the taxpayer is going to say, you know, cash expended, needs the resulting cash back into the shareholder's—taxpayer's wallet. And is that—and during that process I believe that the common stock will largely be—you're not going to find a lot of value left for the common shareholder.

So, I think it all comes down to a question of—when I talk to the bulls on the stock—that there is value in the company, yet in the same breath there's this discussion of somehow the taxpayer taking some losses as the government tries to exit its position. And in my point of view that, if anything, indicates that our initial assessment is right. I mean if the taxpayer is expected to take a loss, how can there really be value here in the company?

[The prepared statement of Mr. Gallant follows:]

To the Congressional Oversight Panel,

The equity research team at KBW on 4/27/10 downgraded the common shares of AIG to an Underperform and established a price target of $6. Key conclusions were:

1. **Common Shares Overvalued.** From a fundamental perspective, we view that AIG continues to own some very valuable businesses, however, in its totality, under the current operating and financial structure, we view that the publicly traded shares are grossly overvalued.
2. **Earnings Do Not Accrue to Common Shareholder.** We expect no net EPS near term. After liquidity needs are met, we expect that earnings generated by the underlying operations are obligated to be used to make Series E dividend payments. While the company may report positive EPS, we believe these earnings cannot be valued in the normal sense because these earnings do not accrue to the common shareholder but to the preferred shareholder.
3. **Book Value Is Not a Measure of Value.** We view that tangible book value is an irrelevant measure of value, given AIG's highly unusual capital structure. In addition, we see many risks to that book value calculation.
4. **The Taxpayer Will Outrank the Common Shareholder.** As the threat of systemic risk fades, we view that there will be a shift in government priorities to favor its own interests. Without a material transfer of value from the taxpayer to the shareholder, we believe the effects of full dilution, debt/preferred repayment and stock sales will leave little value left for the stub common shareholder.

Strong Global Franchise but Earnings Are Not Accrued to Common Shareholders

AIG's global insurance franchises were long the envy of the industry and even today, despite it all, AIG's global platform, size, diversity and technical expertise position the company among the world's best insurers. In our estimation the company is capable of run-rate after-tax earnings in the range of $2.8 billion, excluding the companies slated to be sold and before government interest expense and excluding dividend payments on the Series E preferred stock. Within our estimate, we include approximately $2.0 billion for the Chartis P&C business, $2.6 billion for the domestic Life businesses and a loss of $1.8 billion at the parent level for other items including normal corporate expense and debt service. In 1Q10, adjusted operating earnings were $809 million with signs of stabilization throughout the underwriting businesses.

We would stress, however, that at this stage, these earnings cannot be valued as is done typically for publicly traded companies. AIG continues to face the challenges of public debt refinancing which has resulted in additional government borrowing and moreover, the company's net earnings do not accrue to the common shareholder but to the higher ranking Series E Preferred holders.

Book Value Is Irrelevant

In normal equity analysis, tangible book value is a natural starting point. Tangible book value is viewed to be a measure of the store of value created by a company over time, or an approximation of a run-off value. However, AIG's capital structure is so unusual that we believe it does not fall under this definition. Would AIG be in business today without government aid? Or consider the CEO's public admission that selling all of the pieces of

AIG would not be enough to fully repay AIG's debts. Doesn't this imply negative real worth, despite a positive book value calculation?

The typical insurer, P&C or life, carries debt loads at 20-30% of total capital. While AIG's business model and capital structure were always different from the typical insurer, today, AIG's debt levels are enormous. If one were to include the Series E preferred stock as debt, then the total AIG debt level is $188 billion versus diluted common equity of just $25.9 billion. Debt is more than 8 times greater than equity! In comparison, most insurers have the inverse relationship at a four-to-one level and even the "old AIG", at its most highly leveraged, was less than 2-to-1 of debt-to-equity.

In addition, we see potential risks to several balance sheet items including P&C reserves, the DAC asset, the valuation of ILFC, the valuation of AGF, AIGFP's remaining exposures and the carrying values of Maiden Lanes II and III.

On the positive side, the completion of the sales of AIA and ALICO both result in material gains to book value and the formation of an SPV in December of 2009 to hold these entities has already materially reduced government-owed debt.

Issues to Consider in Valuation

1. Can AIG "go it alone" without taxpayer support? ILFC has accessed public debt markets, although expensive. AIG has yet to do so and refinancing has led to further accessing government lines of credit.
2. The company may eventually need to raise significant equity capital from public markets in order to fully stand alone.
3. Impact of the exercise of government-held warrants and their sales.
4. Resolution of Series E & F shares. Should a conversion to common shares be pursued, we would assume that conversion would need to take place significantly below the current shares trading price and would be soon followed, if not done concurrently, with a material sale of shares.
5. Aforementioned risks to the balance sheet.
6. A peer group valuation trading below book value.

Conclusion

The underwriting franchises of AIG have great value but they always have, even in September of 2008. We believe the main issue facing the common shareholder is how to value the company on a "normalized" basis, which presumes a full exit of government interests and the ability to operate independent of government backing. As a result of systemic concerns, the financial interests of the U.S. government have been placed behind those of the common stock and debt owners. However, as systemic risk fades, we view that there is risk of a shift in government priorities to favor its own (the taxpayers') interests. Without a material transfer of value from the taxpayer to the shareholder, we believe the effects of full dilution, debt/preferred repayment and stock sales will leave little value left for the stub shareholder.

Clifford Gallant
Managing Director
Keefe, Bruyette and Woods

Chair WARREN. Very helpful. Thank you.

So let me see if I can just disaggregate this a little bit and figure out what's going on.

Mr. GALLANT. Sure.

Chair WARREN. Do you have any assessment of whether or not AIG is likely to need more government assistance to meet its liquidity needs?

Mr. GALLANT. In their—they disclose debt that's coming due throughout this year. You know, even excluding ILFC and AIGFP, there's something like $10 billion due in 2010. Since AIG is not able to access normal debt markets, I have to believe that they will further draw down on government credit lines to make those payments.

Chair WARREN. Okay, do you have any sense, just as you project this out, when the point might come that the government will not be called upon to continue its support for AIG? Before we get to the question——

Mr. GALLANT. Sure.

Chair WARREN [continuing]. Of unwinding the interest——

Mr. GALLANT. Absolutely, yeah.

Chair WARREN [continuing]. That we already have there.

Mr. GALLANT. No, that's a good question and I can't really answer. I think AIGFP, as that portfolio winds down, that would seem to be at least one indication of less systemic risk being posed by AIG. You know I think that the insurance subsidiaries, as I know other panels have discussed today, are probably financially stable and sound.

And so that is probably not a reason to wait. It seems to me that the systemic risk seems to reside in the parent company.

Chair WARREN. So, actually, let me ask it in a slightly different way. What are the conditions that need to be met? And we'll take them in all, that the government doesn't have to put more money in and then we can talk about the second one, about how the government starts unwinding its position.

What do we need to see happen? We've got two sales—AIG has two sales pending, right? So I presume part of it would be the completion of those sales?

Mr. GALLANT. Right, right. That's a big step, right? You really start to see—again, cash back into the taxpayer's wallet. You know I think the ability for AIG to access debt markets in a normal fashion would be a—is a key to——

Chair WARREN. It would be a very good sign when you can see AIG borrowing in the debt market?

Mr. GALLANT. That's right. That's right. Presumably with the expectation that they'll be able to internally generate the funds to repay that debt.

Chair WARREN. That's right.

Mr. GALLANT. Yeah, I think those are the big things that we would expect to see over the next year.

Chair WARREN. Okay. I noted in your written testimony you talk about how the current structure is unsustainable and that some sort of resolution must occur.

Mr. GALLANT. Yes.

Chair WARREN. Can you just elaborate——

Mr. GALLANT. Sure.

Chair WARREN [continuing]. A little bit on that?

Mr. GALLANT. Well simply that the government——

Chair WARREN. That wasn't all the way to a blueprint.

Mr. GALLANT. Yeah, well the government doesn't want to be a permanent investor in AIG. That's basically the bottom line for me. And I think if you were going to value the common stock, if you want to invest in this company, you have to assume that the government is going to get out. And so that's the approach we took in coming up with our price target.

Chair WARREN. Okay. Very valuable, thank you very much. Mr. McWatters.

Mr. MCWATTERS. Thank you. The Congressional Budget Office says the taxpayers may lose $36 billion dollars on AIG, and OMB says about $50 billion dollars. Do you have a guess as to whether or not these numbers are anywhere near accurate? Or can you see a larger or smaller number?

Mr. GALLANT. Yeah, that's a very difficult question to answer. I think the current debt outstanding is something like $79 billion. I've come up with my assessment of what the earnings power of the ongoing operations is—something like $2.8 billion a year.

You could put a 10 to 15 multiple on that, add the gain that you expect on the operations that are to be sold and you're still short of what you need to cover a loss. So it might be—it still seems like that will be difficult for the taxpayer to break even.

Mr. MCWATTERS. If it was your job, how would you restructure AIG? How would you make it stronger?

Mr. GALLANT. That's probably beyond me to answer. But I would say that probably as a first step, I think there needs to be a test of what the common value, what the market price is for the common stock.

You know the government does have the 80 percent ownership in the form of warrants. A public offering of part of those, part of that ownership might tell you what the market really does think AIG is worth. And that is a sort of a starting point as to where you can sort of go from there.

Mr. MCWATTERS. Do you think AIG is solvent? Or is it just simply getting along on its implicit government guarantee?

Mr. GALLANT. I think the government guarantee is intrinsic to its ability to conduct business on a daily basis.

Mr. MCWATTERS. Okay, okay. So it's possible, or I don't want to put words in your mouth, but I guess you're—is it possible AIG cannot be solvent?

Mr. GALLANT. If the government were to walk away today and you know, pull back all its support, then AIG would be a——

Mr. MCWATTERS. Oh, sure.

Mr. GALLANT [continuing]. Would not be in a position to be able to conduct business.

Mr. MCWATTERS. In your testimony or in some interviews I think you said that AIG has the potential to become—the government has the potential to be embarrassed by AIG. What did you mean by that?

Mr. GALLANT. You know I think I was just referencing the fact that AIG is obviously a very high profile name. There have been

other high profile issues, you know, the compensation for the people at AIGFP about a year ago was obviously a big embarrassment.

Mr. MCWATTERS. Okay.

Mr. GALLANT. And you just want to—you don't want to have that risk out there.

Mr. MCWATTERS. And I'll close by just asking, what is your current outlook on AIG?

Mr. GALLANT. We maintain our $6.00 price target. We're advising our clients not to buy the stock.

Mr. MCWATTERS. Is that because 80 percent is owned by the government and there's only 20 percent outstanding and there's so much pressure that ultimately that 20 percent just might get crushed?

Mr. GALLANT. Yes, eventually that's right. I mean we believe that, as I said, as the government exits its position and tries to repay the taxpayer, there's not going to be a lot left for the common shareholder.

Mr. MCWATTERS. Okay, thank you.

Chair WARREN. Thank you. Mr. Silvers.

Mr. SILVERS. In a way I want to revisit my colleague, Mr. McWatters' questioning in a different way. Obviously, you write analyst reports for private investors in AIG's equity in particular——

Mr. GALLANT. Sure.

Mr. SILVERS [continuing]. Who are junior to the government, right? We are talking to you about the interest of the government.

Mr. GALLANT. Right.

Mr. SILVERS. That's the investor we represent, in a sense. So from what you were saying, it seems to me that you're basically saying there's not enough earning power, or cash flow power, so to speak, in this firm to support not only the stock price as it is today.

I mean it's an astounding gap between what it is and what you say it should be, but perhaps not enough to even support repaying the government ultimately. Is that—am I reading back to you what you were saying, correct?

Mr. GALLANT. Yes, that's correct.

Mr. SILVERS. And AIG is currently drawing, as you point out, drawing on the government's, on the Fed's line of credit. Not paying down, but drawing.

Mr. GALLANT. That's right.

Mr. SILVERS. Now if you put those two things together, doesn't that suggest that from the government's perspective, not just as a senior, and a senior equity holder to the common, but as the continuing source of funding, right?

That what we ought to, what the government ought to, be doing is demanding hair cuts from other investors in order to get this company to function properly. Or is there some other path here? Is there a way to get growth out of this firm? To get growth in earnings or in cash flow out of this firm?

Is there an expectation that the market will view the underlying assets of AIG differently in the future? And I'm particularly interested in your perspective on AIG as a global firm given what seems to be happening in the global economy right now, as of today.

Mr. GALLANT. Well in terms of the ability for the company to increase its earning power or cash flow. You know you are in a dif-

ficult environment right now. Obviously the global economy is not on sound footing yet.

And actually the insurance businesses are in a somewhat difficult environment as well. The property and casualty business prices are going down throughout the industry. And the profit outlook, at least our view of the profit outlook for the property and casualty, is not great. So the backdrop is not good.

You know, AIG of course is still, even in the continuing operations, under earning what it once did. So there is always the potential to recapture some of that lost value. And I would say that the current management team seems to at least be moving towards that as they've stemmed the flow of lost employees and all.

But, you know, in terms of another route, I don't see it. I mean I think it's a very difficult road ahead of them.

Mr. SILVERS. I'm sorry, in terms of—you don't see what?

Mr. GALLANT. No, I'm sorry, I thought you were asking about a second—in terms of generating more, additional earnings power.

Mr. SILVERS. You don't see a way to generate additional earnings power by a multiplier effect. By the way, and this is sort of unfair, but your somewhat radically pessimistic view, does that make you a maverick so to speak?

I mean I just find it extraordinary the difference between a current market price of $44.00 in what is an active trading market, and then your view of $6.00.

Mr. GALLANT. It's hard—that is—I ask myself that question a lot. You know I think there are a few factors. I think for one, it is a complicated scenario. I mean AIG's balance sheet is not a typical balance sheet. It does have a stated book value number of $37.00, $36.00 and that I believe is a misleading number. But you know, it is out there. There is the underlying value of the company.

Right, these insurance companies which are, like you said, it's a great global franchise. And that's actually a very frustrating thing for those who were watching the company in 2008 as well. I was an analyst then and you saw all these underlying earnings that were very strong and you had this great franchise. It was hard to believe that the stock was zero. There's also been a series of good headlines. As I say, management has done a good job——

Mr. SILVERS. Right.

Mr. GALLANT [continuing]. And there's been some good headlines over the last year or so.

Mr. SILVERS. But fundamentally——

Mr. GALLANT. Yeah.

Mr. SILVERS [continuing]. You don't have a critique of what management is doing, you know I don't hear one. What you basically have is a critique that there are too many claimants on the cash flows to support either the stock price or the Government getting paid back?

Mr. GALLANT. That's—yes, that's ultimately correct.

Mr. SILVERS. All right. Why is that not sort of a no-brainer in terms of that the government shouldn't really give this firm any more money until the existing claimants take haircuts?

Mr. GALLANT. You know I think the——

Mr. SILVERS. I mean what other choice——

Mr. GALLANT. Sure.

Mr. SILVERS. What other choice do we have?

Mr. GALLANT. Yeah, I can connect that to the question about the stock price. Because I think the bulls on the stock believe that through exiting, the government is going to be very generous as it tries to exit its position in AIG. Whether—that could mean walking away from things—walking away from ownership interests or forgiving parts of loans. You know I've—this is through private conversations with investors.

Mr. SILVERS. Do these people talk to their fellow citizens? Do they have any notion of what would occur if that—if we started handing out public money to the private investors in AIG in that way?

Mr. GALLANT. That's the argument. And to be fair, I think the reason that they might have held that view is that the government has been generous to AIG already, right? You know taking the top debt, which paid an interest, had an interest payment attached to it and shifting it to a preferred status that's non-cumulative, very generous acts.

Interest rates have been changed for the company. You know government-owned debt has been moved from AIG's balance sheet to off balance sheet vehicles, which has lowered them out of debt that AIG itself owes, but with only a fraction of the result actually ending up back in the taxpayer's wallet. So I think there's reason for the investors to think that perhaps that will continue.

Mr. SILVERS. Thank you.

Chair WARREN. Thank you very much Mr. Gallant. Thank you, Mr. Silvers. Professor Troske.

Dr. TROSKE. Thank you. You can call me Mr. If you really——

Chair WARREN. Oh, okay.

Dr. TROSKE. That doesn't bother me. So I just want to follow-up a little bit and I guess I'm going to try to be very straight forward and clear. Basically—the stock price is, I believe, $33.00 you said.

Mr. GALLANT. Yeah.

Dr. TROSKE. And you're estimate is it should be $6.00. So you're basically saying there are a lot of people out there that are making a mistake. Is that a fair assessment?

Mr. GALLANT. Yeah, I think buying the stock today is a mistake.

Dr. TROSKE. Okay, or if you owned it right now, if someone owned it, would you advise them to sell it?

Mr. GALLANT. Yes I would.

Dr. TROSKE. Okay, I just want to—and I guess you've elaborated a little bit on what you think the, where the mistake is coming from. And I read it as you're saying, it's really hard to figure out what this company is worth so we could get a bunch of different guesses. The market's got a guess, you've got a different guess. It's hard——

Mr. GALLANT. That's fair.

Dr. TROSKE. Okay.

Mr. GALLANT. And in addition, that is a thesis of the government, as an interest.

Dr. TROSKE. Okay, and yes, thank you, that's right. You did mention that the subsidiaries were solid. If I could remove them from the structure, just reach down, pull out and make them independent.

Mr. GALLANT. Sure.

Dr. TROSKE. What would they be worth? Do you have a guess? And is that something equivalent to what we're—I mean is the price coming from this implicit value of at some point maybe we could just sort of remove them from——

Mr. GALLANT. Sure. I still think there is significant value in those insurance subsidiaries. I'd say the earnings power of the domestic life company, the ongoing operations, the ongoing insurance operations you know, could be $40, $50 billion dollars if they could in fact be, as you say, removed from the parent company.

Dr. TROSKE. Okay, okay. And is there a way to actually do that without sort of—that you can see going forward that we can just sort of remove them from that and just keep that entity whole, which seems to be producing value for the market. There are parts of it that are a valuable company. There's parts of it that seem to be a very valuable company.

Mr. GALLANT. I mean you know, you could always sell the operations, right? Which would separate it and immediately recognize some value.

Dr. TROSKE. And so why don't we?

Mr. GALLANT. [No response.]

Dr. TROSKE. You don't know.

Mr. GALLANT. Well I think that there is, if you want to try to pay back the full amounts of the loans, you need an asset to create value to pay that back.

Dr. TROSKE. Okay.

Mr. GALLANT. And so you can't, you can't remove all of the earnings generators.

Dr. TROSKE. That's all.

Chair WARREN. Thank you very much. Thank you Mr. Gallant. We appreciate it, thank you for being here today.

Mr. GALLANT. Thank you.

Chair WARREN. And Mr. Benmosche if you could join us. Robert Benmosche is the President and Chief Executive Officer of AIG. Mr. Benmosche joined AIG as CEO in August of 2009. Mr. Benmosche when you're ready, welcome.

Mr. BENMOSCHE. Thank you.

Chair WARREN. Five minutes for an opening statement.

Mr. BENMOSCHE. Okay.

Chair WARREN. Thank you.

STATEMENT OF ROBERT BENMOSCHE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN INTERNATIONAL GROUP, INC.

Mr. BENMOSCHE. First of all, I appreciate the opportunity to be here with all of you and describe AIG's progress in stabilizing the company, preserving and growing the value of our businesses, reducing our risk, and repaying the taxpayers.

I joined, as you said, in August of 2009 with a priority goal of stabilizing the company and boosting employee morale, a high priority. Throughout my years in the insurance industry, I respected AIG as a company and as a competitor.

And in just nine months at the company, I can see substantial progress in redefining our strategy and in restoring credibility and

confidence in AIG. Of course, were it not for the commitment of the U.S. Government at a time of great uncertainty, AIG would not be on the path it is today.

I want to thank the Government and the American taxpayer. Since receiving that support, AIG has worked in close coordination with the Federal Reserve and U.S. Treasury. We appreciate very much the constructive role that they have played.

Today, AIG remains a significant contributor to the U.S. economy and a critical provider of financial security to countless communities and individuals across the country. AIG has over 40,000 hard working and dedicated employees across the nation. Tens of millions of Americans are employed by entities that are protected by our commercial insurance.

AIG is also one of the largest holders of municipal bonds, providing a much needed source of capital for municipalities to build new schools and better roads. Chartis, our property and casualty group, had gross written premiums of more than $40 billion dollars in 2009, serving more than 40 million customers around the world.

SunAmerica Financial Group, our life and retirement services business, is one of the largest life insurance organizations in the U.S., and served more than 16 million customers in 2009.

And ILFC, our aviation leasing company, has a fleet of approximately 1,000 aircraft and has purchased more Boeing aircraft than any other airline or leasing company since 1990.

At AIG, we take seriously the responsibility that comes with being so heavily integrated with the U.S. economy and we are well on our way to remaking AIG into a more streamlined and focused company with sound, well-managed businesses, a transparent and consistent governance system and a stable risk profile and capital structure.

Prior to my arrival, AIG had focused on repaying taxpayers by moving quickly to divest certain parts of the organization. I was concerned that this course of action might not enable AIG to repay the aid the company had received. So I immediately set about to change this approach and secure greater value for the taxpayers.

This strategy is beginning to pay off. We recently announced the sales of AIA and ALICO for approximately $51 billion dollars, nearly $30 billion in cash and approximately $21 billion dollars in securities. AIA and ALICO both have demonstrated in these sales our inherent strength in our brands and the success of our strategy to maximize the value of our assets.

Once closed, they will mean that AIG can repay the Federal Reserve Bank of New York with cash and sell securities over time to further repay the government. Our successes are now being reflected in the marketplace. Chartis reported a first quarter operating profit of $879 million dollars compared to a $710 million dollar profit the year before, a 24 percent increase.

SunAmerica Financial Group reported first quarter operating income of $1.1 billion dollars compared to an operating loss of $160 million in the first quarter of 2009. In a sign of market confidence, ILFC has raised $4 billion dollars from private markets. And I might add, parenthetically, that is both secured and unsecured credit markets.

And AIG financial products continues to make substantial progress in reducing and de-risking its portfolio from a high of over $2 trillion dollars at the end of 2008 to $755 billion dollars as of March 31, 2010. These many accomplishments are enabled by the dedicated and tireless efforts of tens of thousands of AIG employees.

At AIG, it is critical that we strike the right balance between paying competitively and ensuring that pay levels are appropriate in light of our government support. We are implementing new compensation programs to create a consistent performance management culture, one that aligns our employees' day to day activities with the interests of our stakeholders. And with this approach, we are retaining top talent as well as attracting new talent to help manage our businesses.

Chair Warren and Members of the Panel, I am confident that AIG is now on a clear path to repaying the taxpayers. I thank you for this opportunity to bring you up to date and look forward to your questions.

[The prepared statement of Mr. Benmosche follows:]

TESTIMONY BY MR. ROBERT BENMOSCHE

PRESIDENT & CHIEF EXECUTIVE OFFICER

AMERICAN INTERNATIONAL GROUP

BEFORE THE CONGRESSIONAL OVERSIGHT PANEL

WEDNESDAY, MAY 26, 2010

CHAIR WARREN AND MEMBERS OF THE PANEL, I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE YOU TODAY TO DESCRIBE AIG'S PROGRESS IN STABILIZING THE COMPANY, PRESERVING AND GROWING THE VALUE OF ITS BUSINESSES, REDUCING RISK, AND REPAYING U.S. TAXPAYERS.

I JOINED AIG IN AUGUST 2009, WITH THE PRIORITY GOALS OF STABILIZING THE COMPANY AND BOOSTING EMPLOYEE MORALE. THROUGHOUT MY YEARS IN THE INSURANCE INDUSTRY I RESPECTED AIG AS A COMPANY AND AS A COMPETITOR. I VIEWED THIS JOB AS AN OPPORTUNITY TO GET AIG BACK ON ITS FEET AND RESTORE CREDIBILITY AND CONFIDENCE TO A GREAT COMPANY.

THOUGH I HAVE BEEN AT AIG JUST NINE MONTHS, I SEE SUBSTANTIAL PROGRESS. WE ARE REDEFINING OUR STRATEGY, RESTORING OUR

FINANCIAL STRENGTH, STRENGTHENING OUR KEY BUSINESSES, BOLSTERING OUR CORPORATE GOVERNANCE, INSTILLING A FOCUS ON PERFORMANCE MANAGEMENT, AND MAKING STRATEGIC HIRES TO ENSURE THAT OUR REMAINING BUSINESSES THRIVE.

OF COURSE, WERE IT NOT FOR THE COMMITMENT OF THE U.S. GOVERNMENT AT A TIME OF GREAT UNCERTAINTY, AIG WOULD NOT BE ON THE PATH IT IS TODAY. FOR THIS, I WANT TO THANK THE GOVERNMENT AND THE AMERICAN PEOPLE. IT IS NOT LOST ON AIG'S MANY EMPLOYEES THAT THE TURNAROUND WE HAVE EMBARKED UPON WAS MADE POSSIBLE BY THE DIRECT SUPPORT OF AMERICAN TAXPAYERS.

SINCE RECEIVING THAT SUPPORT, AIG HAS WORKED IN CLOSE COORDINATION WITH THE NEW YORK FEDERAL RESERVE BANK AND U.S. TREASURY DEPARTMENT SO THAT THEY ARE CONSTANTLY AWARE OF, AND CAN HAVE INPUT ON, OUR STRATEGIC DECISIONS AND PLANNING. WE APPRECIATE VERY MUCH THE CONSTRUCTIVE ROLE THAT THEY HAVE PLAYED.

WITH THIS SUPPORT, THE COMPANY REMAINS A SIGNIFICANT CONTRIBUTOR TO THE U.S. ECONOMY AND A CRITICAL PROVIDER OF

FINANCIAL SECURITY TO COUNTLESS COMMUNITIES AND INDIVIDUALS ACROSS THE COUNTRY.

AIG HAS OVER 40,000 HARD-WORKING AND DEDICATED EMPLOYEES IN CITIES AND TOWNS ACROSS THE COUNTRY. IN ADDITION, TENS OF MILLIONS OF PEOPLE IN THE UNITED STATES ARE EMPLOYED BY ENTITIES PROTECTED BY OUR COMMERCIAL INSURANCE COVERAGE.

AIG IS ONE OF THE LARGEST HOLDERS OF U.S. MUNICIPAL BONDS, PROVIDING A MUCH-NEEDED SOURCE OF CAPITAL FOR MUNICIPALITIES ACROSS THE COUNTRY TO PURSUE DEVELOPMENT GOALS THAT RANGE FROM NEW SCHOOLS TO BETTER ROADS, BRIDGES AND TUNNELS.

CHARTIS, OUR PROPERTY AND CASUALTY GROUP, HAD GROSS WRITTEN PREMIUMS OF MORE THAN $40 BILLION IN 2009, SERVING MORE THAN 40 MILLION CUSTOMERS WORLDWIDE.

SUNAMERICA FINANCIAL GROUP, OUR LIFE AND RETIREMENT SERVICES BUSINESS, WHICH IS ONE OF THE LARGEST LIFE INSURANCE ORGANIZATIONS IN THE U.S., SERVED MORE THAN 16 MILLION CUSTOMERS IN 2009.

ILFC, OUR AVIATION LEASING COMPANY, HAS A FLEET OF APPROXIMATELY 1,000 AIRCRAFT AND HAS PURCHASED MORE BOEING AIRCRAFT THAN ANY OTHER AIRLINE OR LEASING COMPANY SINCE 1990.

AT AIG, WE TAKE SERIOUSLY THE RESPONSIBILITY THAT COMES WITH BEING SO HEAVILY INTEGRATED WITH THE U.S. ECONOMY. BY RESTORING AIG'S HEALTH, WE CAN CONTRIBUTE TO RESTORING THE STRENGTH OF THE AMERICAN ECONOMY. AND WE HAVE MADE IMPORTANT STRIDES.

WE ARE WELL ON OUR WAY TO REMAKING AIG INTO A MORE STREAMLINED AND FOCUSED COMPANY. AND AS WE WORK TOWARD THAT GOAL, WE REMAIN COMMITTED TO MAKING SURE THAT OUR COMPANIES ARE STRONG – WITH SOUND, WELL-MANAGED BUSINESSES; A TRANSPARENT AND CONSISTENT GOVERNANCE SYSTEM THAT PROVIDES PROPER OVERSIGHT; AND A RISK PROFILE AND CAPITAL STRUCTURE IN WHICH OUR CUSTOMERS, REGULATORS, EMPLOYEES, SHAREHOLDERS, AND OTHER STAKEHOLDERS CAN HAVE CONFIDENCE.

PRIOR TO MY ARRIVAL, AIG HAD FOCUSED ON REPAYING TAXPAYERS BY MOVING QUICKLY TO DIVEST CERTAIN KEY PARTS OF THE ORGANIZATION. ALTHOUGH THE COMPANY FACED PRESSURE FROM MULTIPLE STAKEHOLDERS TO QUICKLY SELL ASSETS TO SHOW PROGRESS, I KNEW THAT THIS WAS NOT THE BEST COURSE OF ACTION

AND COULD NEVER RESULT IN THE SUCCESSFUL REPAYMENT OF TAXPAYERS. I REVIEWED THIS APPROACH AND IMMEDIATELY SET ABOUT TO MAKE CHANGES THAT WOULD SECURE GREATER VALUE FOR TAXPAYERS.

THIS STRATEGY IS BEGINNING TO PAY OFF. AS YOU KNOW, WE RECENTLY ANNOUNCED THE SALES OF TWO INTERNATIONAL LIFE INSURANCE SUBSIDIARIES, AIA AND ALICO, FOR A TOTAL OF APPROXIMATELY $51 BILLION – NEARLY $30 BILLION IN CASH AND APPROXIMATELY $21 BILLION IN SECURITIES. AIG IS COMMITTED TO THE SALE OF AIA TO PRUDENTIAL PLC AS IT PRESENTS A STRONG BUSINESS CASE AND MAKES AIG A MAJOR SHAREHOLDER IN PRUDENTIAL PLC.

THE AIA AND ALICO TRANSACTIONS, WHEN CLOSED, WILL DEMONSTRATE BOTH THE INHERENT STRENGTH OF OUR BRANDS AS WELL AS THE SUCCESS OF OUR STRATEGY TO MAXIMIZE THE VALUE OF OUR ASSETS. ONCE CLOSED, THEY WILL MEAN THAT AIG CAN REPAY THE FEDERAL RESERVE BANK OF NEW YORK WITH THE CASH, AND SELL THE SECURITIES OVER TIME TO FURTHER REPAY THE GOVERNMENT.

THESE TRANSACTIONS GIVE AIG GREATER FLEXIBILITY TO MOVE FORWARD WITH OUR RESTRUCTURING AND REBUILDING EFFORTS, AND

ALLOW US TO FOCUS ON ENHANCING THE VALUE OF OUR KEY BUSINESSES.

THE SUCCESSES THAT AIG HAS ACHIEVED OVER THE LAST YEAR ARE NOW ALSO BEING REFLECTED IN THE MARKETPLACE, AS OUR RECENTLY ANNOUNCED FIRST QUARTER 2010 EARNINGS INDICATE.

AIG'S INSURANCE BUSINESSES HAVE REMAINED HEALTHY. CHARTIS'S FIRST QUARTER OPERATING INCOME WAS $879 MILLION COMPARED TO $710 MILLION IN THE FIRST QUARTER OF 2009, A 24-PERCENT INCREASE. CHARTIS HAS BEEN TAKING IMPORTANT ACTIONS TO FURTHER STRENGTHEN THEIR RISK MANAGEMENT AND POSITION THEIR BUSINESS FOR THE FUTURE.

SUNAMERICA FINANCIAL GROUP REPORTED FIRST QUARTER OPERATING INCOME OF $1.1 BILLION COMPARED TO AN OPERATING LOSS OF $160 MILLION IN THE FIRST QUARTER OF 2009, AS INVESTMENT INCOME INCREASED AND MORE DISTRIBUTION PARTNERS SOLD OUR PRODUCTS. THIS BUSINESS HAS CONTINUED TO STABILIZE AND WILL CONTINUE TO PLAY A KEY ROLE IN AIG'S DIVERSIFICATION OF INCOME.

IN 2010, ILFC WAS ABLE TO ACCESS THE CREDIT MARKETS ON BOTH A SECURED AND UNSECURED BASIS, AND RAISED APPROXIMATELY $4 BILLION TO MEET ITS FINANCIAL AND OPERATING OBLIGATIONS.

AT AIG FINANCIAL PRODUCTS CORP (AIGFP), OUR EMPLOYEES CONTINUE TO MAKE SUBSTANTIAL PROGRESS IN REDUCING AND DE-RISKING THE PORTFOLIO FROM A HIGH OF OVER $2 TRILLION AT THE END OF 2008 TO $755 BILLION AS OF MARCH 31, 2010. OUR STRATEGY REMAINS TO EXIT THE VAST MAJORITY OF THE RISK AT AIGFP BY THE END OF THIS YEAR.

THESE MANY ACCOMPLISHMENTS ARE ENABLED BY THE DEDICATION AND TIRELESS EFFORTS OF TENS OF THOUSAND OF AIG EMPLOYEES. I STRONGLY BELIEVE THAT HOLDING EMPLOYEES ACCOUNTABLE FOR RESULTS AND PAYING FOR PERFORMANCE ARE KEY HALLMARKS OF GREAT COMPANIES. AT AIG, IT IS CRITICAL THAT WE STRIKE THE RIGHT BALANCE BETWEEN PAYING COMPETITIVELY SO THAT WE ATTRACT AND RETAIN TOP TALENT, WHILE ENSURING THAT PAY LEVELS ARE APPROPRIATE IN LIGHT OF THE GOVERNMENT'S SUPPORT OF AIG.

WE ARE DEVELOPING AND IMPLEMENTING NEW COMPENSATION AND REWARD PROGRAMS THAT WILL RECOGNIZE OUR EMPLOYEES' CONTRIBUTIONS AND DIFFERENTIATE PAY BASED ON PERFORMANCE.

AT THE SAME TIME, WE ARE DEVELOPING LONG-TERM INCENTIVE COMPENSATION PROGRAMS THAT PROMOTE SOUND JUDGEMENT ON RISK. THESE ARE IMPORTANT STEPS IN CREATING A TRANSPARENT AND CONSISTENT PERFORMANCE MANAGEMENT CULTURE – ONE THAT ENSURES THAT OUR EMPLOYEES' DAY-TO-DAY ACTIVITIES ARE ALIGNED WITH THE INTERESTS OF TAXPAYERS.

UNDER THIS APPROACH, WE ARE RETAINING TOP TALENT AS WELL AS ATTRACTING NEW TALENT WE NEED TO MANAGE OUR BUSINESSES. AND ALL OF US ARE WORKING TOGETHER TO ENSURE THAT AIG MEETS ITS OBLIGATIONS.

AIG IS NOW ON A CLEAR PATH TO REPAYING TAXPAYERS. IN RECENT MONTHS, WE HAVE BECOME LESS RELIANT ON GOVERNMENT AID AND HAVE BEEN ABLE TO INSTEAD TAP THE CAPITAL MARKETS. WE ARE WORKING HARD TO COMPLETE THE SALES OF AIA AND ALICO BY THE END OF THIS YEAR, TO INCREASE PROFITS AT OUR REMAINING BUSINESSES AND TO IMPROVE OPERATING RETURNS. THEN WE CAN BEGIN TO EXAMINE THE ALTERNATIVES WE HAVE TO ADDRESS THE TREASURY'S TARP INVESTMENT AND EQUITY HOLDINGS.

CHAIR WARREN AND MEMBERS OF THE PANEL, I AM CONFIDENT THAT AIG IS ON THE RIGHT TRACK, WITH SOUND, WELL-MANAGED BUSINESSES THAT ENABLE US TO REPAY THE U.S. GOVERNMENT AND THAT CONTINUE TO PROVIDE GREAT VALUE TO THE COMMUNITIES WHERE WE OPERATE.

THANK YOU AGAIN FOR YOUR INVITATION TO TESTIFY AND I LOOK FORWARD TO ANSWERING YOUR QUESTIONS.

AIG

ADDENDUM TO TESTIMONY BY MR. ROBERT BENMOSCHE
PRESIDENT AND CHIEF EXECUTIVE OFFICER
AMERICAN INTERNATIONAL GROUP, INC.

BEFORE THE CONGRESSIONAL OVERSIGHT PANEL

WEDNESDAY, MAY 26, 2010

AIG Addendum

I. Chartis Progress Since September 2008

II. SunAmerica Financial Group Progress

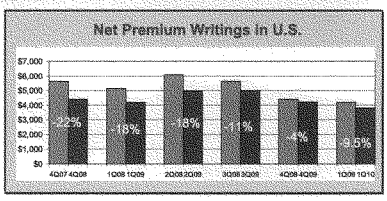
III. AIG Restructuring Progress

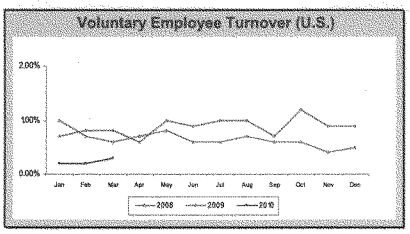
IV. AIG Financial Products Corp. Unwind Progress

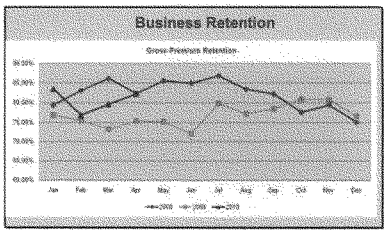
AIG I. Chartis Progress Since September 2008

Chartis continues to show significant improvement in business performance quarter over quarter despite challenges from the economy and a soft property-casualty market. Its franchise has emerged from the issues of 2008-2009 more formidable and its leadership position is secure.

- **Net Premiums:** Continue to improve; decline in recent period driven by the economy and deliberate strategy to reduce policy writings in lines with unfavorable pricing
- **Employee Retention:** Performing better than prior year periods and overall historically; over 14,000 U.S. employees
- **Business Retention:** Retention of business premium continues to improve; first quarter 2010 best performing quarter since Sept. 2008



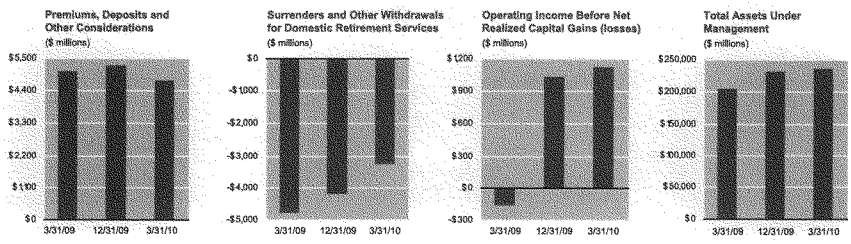




AIG II. SunAmerica Financial Group Progress

Comparison of quarterly results shows progress toward stabilization and return to normalcy

- Premiums and deposits for fourth quarter 2009 were 4% higher than first quarter 2009
  - Premiums and deposits did decrease in first quarter 2010 primarily due to a decline in industry sales of individual fixed annuities as rates on bank CDs became more competitive; continued to maintain #1 ranking for fixed annuity sales in banks for first quarter 2010
- Surrenders have decreased significantly over the last year and have returned to historic levels
  - Domestic Retirement Services surrender levels for first quarter 2010 were 32% lower than first quarter 2009
- Operating income for first quarter 2010 was $1.123 billion compared to a loss of $160 million in first quarter 2009
- Total assets under management increased by 15% from March 31, 2009 to March 31, 2010



Source: AIG First Quarter 2010 Financial Supplement

AIG III. AIG Restructuring Progress

AIG has made substantial progress in achieving its restructuring objectives.

Goals / Objectives	▪ Development of strong insurance businesses worthy of investor confidence to stabilize and protect the value of AIG's important franchise businesses ▪ Divestment of assets and implementation of restructuring program to enable repayment to the U.S. government ▪ Comprehensive review of AIG's cost structure to significantly reduce operating costs ▪ Wind-down of AIG's exposure to certain financial products and derivatives trading activities to reduce excessive risk
Progress to Date	▪ Over the last several months, AIG has accomplished the following: ▪ ***Strengthening Capital Base*** – AIG's insurance subsidiaries are strong and well capitalized ▪ ***Significant Asset Sales*** – The pending sales of AIA, ALICO, and Nan Shan for $53 bn will provide AIG with funds to repay the FRBNY Facility. In the aggregate, AIG has announced or completed over $66 bn of divestitures ▪ ***Major Financings*** – ILFC and AGF have stabilized their capital structures through nearly $12 bn of financing and capital markets transactions, covering maturities into 2012 ▪ ***Expense Reduction Initiatives*** - AIG has initiated new policies and procedures aimed at reducing expenses and improving efficiencies ▪ ***De-Risking*** – AIGFP has made substantial progress in its unwind

IV. AIG Financial Products Corp. Unwind Progress

	9/30/08	12/31/08	3/31/09	6/30/09	9/30/09	12/31/09	3/31/10	Comments (since 12/31/08)
Approximate number of outstanding trade positions	44,000	35,000	28,000	22,500	19,200	16,100	14,300	▪ Significant progress made in reducing portfolio size, with 59% of trades removed since 12/31/08 ▪ Portfolio complexity has been greatly reduced – Counterparties reduced by ~43% – Long dated trades (>50 years) reduced by 91% from 67 to 6
Notional of derivatives outstanding ($ Trillion, FAS 161 adjusted*)	2.00 (1.9**)	1.80 (1.6**)	1.52	1.33	1.16	0.94	0.76	▪ Total derivative notional is $755 B as of 3/31/10 ▪ 58% of 'Non-credit' derivatives terminated or reduced since 12/31/08 ▪ 55% of credit notional terminated or reduced since 12/31/08 – 53% reduction in Reg Cap ($234 B to $109 B) – 69% reduction in Corp Arb ($51 B to $16 B) – 40% reduction in Other Credit ($20 B to $12 B)
Non-Credit	1.61	1.49	1.25	1.09	0.95	0.76	0.62	
Credit	0.39	0.31	0.27	0.24	0.21	0.18	0.14	
Estimated Exposure to change in volatility (Gross Vega in $ Billion)* **	1.39	1.25	0.80	0.68	0.58	0.31	0.23	▪ Portfolio has been significantly de-risked, with overall hedging volatility reduced by 82% since 12/31/08 – Interest Rates – down 82% – Commodities – down 99% – Foreign Exchange – down 88%
Number of businesses (risk books)	22	21	17	15	15	15	13	▪ 8 books almost completely exited since 12/31/08, including both Commodities books, FX, Infra, 2 Fund of Fund books & PRD; prime brokerage exited in 2008 ▪ Priority in 2010 to pursue strategies to unwind complete books (e.g., business sales, portfolio transfers) *Note: Risk book reduction determined as 75% of trade count or risk reduced*
Number of employees	429	375	362	319	257	237	233	▪ Headcount reduction of 38% is in line with ongoing unwind of portfolio and operations since 12/31/08 ▪ FP closed Tokyo office in Q3 2009

* Due to FAS 161, FP is changing its methodology for computing notional, leading to a slight increase of previously reported values; Sept and Dec FAS 161 notionals are estimates

** Unadjusted for FAS 161

*** The Gross Vega is calculated as the sum of all the individual positions' absolute vegas as if each position is not hedged. Although FP's books are almost completely hedged on a net Vega basis, the Gross Vega measure will help monitor how well the volatility risk is being eliminated. The interest rate option vega denotes the change in value due to a 0.1% increase in normal volatility. For other derivatives (i.e., Equity, Commodity and FX option), vega denotes the change in value due to a 1% increase in lognormal volatility.

Chair WARREN. Thank you very much Mr. Benmosche, we appreciate you being here today. Do you anticipate that AIG will need any more taxpayer money?

Mr. BENMOSCHE. Right now, we don't anticipate that. We are looking at where we're at. We're still dealing with minor cash flow issues. But if you look at the success we had with ILFC—keep in mind we've been able to raise, with some sales of assets in the secured and unsecured markets, as well as renegotiating our bank lines after a lot of work with the banks examining our success there. That's almost an $8 billion dollar improvement.

We were also able to raise in the market, with securitized financing, $3.5 billion dollars to support American General Finance. So thus far, as we continue to operate our company strongly, profitably, we show that we're retaining people, we're retaining business, we're showing new sales, all of the things you want with strong, vibrant companies. We're beginning to see we get more access to financing. So we would hope not.

Chair WARREN. Well we all hope not. What we're trying to do is just pin down a bit more. So when Mr. Gallant says he doesn't think you're going to be able to make it through the year without having to call on taxpayer funds, you're saying you think the combination of sales of major assets, the renegotiation of some of the outstanding debt, and raising more money in debt markets will be enough to meet your cash needs as they go forward? I just want to make sure I'm getting the strategy right.

Mr. BENMOSCHE. We, at this stage of the game, we look at, we have a credit line with the Federal Reserve.

Chair WARREN. Yeah.

Mr. BENMOSCHE. And so we see that as going up and going down. So you'll see, based upon activities or cash flows we may come down a little bit, we may go back up again. So we see that as a line of credit that we're using, that we have available until 2013.

Chair WARREN. Okay.

Mr. BENMOSCHE. We also, we'll go through certain activities like, we went to the Treasury and in order to strengthen the insurance company—keep in mind, that for AIG, our insurance companies are strong, and we want to make them stronger. And that's important because our clients look to us for our promises and our guarantees.

And so therefore, when the state of Pennsylvania says that they're concerned about Chartis, the property and casualty insurer owning stock in the aircraft leasing company, and they say they're concerned about that being in their capital, they'd like us to remove it. Then if it strengthens the insurance company, which allows us to be able to continue to compete in the marketplace, we did in fact ask for money to be able to do that shift from the property and casualty company into the AIG holdings.

So there is some of that financing going on, but it's only to make sure that we maintain solid strength in all of our insurance companies. And I don't see a huge amount of demand to do that between now and the end of the year.

Chair WARREN. Okay, so you think that you both have the cash to meet your needs for loans that are coming due, for payments that are coming due, and that the only time you'll be drawing down

on government funds will be in order to strengthen the capital position of the individual insurance subsidiaries, is that right?

Mr. BENMOSCHE. That's correct.

Chair WARREN. I just want to make sure I've got the——

Mr. BENMOSCHE. Right, so for example, we are planning once the markets settle down, and here these are very unstable markets——

Chair WARREN. Okay.

Mr. BENMOSCHE [continuing]. As we can all read and see. We would like to repay the Fed their $4 billion dollars they lent ILFC. We believe that we can take some of the collateral that they've had holding against that $4 billion, we can go to the marketplace and raise the additional money to pay down $4 billion dollars to the Federal Reserve.

Now we may decide to pay it down and we may need $500 million later on. So there will be some of that up and down. But we see major activities now, between now and the end of the year, to begin to reduce the amount of money we owe the Federal Reserve.

Chair WARREN. Now I note that Mr. Gallant was complimentary of the way that you have managed the company since you've taken over. But what I'd like to hear, if you have the strategy mapped out, what are the biggest challenges to the strategy, what are the risks? What are you know, where are the places that you might run into trouble and see problems?

Mr. BENMOSCHE. To me, the greatest risk has been the day-to-day operations of the insurance companies in particular. We have never had a problem, through this entire crisis, with the insurance companies. They are well regulated, very well regulated by the states and by the countries we do business within.

And so they have made sure that all of the things we do are protected for the policyholders. So we have to make sure we run those businesses successfully and we make sure that we have the right capital in those businesses and we have the right risk-based capital ratios that are expected in those businesses.

And that we show that we can retain and attract people, that we can be able to retain our current customers, and we can grow new customers as a vibrant, strong, operating unit, that's a successful company. That's our highest priority, and that's what we're focused on.

The second priority is to show that we can exit the support of the U.S. Government in a way that we're left with an investment grade company that people will continue to feel confidence and support in.

Chair WARREN. Let me just focus you though, Mr. Benmosche.

Mr. BENMOSCHE. Sure.

Chair WARREN. I do understand that these are the goals, and of course I've read your testimony. My question was, the places that you see the most risk in not meeting those goals?

Mr. BENMOSCHE. By talking about not being able to achieve good operational results.

Chair WARREN. Good, that's what I needed.

Mr. BENMOSCHE. Pretty simple.

Chair WARREN. Thank you sir.

Mr. BENMOSCHE. All right. Took too long.

Chair WARREN. Mr. McWatters.

Mr. MCWATTERS. Thank you, and thank you for attending the hearing today. It appears that you will not need additional TARP funds, at least that's what you just said. Today, in your opinion, is AIG a solvent entity?

Mr. BENMOSCHE Absolutely.

Mr. MCWATTERS. Great, great. You also said, in your opening statement, that you intended to pay back the taxpayers. You didn't say, I'm going to pay back everything but $5 billion or $50 billion. It sounded like the intent is to pay back everything.

Mr. BENMOSCHE. I believe that we will pay back all that we owe the U.S. Government. And I believe at the end of the day, the U.S. Government will make an appropriate profit.

Mr. MCWATTERS. Okay, the CBO says we, meaning the taxpayers, will lose $36 billion and the OMB says we will lose $50 billion. So there's a spread here, it's a big spread. Can you help me close this gap in my own head to understand how you can pay back everything, how you can run the company, pay back everything when the CBO and OMB say to the contrary?

Mr. BENMOSCHE. I would love them to be able to let me buy back everything that we owe and go to investors and take a $50 billion loss. I would be able to hit that bid tomorrow. And the fact is, nobody will sell it to me for a $50 billion loss. Because the fact is, we are a strong, vibrant company that's worth a lot of money. I can't tell you how they do their analysis, but I am confident you're going to get your money plus a profit.

Mr. MCWATTERS. Well then specifically, what is the exit strategy? I mean, when you come up with one, if you had to write a one-page exit strategy to pay back the taxpayers, what would it be?

Mr. BENMOSCHE. The first goal is to make sure that we pay back the Federal Reserve. And so we are working hard to monetize the assets that we have. We are continuing to look at other strategies and different forms of monetization.

So the key is to pay back the $52 billion. Once that is paid back and the Fed is completely covered, and keep in mind again, we're doing that as quickly as we can knowing that we have a 2013 date, we still would like to get it done this year or next year, if at all possible. That's our goal.

These sales give us a tremendous shot at getting that done. And then we're going to continue to monetize. So once the Fed is covered, then we're going to begin to talk with the U.S. Treasury about how they deal with the preferreds.

Mr. MCWATTERS. How about return to profitability? It's one thing to sell a subsidiary, take the cash, pay down the debt. But how do you return AIG systemically, to a profitable company?

Mr. BENMOSCHE. If you look at our first quarter, in fact, if you look at our fourth quarter where we reported a huge loss, if you look at what were the components of that loss, we actually made a profit.

And so I believe that you're looking at a company that once we sell off the companies that we've talked about, or assets that we've talked about, I still think we're talking about a company that could earn, in 2011, without extraordinary charges and goodwill charges, and all these other things, I believe we have a company that can earn between $6 billion and $8 billion after taxes.

So it is a substantial earner. If you look at the first quarter of Chartis, we had a huge earthquake in Chile, that cost us a lot of money because we're a huge insurer and so we covered a lot of damage. If you look at this quarter, we have the Gulf and the issues in the Gulf. We're going to take losses there as well.

In spite of those losses, those catastrophe losses, we are still showing a healthy profit in Chartis. And if you look at our retirement business, and life and retirement business, we're also showing healthy profits. So we are restoring all of the aspects of AIG to profitability right now.

Mr. MCWATTERS. On Financial Products, are you making money winding down Financial Products or are you losing money?

Mr. BENMOSCHE. If you look at our numbers, right now I think basically we're holding our own, breaking sort of even. Keep in mind that one of the variables that occurs, is that we have a lot of debt against that business. And it's one of the anomalies of our accounting system. As people become more concerned about AIG, it actually improves the profitability of Financial Products because our spreads widen and therefore we can take an earnings, which is unfortunate, we shouldn't do that but we do, that's how we account for it. So in bad times we look better and in good times we look worse.

But I will tell you that if you take all of that accounting out of the noise you will see that we're de-risking. The team has done an absolutely outstanding job. We are fortunate that they're still there. They're fortunate, even though they were vilified inappropriately, that they are working as hard as they can to de-risk this book, sell off the book, and do it in a break-even to slight profit.

Mr. MCWATTERS. When they close out a credit default swap, are they currently closing them out at par or are they attempting to negotiate discounts?

Mr. BENMOSCHE. We negotiate what we can negotiate in the marketplace from a position of strength. So I don't have the analysis. So I'm going to give you how much of that is at what level. But I will tell you that when we look at the market value and what the anticipated market values could be, and where we think is a good optimum position where we're getting a good price and getting out, and dealing with, in effect, de-risking the company from where we have collateral potential calls and so on. I think they're doing an excellent job of getting good prices. They were not getting good prices a year ago.

Mr. MCWATTERS. Okay.

Mr. BENMOSCHE. We were getting hammered a year ago in the marketplace. That has changed dramatically.

Mr. MCWATTERS. Did it change because of the personnel within Financial Products, or the market?

Mr. BENMOSCHE. It changed because the market realized that we were going to change our approach. That we're not going to liquidate this company. And therefore, the Street realized that if they wanted to negotiate with us, they have to negotiate with us from a position of strength.

Mr. MCWATTERS. Yeah, if it's possible to let us know in general terms if you're able to negotiate discounts that would be helpful.

Mr. BENMOSCHE. I think it's more about trading and selling and doing things. And I think we're not—I'd have to go back and have the people give you an exact answer. I don't have that.

Mr. MCWATTERS. Okay, fair enough.

Chair WARREN. Thank you.

Mr. Silvers.

Mr. SILVERS. Mr. Benmosche, I'm sort of interested in the contradiction or the contrast between your testimony, Mr. Gallant's testimony, and the testimony of Mr. Clark from S&P.

Can you (a) explain to me your understanding of the difference between your estimation of the company's earning power going forward, after your asset sales, and Mr. Gallant's? And can you (b) explain to me if your general characterization of your company's financial position is consistent with S&P's view that absent government support you're Double B?

Mr. BENMOSCHE. I can't comment on Mr. Gallant, you'll have to get him to figure it out. I know what I'm running, I know the company I'm running, and I have confidence in this company, and I know what I'm talking about. So you'll have to see whether he understands the company as well as I do.

Mr. SILVERS. Mr. Benmosche, that's not an acceptable answer.

Mr. BENMOSCHE. Okay.

Mr. SILVERS. You know we represent your majority stockholder, or at least we kind of do. We are trying to look out for your majority stockholder. I am frankly frightened by what Mr. Gallant said on behalf of the American public. And I would like you to explain specifically with reference to numbers why he's wrong.

Mr. BENMOSCHE. I have not looked at his report. I'd be glad to have a team of people study it and do a side-by-side. We did that when we had a report that said that we had an $11 billion hole in our reserves. It was written by Bernstein, and in fact, you found out we did not have an $11 billion hole. We actually went through that report, showed them why they were wrong, and they still went forward with it. So I'm happy to do that for him as well.

Mr. SILVERS. Well perhaps there's a different—perhaps I can put it in a different way. Explain to me how you get from today's operating results to the type of cash flows that you were just describing, the $6 billion to $8 billion range in 2011. How do you get from here to there?

Mr. BENMOSCHE. Well look at the first quarter. If you look at the first quarter we made $879 million——

Mr. SILVERS. Right.

Mr. BENMOSCHE [continuing]. In Chartis.

Mr. SILVERS. Okay.

Mr. BENMOSCHE. Okay, with casualty losses in Chile. If you look at what we did in our SunAmerica, we had a strong result of almost a billion dollars. If we continue to operate all the other companies at break-even to a positive, and just deal with those two companies alone, and deliver the times four, you get pretty close to the number.

And so I would say to you that if you look at our results for the fourth quarter, without extraordinary charges, if you look at where we were in the first quarter——

Mr. SILVERS. Mr. Benmosche, I'm missing something. Your total operating income at corporate level in first quarter of this year was $800 million, I multiply that times four, I get $3.6——

Mr. BENMOSCHE. I don't know what number you're referring to then. We made a profit of $1.4 billion in the first quarter.

Mr. SILVERS. I'm talking about your operating income which is, I think, kind of more relevant to what we're talking about, is it not?

Mr. BENMOSCHE. You have to look at all of the pluses and minuses, all of the accounting charges. For example, we have to take the charge of the fee that is assumed by the government taking 80 percent ownership of $23 billion. We take charges of between $500 million and $800 million a quarter to amortize a $23 billion fee which represents the price we pay for the line of credit from the Federal Reserve. So in effect, we pay $23 billion in points for an $85 billion——

Mr. SILVERS. But if you're a Double B——

Mr. BENMOSCHE [continuing]. Which is more——

Mr. SILVERS. But if you're a Double B credit without support from the government, aren't you going to have to replace that with comparably expensive capital?

Mr. BENMOSCHE. We're going to replace it. And I don't know how expensive it will be. And keep in mind what S&P said today, we're a Double B. As we begin to achieve our plans we'll be investment grade by the end of the year.

Mr. SILVERS. You can imagine, I think our concern is about just the gap between different assessments here. I would very much welcome, and I'm sure the other panel members would welcome a more detailed explanation of how you think you're going to not be a Double B without government support. Which seems to me to be critical to the question of whether or not you know, your representations about the likely outcome here for the public, being paid back in full with a respectable profit, are realistic and can be realized.

You know, I think we have heard, I think in general, a great deal of support and a number of compliments for the way that you've managed the company so far. But you know we, I think we need to see some support for what the likely outcomes are here and why we don't have a structural problem. A problem not really susceptible to managerial skill.

If I might turn and ask you a different question. Some have suggested including I think one of my colleagues, including Professor Troske, have suggested that we really ought to be selling assets more quickly. I would—I know that's not been your view. Can you explain why that—and I'll put my cards on the table, I'm sympathetic to your position. I think selling assets prematurely is a certain way to realize losses. But I'd appreciate to hear it from you, in your own words, why you've taken that view and what the benefit has been for the public as an investor in AIG?

Mr. BENMOSCHE. I think so far you have seen prices improve. I think at one point, they were thinking of selling AIA for the high teens. And so we got a very aggressive price. And other properties that are out there we are finding people willing to come to the table and talk to us about more value. Because you cannot buy a

business that is in trouble, number one. And number two, you have to sell when the time is right. And we have to make sure that we're prudent, we move as quickly as we can. But so far, even for example, in Financial Products, we probably would have been down an additional $5 billion had we rushed the sales and tried to de-risk that business too quickly.

And so now that we've reduced—taken the risk out, de-risked it, you're going to see the fact that we have the money that's here. Sometimes it's not obvious that we didn't make it, but we didn't lose it. So I can only tell you that as we move, we're moving quickly. We're finding more people coming to the table. More people wanting to invest with us. I think you'll see more options open up. We just met with Boeing, as you know, we're a large customer of Boeing and our goal is to continue to buy Boeing aircraft. But Boeing is going to work with the XM Bank with us and others to be able to get sources of capital to continually invest and to continually strengthen that business over time. That will provide good operating earnings.

So throughout the company, at all levels, we're looking at ways to improve our position, strengthen our position, and then find appropriate buyers when it makes sense. And I think we will do that as quickly as we can. We're not just sitting here saying, let's wait for 2013, but you got to do it when the market's right.

For example——

Chair WARREN. Okay, I'm going to stop you there Mr. Benmosche.

Mr. SILVERS. Thank you.

Chair WARREN. Thank you. And I appreciate your offer to provide the numbers. And we'd like to have those numbers for the record on the Gallant analysis, why you have a different analysis on the profit projections, where those are coming from, and on the credit rating.

Mr. BENMOSCHE. I'll bet you my staff—I just heard her say that they're watching the TV, and I'll bet you they're off and running already.

Chair WARREN. I'm delighted to hear that.

Mr. BENMOSCHE. I'm sure they're running right now.

Chair WARREN. We will hold the record open so that we will be able to get those numbers.

Mr. BENMOSCHE. I'm not sure I'll have it in the next hour, but they're working on it.

Chair WARREN. That sounds good.

Professor Troske.

Dr. TROSKE. Thank you. I guess so I don't want you to ask you to comment on a report that you didn't write or maybe haven't even read. But the previous witness said his guess was $6.00, the market says $33.00. Do you have a guess as to what you think the share price for AIG should be? Just your own opinion?

Mr. BENMOSCHE. Totally inappropriate to even comment.

Dr. TROSKE. Okay.

Mr. BENMOSCHE. I wouldn't.

Dr. TROSKE. Okay, that's fine. You seem to suggest that you can operate in the—you are borrowing money in an unsecured credit

market, so you are operating in the debt market, is that what I heard you say? That you——

Mr. BENMOSCHE. At ILFC, we have done that.

Dr. TROSKE. Okay, and so the previous witness said that you couldn't borrow money and you're telling us you can?

Mr. BENMOSCHE. No, I'm telling you I borrowed $2.7 billion——

Dr. TROSKE. You did.

Mr. BENMOSCHE [continuing]. For ILFC aircraft leasing unsecured, without a guarantee from AIG.

Dr. TROSKE. So can you give me, I guess some more background. Exactly when you say you're you know, spinning AIGFP down. Exactly as you are removing the risk from AIGFP, is that going to be—is that part of the long term solution for the company? Do you view AIGFP continuing to be a part of AIG in the long run?

Mr. BENMOSCHE. I do not.

Dr. TROSKE. Okay, and so can you describe to me a little how you, how you're going to move from where you are today to a company that looks a little different?

Mr. BENMOSCHE. Well I think what's important now is we focus on the core businesses of AIG——

Dr. TROSKE. Okay.

Mr. BENMOSCHE [continuing]. Which is the insurance companies.

Dr. TROSKE. Okay.

Mr. BENMOSCHE. What you have is a lot of other companies were created outside that entity, which you heard a lot about. I think we should minimize all of those, which were basically trading the Triple A of the insurance companies, and being able to borrow in the market short, and then begin to do things with assets long. And so those kinds of carry trade kinds of businesses, we need to stop. That's not a business we should be in.

We should be in a solid business that talks about, we provide protection in various forms, whether it's property, casualty, life, annuities, and so on. And those should be the primary businesses that we'll run, and run them in a way that they're not over-leveraged.

Dr. TROSKE. Okay. Okay, and so that's essentially your vision of what your company is going to look like at the end of the day when you are out of all of this, these problems, focus primarily on the core insurance businesses.

Mr. BENMOSCHE. We will be the world's largest property and casualty insurer with a strong life and annuity business in the United States and other selected businesses that will enhance that nucleus and core.

Dr. TROSKE. Okay, thank you.

Chair WARREN. Mr. Benmosche, I have been struck as I've read through the documentation on AIG about the incredible number of intra-corporate guarantees and loans among the various, particularly among the various insurance subsidiaries and the parent and the various insurance subsidiaries among themselves. And I see that as once the parent got into trouble, as everyone likes to point out, AIGFP was just one tiny little part of AIG. And it at least threatened the entire rest of the company in part, because of this incredible interconnection.

So I'd like to know about how you're managing that going forward. Is this a company that will still be run as one that has lots of cross guarantees and intra-company loans and inter-subsidiary loans?

Mr. BENMOSCHE. The answer is no. I think that it was created out of a lot of complexity over a lot of time. We're a company that has over 500 general ledgers in it today. The degree of complexity to run the business every day is huge. Which is why the people are so important to this company. And so I will tell you that they are working daily looking at ways to deliver, to change, and move.

So part of what you'll see is us going to the Treasury saying, we need capital to put into the insurance company. You just don't take something out of an insurance company without the approval of the regulator. Whether it's in Malaysia, or whether it's in Korea, or whether it's in Tennessee. All of those, as well as New York and Pennsylvania, and so and so. You've got to make sure, as we do this, we do it in an appropriate way such that the regulators are satisfied.

But at the end of the day, we want very clear discreet businesses that we can see what they are, where we can see their financials. And therefore, we can go to the capital markets for that insurance company. And for example, deal with raising debts through bonds and so on which is what makes them even stronger from a ratings agency point of view. Because they have access to the markets and so we've got to have them understood, clean and plain. It's not easy to do. It's taking us time to get there. Which is why you can't accelerate some of the sales. Because it's too intertwined, too complex.

Chair WARREN. So would it be fair then to say that you're striving for a simpler, a more transparent business than you had in the past?

Mr. BENMOSCHE. We will achieve a simpler organization.

Chair WARREN. I like that.

Mr. BENMOSCHE. Not striving for. We will do that because you have to do that to have your exit from the government. You're going to have to be able to do that to get the rating agencies to give us very good ratings for our insurance companies.

Chair WARREN. And would you be able to demonstrate some progress along that line, say from a year ago?

Mr. BENMOSCHE. [No response.]

Chair WARREN. You don't have to do it off the top of your head.

Mr. BENMOSCHE. No, I think that the whole——

Chair WARREN. We can hold the record open for this.

Mr. BENMOSCHE [continuing]. The whole rating agency, or feedback from S&P in particular, basically talks about the kind of progress we're making. And I think that at the end of the day when we have rating upgrades in our insurance companies will be the sign that we've achieved.

Chair WARREN. But you would forgive us if we weren't entirely reliant on rating agencies at this moment.

Mr. BENMOSCHE. I won't comment on that.

Chair WARREN. Thank you.

Mr. BENMOSCHE. You're welcome.

Chair WARREN. But it would be helpful, I just want to stress this point because I think it's very important, about if you could give

us, as a supplement to your testimony, some examples of the work that has already been done to make this a more transparent company, let us describe it as one with a simpler chart of how it works.

Mr. BENMOSCHE. I'm happy to have the team put together things we've done in Chartis and SunAmerica and things we're starting to do to begin to pull things apart so we don't have to deal with all of the cross-guarantees and cross-collateralization agreements.

Chair WARREN. Thank you.

Mr. McWatters.

Mr. MCWATTERS. Thank you. I'll follow-up on Professor Warren's comment and I'll put it this way. It still seems to me that AIG is too big to fail. That if, for whatever reason, you ran out of cash, you had a liquidity crunch again, chances are the taxpayers would have to come to your rescue.

Okay, let's just stipulate that for a second. What has your firm done to negate that status? How are you drawing back from this too big to fail situation where a year from now, two, three years from now, we're not going to have to worry about AIG being too big to fail? If you fail, than you can just be liquidated, sold off, broken up, or whatever. In other words, do you have a living will? Do you have a plan? Are you developing a plan?

Mr. BENMOSCHE. I think that to say that we're too big to fail comes from the fact that we have a lot of assets and all the different insurance companies are added up. My personal belief that the reason you might think we're too big to fail is we owe you a lot of money. And therefore, we can't fail until we pay you back.

Mr. MCWATTERS. That would be nice, yes.

Mr. BENMOSCHE. Well I think that's the issue. The issue is we're not too big to fail, but we are right now because you got to make sure that we do this in a way that clearly pays back the taxpayer 100 cents on the dollar with an appropriate profit.

And I think to the extent we do that, the remaining company, other than by what Congress decides is too big to fail in terms of assets size or whatever, I don't believe that AIG, once we pay back the government and we exit as an investment grade company, I believe that we are no longer too big to fail.

Mr. MCWATTERS. So there will be no "Financial Products II" or "Son of Financial Products"? I mean you're out of that business?

Mr. BENMOSCHE. I can only tell you what I will do. I hope that somehow we find the appropriate regulations that say in the future that any company that decides to get in businesses and put at risk some of the businesses that we had in insurance or banking is prevented.

I can't tell whether my successor will come in and find a clever way to go back into the FP business. But I will tell you, while I'm here I want to make sure that that is not part of this company because that's not what we should be doing.

Mr. MCWATTERS. Well specifically, have you adopted risk management and internal control provisions that will just simply prevent, prohibits FP from coming back?

Mr. BENMOSCHE. You cannot create policies that will prevent people from making bad management decisions. At the end of the day, the CEO has to take responsibility for the activities in their

company. And when they blow up, they have to take responsibility for why they let that happen.

At the end of the day, I am very confident we have all of the processes in place in risk management. But at the end of the day, if I don't listen to it and I don't lead this company the right way, I can get the company in trouble.

And the Board of Directors will do their best to oversee me. They will make sure they have the checks and balances. But at the end of the day, if we don't listen to what we hear, we can get in trouble. And I believe our Board at AIG today is very strong. It would not let that happen. I will not let that happen. And over time, we hope new Board Members and new CEOs will also make sure that doesn't happen.

Mr. MCWATTERS. So is it fair to say you're developing a culture that is anti-FP?

Mr. BENMOSCHE. We're developing a culture that is anti-taking inordinate risks. That would jeopardize the quality of our businesses when the businesses we are in make guarantees to people, sometimes for their lifetime.

Mr. MCWATTERS. Are you in doing that, making any effort to separate risk from reward? So if you have an employee who comes up with a brilliant idea like someone did at FP a few years ago on credit default swaps, where they are paid a huge bonus, let's say in year one, for doing the deal. If the deal blows up four years later, I mean is that still possible?

Mr. BENMOSCHE. It wasn't possible before either. I think I need to clear up something. When you look at AIG and the people at AIG, the 10 people that reported to me when I got there, those 10 people lost $168 million dollars of their prior pay because of what happened at FP.

They lost $168 million. Five senior people at FP, leadership at FP, those five people lost $88 million dollars of their prior pay. Their pay has always been at risk for almost a five-year period of time through stock and cash plans.

So you've got to have something other than pay. You got to reward pay, you have to have risk in the pay process. You have to have controls over when it gets paid out. But at the end of the day, the real challenge is to make sure you have good risk management and a good management of the company, and not rely on the compensation system. Either way, we've got to run the company the right way. So I can tell you that at FP, that was never the case, of getting rewarded in one year.

Mr. MCWATTERS. Never the case?

Mr. BENMOSCHE. Never the case.

Mr. MCWATTERS. As I suspect right now, and from what I've read, at least in the popular press, at 2:45 in the afternoon there's some guys on the 14th hole right now teeing off. And it's because they made a lot of money at FP and then left. But they left the damage behind, which is the key.

Mr. BENMOSCHE. There are people who worked there, and I will tell you in the last five years, most of their compensation was wiped out. In fact, even the bonuses that I got approved for people——

Mr. MCWATTERS. Right.

Mr. BENMOSCHE [continuing]. 40 percent of that bonus goes into a deferred compensation plan at FP, which is so negative they will never see the light of day. And so people today are still losing pay for what happened in the past. Unfortunately, there are people who caused the problem that aren't there which is what——

Mr. MCWATTERS. That's my point.

Mr. BENMOSCHE. And my point is, it's a shame that we picked on the people who are there trying to get the job done. So I can only tell you that they still, the people who left, even the person who ran it, lost almost $70 million of his prior pay. But he got a lot of money from prior years, no question about that.

Mr. MCWATTERS. Exactly.

Mr. BENMOSCHE. But at the end of the day my concern is, from what you said is, it's not about their pay. It's about the fact we should have strong risk management and we should have a company that doesn't over leverage itself and too cheaply allows parts of the company to leverage a Triple A of a solid insurance company. That was the mistake, not the pay.

Mr. MCWATTERS. Okay, thank you.

Chair WARREN. Mr. Silvers.

Mr. SILVERS. I'd like to come back to this pay question and look at it a different way. Last fall, the Federal Reserve system promulgated a sort of set of principles around pay for entities they regulate. And indicated that they would, that the Fed was going to be looking at pay at financial institutions that they regulated. Basically, looking at two issues, risk and time horizons.

What processes do you have in place, as an entity that has this sort of unique relationship with the Federal Reserve system, what processes do you have in place and what, if anything, is the Fed doing to oversee them in relation to those policies?

Mr. BENMOSCHE. I believe that the Fed is overseeing not only our compensation policies, but I will tell you first and foremost, that they're in every aspect of our business, and rightfully so, because we owe them a lot of money.

I will also tell you that I believe the working relationship—I'm going to make a comment. Our working relationship with them is extremely professional and very effective. They've been terrific partners. So they watch everything we're doing and everything we're working through.

Mr. SILVERS. So tell me exactly what does that mean in relationship to compensation policy? What are they asking you—how is that oversight manifest?

Mr. BENMOSCHE. Well, first of all, we can start with Ken Feinberg. And so Ken Feinberg deals with the way we're paying the top 100 people.

Mr. SILVERS. Yes, but I'm asking you about the Fed, and the Fed's relation—and the Fed's implementation of their policy.

Mr. BENMOSCHE. They are aware of our compensation plans. We share with them all the long-term incentive plans, what our goals are. We talk about the vesting, we talk about claw back, we talk about how we're doing it. All of our plans are presented to them and they're aware of the things we're doing.

Mr. SILVERS. Okay. Now to pick up on my colleague's question about sort of downside exposure. You described that some individ-

uals made money in AIG during the boom period and then lost it during the bust. I don't doubt that that's true.

If you look at it though from the beginning of the process, the moment when people make decisions as executives about taking risk. All that money all right, all the gain is the upside. You don't seem to have described any kind of actual downside that anybody took.

So my question is, going forward, how do you build real downside around risk, around risk for your senior employees? And how do you avoid this asymmetry where it's all about how much you gain and the comp plan can't really embody the notion of the loss that investors in your company or ultimately the public, it appears, will bear?

Mr. BENMOSCHE. I think it's a question of how you design your goals and you design things. So for example, if you have part of the company where they are incentivized to create operating earnings——

Mr. SILVERS. Okay.

Mr. BENMOSCHE [continuing]. And that's all they're asked to do, then they will do that.

Mr. SILVERS. Right.

Mr. BENMOSCHE. They may also make that part of the business insolvent. They also may not choose to clean out the inventory of some antiquated product and therefore, they're not taking losses that you should take. So you have to design your compensation program that takes risk into account, sets parameters of what those risks are, and you have to manage it.

You cannot let the compensation program drive results. And that's why, for example, in the securities industry, I have always been against just revenue compensation plans. Because I think they don't talk about risk, they don't talk about bottom line.

Mr. SILVERS. How do you build downsides, how do you build true downside in from any perspective?

Mr. BENMOSCHE. What would you like downside to be?

Mr. SILVERS. Well I mean, look, from an investor perspective downside is downside. I put up money and if I don't—and if I lose, I lose, right? If you think about it graphically, I have real downside exposure and real upside exposure.

Most executive pay plans I am familiar with, that purport to be performance based or to tie compensation to performance have only the upside of that line, they don't have the downside. And that creates situations like that which my colleague Mr. McWatters was referring to. Where executives are not really fully exposed to the risks that investors are exposed to and the public is exposed to.

Mr. BENMOSCHE. Well——

Mr. SILVERS. I'm just curious if you've got a solution to this problem given——

Mr. BENMOSCHE. YES.

Mr. SILVERS [continuing]. Given the stakes involved for AIG and for the country.

Mr. BENMOSCHE. I think when you have stock ownership, you want to have downside. If you look at what happened to the associates of AIG. People have been there their whole careers have been

totally wiped out through no fault of their own. Keep in mind there were 44,000 trades at FP, 44,000. Less than 125 went bad.

Almost all the people at FP, all the people, 100,000 employees of AIG all suffered huge losses in various forms because of what happened here. Because a lot of them owned AIG stock either in their 401k or in their bonus plans or stock plans.

So I will tell you that there was huge losses taken by people who owned the company. And that's about the only way you're going to be able to do it. The downside is, you own the company and if you screw it up you're going to lose money.

Mr. SILVERS. I don't think—my time is up, but I don't think that's exactly what happened. People lost some of the money they made. It's not the same thing as the perspective of investors or the public who are at risk of losing money they brought to the table. It's quite different. Thank you.

Chair WARREN. Professor Troske.

Dr. TROSKE. One of the advantages of going last is I get to free ride on my colleagues and they get to ask all the questions. And so I don't have very many left. But I guess I do have one. And that would be, does AIGFP still pose a threat to the success of the overall company?

Mr. BENMOSCHE. I believe the AIGFP threat at the end of, at the beginning of 2009, was probably a $20 billion to $22 billion cash call.

Dr. TROSKE. Okay.

Mr. BENMOSCHE. That has been reduced to almost $4 billion. So there's still a risk. I think the greatest risk is downgrade. That's why operating results are important and as long as we continue to do that I think that will be further de-risked as we go through the year.

So I think that it's manageable and will continue to be manageable until we get through the end of the year and then the rest of it gets absorbed into the rest of the company as just investments that have to wait until the duration gets there.

Dr. TROSKE. Okay. Thank you.

Chair WARREN. Thank you very much Mr. Benmosche.

Mr. BENMOSCHE. Thank you.

Chair WARREN. We appreciate your coming and we will hold the record open for the additional information.

Mr. BENMOSCHE. Okay, thank you very much.

Chair WARREN. Okay, thank you.

Mr. Millstein.

We now call our fifth and for the day, final panel, Jim Millstein, Chief Restructuring Officer of the U.S. Department of Treasury.

Have you found a comfortable place? I think you found a low chair sir. That or you're shorter than I recall.

Mr. MILLSTEIN. It might be that.

Chair WARREN. There we go, much better. When you're ready if you could give us an opening statement and hold it five minutes please.

Mr. MILLSTEIN. I will.

STATEMENT OF JIM MILLSTEIN, CHIEF RESTRUCTURING OFFICER, U.S. DEPARTMENT OF THE TREASURY

Mr. MILLSTEIN. Chair Warren, members of the panel, thank you for the opportunity to testify today. Since joining the Treasury Department in May of 2006, I have been—2009, sorry. I have been—it feels like four years. I have been primarily responsible for overseeing the taxpayers' significant investment in American International Group.

As you know, prior to joining the Treasury Department I spent 28 years working in the private sector focused exclusively on financial restructurings.

I will use my time today briefly to outline our current investments and commitments to AIG, the company's restructuring plan, and the Government's exit strategy.

As of today, the Federal Reserve Bank of New York and the Treasury Department have extended $132 billion of financial support to AIG. The New York Fed has provided $83 billion of this support, $26 billion of which represents loans outstanding to the parent company.

$25 billion of which represents the preferred interest in AIG's two largest international life insurance subsidiaries, AIA and ALICO, and $31 billion of which represent loans to two special purpose vehicles formed to acquire troubled assets from AIG in November of 2008.

The Treasury has provided $49 billion in the form of Series E and F Preferred stock. In addition, the AIG Credit Facility Trust established for the benefit of the taxpayers in connection with the original funding of the New York Federal Reserve Credit Facility, holds AIG's Series C Preferred stock which represents approximately 80 percent of AIG's outstanding common stock on a fully diluted basis.

This substantial financial commitment has enabled AIG to remain a going concern with an investment grade rating. However, without government support, because of its leverage and the risks associated with its financial products business, it would not have an investment grade rating, a rating that is critical to the competitiveness of its insurance subsidiaries.

Therefore, the objective of the company's restructuring plan is to restructure its balance sheet and business profile so that it can sustain an investment grade rating on its own. Thereby, permitting the government to exit its support and to monetize its investments.

The restructuring plan has six essential components. First, the company will have to substantially reduce its debt through asset sales and divestitures. Next, the Company will have to demonstrate independent access to the capital markets and secure standby lines of credit.

Third, the wind down of AIGFP will have to be substantially completed. Fourth, AIG will need to divest any businesses whose potential cash needs or credit rating represent a potential drag on the parent company rating.

Fifth, the company will have to demonstrate that its core insurance subsidiaries are profitable, well capitalized, and have repaired the damage to their franchises that the uncertainty associated with rescue has generated. Finally, the company will have to dem-

onstrate that it has improved its risk management procedures and practices.

Today as you've heard, AIG has made significant progress on each critical front. The pending AIA and ALICO divestitures will result in a substantial deleveraging of AIG's balance sheet and will facilitate its access to third party capital.

AIG's leasing and finance businesses have accessed the long term debt markets again, allowing them to refinance their maturing debt and meet their own liquidity needs without recourse to the parent. The wind down of FP has made significant progress and is targeted to be completed substantially by year end.

Financial results have stabilized and begun to improve at Chartis and SunAmerica Financial, the core businesses of AIG's future. And finally, its risk management practices have improved.

At the conclusion of this process, once it can sustain an investment grade rating without government support the government will exit as promptly as practicable. Whether we get all of our money back remains an open question. Let me briefly review where we stand today.

If the AIA and ALICO divestitures close as planned, proceeds of those sales and the sale of other non-core assets should be sufficient to repay the New York Fed facility and redeem the preferred interest it holds in AIA and ALICO in full with all interest and dividends.

Cash flows from the assets in Maiden Lane 2 and 3 and recent valuations of those assets suggest that the New York Fed loans to Maiden Lane II and III will also be paid in full with interest. And that the equity they own in each of those facilities is likely to have a real value.

As a result, it seems very likely that the $83 billion dollars of outstanding Fed support will be paid in full. Similarly, at current market prices, the common stock that the Series C represents has value. Market conditions may change before the trustees have the opportunity to sell that stock, and the very selling of that stock, given how much they have, will put significant downward selling pressure on the price of AIG's common stock. But the stock market today suggests there's real value there.

Finally, that leaves the Treasuries Series E and F Preferred, the $49 billion. The timing of our ability to monetize those investment in AIG will depend on the pace at which the other steps of the restructuring plan are accomplished.

Whether Treasury ultimately recovers all of its investment or makes a profit, will in large part depend on the company's operating performance and market multiples for insurance companies at the time the government sells its interests.

Chair WARREN. Mr. Millstein, we're at five minutes.

Mr. MILLSTEIN. I'm done.

Chair WARREN. Do you want to just give me another sentence?

Mr. MILLSTEIN. One more sentence.

Chair WARREN. You got it.

Mr. MILLSTEIN. But as soon as we are confident that AIG can stand alone, we will move to exit these investments as promptly as practicable. Now I'm ready for your questions.

Chair WARREN. There we go. I like that, "promptly as practicable."

[The prepared statement from Mr. Millstein follows.]

Written Testimony of Jim Millstein

Chief Restructuring Officer

U.S. Department of the Treasury

before the Congressional Oversight Panel

May 26, 2010

Good morning.

Chair Warren, and members of the Congressional Oversight Panel, thank you for the opportunity to testify today. Since joining the Treasury Department (the "Treasury") in May of 2009, I have been primarily responsible for overseeing the taxpayers' significant investment in American International Group ("AIG" or the "Company"). Prior to joining the Treasury, I spent 28 years working in the private sector focused on financial restructurings.

I am here today in response to the Panel's request for an explanation of the terms of the government's investments in AIG, the evolution of those investments and the strategy for the government's exit. The Treasury is very much a reluctant shareholder, and while we leave the day-to-day management of the Company to the CEO and the Board of Directors, we actively monitor progress on the restructuring front. Our primary goals are to protect the taxpayers' investment in AIG, promote financial stability, and expedite the government's exit.

As of today, the Federal Reserve Bank of New York (the "FRBNY") and the Treasury Department have extended $132.3 billion of financial support to AIG in a variety of forms.[1]

The FRBNY has provided $83.2 billion of this support. This support is in three different forms. First, there $26.3 billion outstanding on the FRBNY loan (the "FRBNY Facility") that was first extended to AIG in September of 2008.[2] Second, the FRBNY holds $25.4 billion of preferred interests in two investment vehicles which hold, respectively, AIG's two largest international life insurance companies, AIA and ALICO (the "AIA and ALICO Preferred Interests").[3] Third, there is $31.5 billion outstanding on loans that the FRBNY made to two other investment vehicles, Maiden Lane 2 and Maiden Lane 3, which purchased certain troubled financial assets from AIG.

The Treasury has provided $49.1 billion of the total support. $41.6 billion of this support is in the form of Series E Preferred and $7.5 billion is in the form of Series F Preferred. The proceeds of the Treasury's preferred stock investments were used to reduce the Company's debt burden, to help buttress the regulatory capital of certain insurance subsidiaries, and to untangle the web of cross-ownership and intercompany funding arrangements between and among AIG and its various subsidiaries.

Finally, the AIG Credit Facility Trust (the "Series C Trust"), established for the benefit of the taxpayers in connection with the original funding of the FRBNY Facility, holds AIG's Series C Preferred, which is convertible into approximately 79.8% of AIG's common stock. The Series C Trust is governed by three independent trustees who act as fiduciaries on behalf of taxpayers.

The purpose of my testimony today is to explain how the taxpayer came to own this varied portfolio of AIG interests and the plan to extract the government from these positions, as soon as practicable.

---

[1] This represents the existing outstanding amounts. Currently, there is approximately $12 billion of undrawn capacity under the FRBNY Facility, and approximately $22 billion of undrawn capacity under the Treasury Series F Preferred commitment.

[2] Amount includes accrued fees and interest.

[3] The AIA and ALICO Preferred Interests were taken in transactions that closed on December 1, 2009 in satisfaction of a portion of the debt then outstanding under the FRBNY Facility.

AIG's rescue in September 2008 sought to avoid the catastrophic consequences to our economy and to American families and businesses that would have resulted from its sudden collapse. As a result of necessary government intervention, the taxpayer became a substantial equity holder in AIG, and taxpayers' ultimate recovery on their investment in AIG depends on the strength of the Company's underlying insurance subsidiaries. Today, AIG is a "going concern" [4] with an "A-"[5] investment grade rating only because of government support. Therefore, the objective of the restructuring plan is to restructure AIG's balance sheet and business profile so that it can maintain this status on its own, thereby permitting the government to monetize the taxpayers' investment.

As a substantial equity holder in AIG, the taxpayers' ultimate recovery on its equity interests in AIG depends on the ability of AIG's management to improve the results of its core insurance businesses. Together with the trustees of the Series C Trust, the government has worked with the Company to recruit an almost entirely new Board of Directors,[6] a new CEO, a new Chief Risk Officer, a new General Counsel and a new Chief Administrative Officer. All of these executives and directors are committed to the objective of protecting the taxpayers' investment in the Company and paying back the taxpayers as promptly as practicable.

The mechanics of the restructuring plan itself are relatively straightforward in concept: sell sufficient assets at fair prices to pay off AIG's obligations to the FRBNY, streamline AIG's business portfolio, and recapitalize AIG's balance sheet to support investment grade status without the need for ongoing government support. At that point, the Company will be a simplified life, property and casualty insurer with solidly capitalized insurance subsidiaries, adequate liquidity, and a stable balance sheet. Executing this plan will enable the government to sell its equity interests in the Company as soon as market conditions permit.

The Structure of USG Assistance

On September 16, 2008 the government committed to provide unprecedented assistance to AIG. In the absence of such assistance, AIG would have then defaulted on more than $2 trillion notional of derivative obligations and on over $100 billion of debt to institutions. Those defaults would have inevitably forced AIG to commence Chapter 11 proceedings for itself, its Financial Products subsidiary (AIGFP), its aircraft leasing subsidiary, and its consumer finance subsidiary.

The initial decision to loan money to AIG fell to the Federal Reserve because, at that time, no one else could act in the same manner as the Federal Reserve. The Emergency Economic Stabilization Act (EESA) was not authorized by Congress until October 2008, and none of the agencies with supervisory authority over AIG had any tools to help directly meet the funding requirements of AIG. No one in the federal government had a mechanism, as we do for banks, to provide for the orderly unwinding, dismantling, selling, or liquidating of a global, non-bank financial institution like AIG.

---

[4] In accounting terminology "going concern" refers to a company's ability to continue functioning as a business entity.
[5] Throughout this testimony Standard & Poor's ratings are used as a proxy for all agencies that rate the Company's debt.
[6] The Series C Trust has elected 11 of the 13 existing board members. The two remaining directors were nominated and elected by the Treasury pursuant to rights under the documents that govern the Treasury's Series E and Series F Preferred shares.

Many observers, with the benefit of hindsight, have concluded that AIG could have been handled differently. Some have suggested that AIG should have simply been allowed to file for bankruptcy and let the losses fall where they may so as to diminish "moral hazard." Others have suggested that AIG could have negotiated a prepackaged plan of reorganization with its creditors and fixed itself without government support. Finally, there has been the suggestion that the government should have structured its rescue financing so as to protect the valuable insurance franchises without protecting the creditors who enabled and underwrote the growth in AIG's leverage.

My colleagues at the Treasury and the FRBNY have devoted thousands of hours over the past year and a half to try to maintain the Company's stability in extremely volatile markets while also de-risking and deleveraging the Company so as to protect the taxpayers' substantial investments. I am convinced today—with the benefit of hindsight and significant experience with AIG, the Treasury, and the FRBNY—that the support provided to the Company in the fall of 2008 was the only responsible and viable option on the table. I will explain why as I address certain suggested alternatives and illustrate the challenges that we still face as we attempt to exit the taxpayers' extraordinary investments in AIG.

Many observers have argued that AIG simply should have been left alone to fail and file for bankruptcy. By virtue of both the size of its balance sheet and the nature of its liabilities, an AIG bankruptcy in September of 2008 would have been catastrophic to global financial and insurance markets.

AIG was one of the largest life insurers in the United States. An uncoordinated bankruptcy filing and the consequent seizure of AIG's insurance subsidiaries could have had devastating "run" effects.[7] In rehabilitation or wind down proceedings for AIG's subsidiaries, AIG's policyholders' access to the cash and the surrender values of their life and annuity policies would have been restricted as regulators sorted out the adequacy of capital and reserves to pay all claims in full. As those restrictions became widely known, other life and annuity providers could have experienced a sharp increase in surrenders and redemptions, forcing those firms to meet the run against them with asset sales of their own. That, of course, would have put even further pressure on markets.

AIG's failure directly threatened the savings of millions of Americans. AIG had provided financial protection to municipalities, pension funds, and other public and private entities through guaranteed investment contracts and products that protect participants in 401(k) retirement plans. Doubts about the value of AIG life insurance products could have generated doubts about similar products provided by other life insurance companies, and opened an entirely new channel of contagion.

Upon the filing of a bankruptcy petition by AIG, holders of hundreds of billions of dollars of financial assets "insured" by AIGFP would have been entitled to: (i) immediately terminate their

[7] Total weekly surrenders in AIG's Retirement Services division spiked to almost $800 million per week in the fall of 2008, before returning to a normalized level of $200 million per week after the November 2008 TARP investment.

insurance contracts with AIG,[8] (ii) apply the collateral AIG had previously posted with them to their termination claims against AIG, and (iii) offset remaining contractual claims they had against AIG against any other obligation they might owe AIG on any other qualified financial contract.

The market consequences of this rapid unwinding of AIG's credit insurance would have been severe. Having lost the benefit of AIG's insurance or "wrap" on hundreds of billions of dollars of credit instruments, AIG's counterparties would have sought to replace the insurance if it were available, or (because such insurance was largely unavailable in September of 2008) to sell the underlying credit instruments so as to mitigate future losses. The widespread sale of hundreds of billions of dollars of a concentrated class of financial assets would have created significant incremental downward selling pressure on financial assets, amplifying the selling panic that had already started following the Lehman bankruptcy. Of equal concern, the default by AIG and AIGFP on more than $100 billion of institutional indebtedness, including $15 billion of commercial paper and $85 billion of short-term repurchase obligations,[9] would have exacerbated the stresses in the money market and repo markets driven by Lehman's bankruptcy.

At that time, with the world economy under severe stress, the failure of a large, global, highly-rated financial institution that had written hundreds of billion dollars of insurance on a range of financial instruments would have dramatically amplified the crisis. Investors around the world would have pulled back from funding, out of fear that other financial institutions would fail as well. Investors would have completely lost confidence in their ability to evaluate the financial sector and distinguish between firms that were viable and those that were not. Financial firms would have been forced into even more dramatic selling of assets.

This damage would have rapidly spread beyond Wall Street. Borrowing costs for businesses would have increased dramatically, the value of pension funds would have fallen even more sharply, and job losses would have skyrocketed. While the decision to save AIG was not an easy one, it was a better choice for the American people than letting it fail.

Some have suggested that the choice between rescue and bankruptcy is a false one and that the government could have helped to arrange a prepackaged bankruptcy. As a way to shorten the Chapter 11 restructuring process, prepackaged plans only have a chance of success if there is sufficient time, before a company defaults, to organize creditors into a negotiating committee, and to negotiate and agree on a comprehensive restructuring plan which can be implemented in an expedited proceeding before the bankruptcy court.

At the end of 2008, in my private sector role as a financial advisor to companies experiencing financial distress, I negotiated just such a prepackaged plan of reorganization for Charter Communications, using the urgency of the financial crisis and Charter's imminent default to accelerate a normally cumbersome, time consuming process. However, even on that accelerated basis, it still took three months to negotiate and agree on the restructuring plan and another six

[8] Under the qualified financial contract exceptions to the automatic stay provisions of the Bankruptcy Code otherwise applicable to creditors in a Chapter 11 proceeding.
[9] Includes securities lending obligations.

months to implement it through the courts (and Charter was only a fraction of the size and complexity of AIG).

In the second week of September 2008, barely a week before AIG would have defaulted on hundreds of billions of dollars of obligations, the FRBNY, having had no previous regulatory or supervisory authority over AIG or AIGFP, simply had no time to organize AIG's thousands of creditors into an effective negotiating committee, let alone negotiate a plan of reorganization with them and implement it.

In addition, the impracticality of a prepackaged plan process for AIG was not merely about timing. Rather, there was a more fundamental problem. AIG's revenues and funding depend on its customers' and lenders' perception of its long-term viability. Unlike a manufacturing company, or a retailer, or a cable company like Charter, the stability of a financial institution like AIG depends entirely on its customers' and counterparties' confidence that it will be "good for the money." A manufacturer or a retailer or a cable company can continue to sell its products through the restructuring of its balance sheet so long as it has cars, clothes or a cable signal to sell. A financial institution like AIG cannot.

A balance sheet restructuring involving the compromise of its debt obligations, whether in or out of formal bankruptcy proceedings, is fundamentally inconsistent with the basic commitment that an insurance company gives to its customers: that it has the financial wherewithal to honor a long-term payment obligation. To seek to compromise indebtedness or to compromise counterparties' credit insurance claims is fundamentally inconsistent with what an insurance company is trying to sell to its customers – its ability to pay valid claims in full as they come due.

For illustrative purposes, assume that:

i. There existed a regulatory regime in which someone had robust supervisory authority over AIG,
ii. That regulator was vigilant and ready to prompt the Company to take actions to improve its capital position well ahead of its potential ratings downgrade,
iii. AIG's thousands of creditors could have been organized into an effective negotiating committee well in advance of its possible default, and
iv. AIG's insurance regulators in the United States and in the 130 countries in which its insurance subsidiaries operate could have been convinced to forebear from ring-fencing the subsidiaries' assets or from pushing them into protective rehabilitation proceedings while AIG negotiated with its creditors.

Even assuming all four of these held true, the highly public negotiations among creditors and regulatory uncertainties would have completely undermined the viability of AIG's insurance businesses. This is because, at the first hint of financial distress (such as any public announcement that the Company had commenced negotiations with its creditors over the potential restructuring of their debt), AIG's ability to sell new insurance policies would have evaporated. Equally, redemptions of old policies would have accelerated. Together, the loss of new sales and the increase in redemptions would have quickly created a huge drain on the insurance subsidiaries' liquidity. Similarly, short-term creditors, such as AIG's securities

lending counterparties, would have refused to roll over their loans, demanding immediate payment to avoid being caught up in AIG's prepackaged plan negotiations. That "run" on AIG and its subsidiaries' liquidity would have been a regulatory trigger, forcing the hands of regulators to protect all policyholders by ring-fencing the insurers' assets or, in the extreme case, forcing the insurer into wind down proceedings.

The rating agencies would also have complicated, if not completely undermined, the possible success or utility of a prepackaged plan. Upon the announcement of a prepackaged plan, under the rating agencies' "distressed exchange" guidelines, AIG at the very least would have immediately been put on "watch negative" and, at the commencement of any plan that sought to reduce AIG's debt burden by paying AIG's creditors less than what they were owed, the rating agencies would have immediately downgraded AIG below investment grade. Further downgrades would have triggered additional collateral calls at AIGFP, putting AIG's liquidity under stress. The policyholder run on AIG's insurance subsidiaries and the counterparty run on AIGFP would have started in earnest before the prepackaged plan could be put to vote.

In my opinion, there were only two practical choices in September of 2008: (i) allow AIG to fail and put the entire financial system at risk of collapse, or (ii) fund AIG to avoid the severe financial maelstrom that would otherwise have ensued had it filed for bankruptcy.

Some have suggested that the rescue should have been structured so as to protect the valuable insurance franchises without protecting the creditors who enabled and underwrote the growth in AIG's leverage. In September 2008, there was no TARP authority nor was there any other federal government mechanism to provide for the orderly dismantling of a large, systemic, non-bank financial institution like AIG. This made it impossible to decouple the ratings of the insurance subsidiaries from the AIG parent company, and therefore impossible to extract concessions from the parent company's creditors without impairing the operating abilities of the insurance subsidiaries.

This situation could have been avoided if certain of the elements of financial reform advancing in Congress had been in place then. Despite regulators in 20 different states being responsible for the primary regulation and supervision of AIG's U.S. insurance subsidiaries, despite AIG's foreign insurance activities being regulated by more than 130 foreign governments, and despite AIG's holding company being subject to supervision by the Office of Thrift Supervision, no one was adequately aware of what was really going on at AIG. If there had there been a systemic regulator with robust oversight authority over AIG and AIGFP in the years preceding September 2008, that regulator would have been in a position to constrain AIG's risk taking. It could have imposed higher capital and liquidity requirements on AIG in the run up to the crisis, and if so AIG might never have needed government support. Both the House and Senate versions of financial reform provide such authority.

Moreover, had the resolution authority included in the regulatory reform bills been available in the fall of 2008, any support from the government that was needed would have taken an entirely different path. For example, if the systemic regulator had been required to supervise the coordination of a resolution plan involving AIG's insurance regulators, it could have pre-arranged the ownership transfer of certain insurance subsidiaries in the months leading up to

AIG's liquidity shortfall. Then, when AIG failed, the systemic regulator could have formed a "bridge bank" and transferred – with all necessary insurance regulatory approvals secured in advance – all of AIG's valuable operating businesses to it. Government financial support would have then been effectively secured by the unencumbered assets of those operating businesses, and limited to the amounts necessary to bridge the insurance subsidiaries' liquidity needs. This would have effectively decoupled the ratings of the insurance subsidiaries from the rating of the AIG parent company, and would have ensured that AIG's unsecured creditors received a recovery only after government support had been repaid.

The comprehensive financial reform legislation proposed by the Administration and advancing in Congress would remedy both deficiencies.

First, the government needs the ability to limit risk-taking for institutions that threaten the overall stability of the system and can cause extraordinary damage to the American economy. The government needs this ability not just for banks, but for institutions that operate like banks. These non-bank financial institutions existed alongside banks and yet were not subject to those constraints in the period leading up to this crisis. The government also needs to make sure that regulators have accountability and flexibility, and that they enforce sensibly-designed constraints on risk. The systemic regulatory authority that is part of financial reform addresses these needs.

Second, the government must have the ability to resolve failing major financial institutions in an orderly manner, with losses absorbed not by taxpayers but by equity holders, unsecured creditors and, if necessary, other large financial institutions. This resolution authority would allow an orderly response to a potential future crisis, protecting both the taxpayer and the overall economy. Both the Senate and House versions of financial reform generally include such tools.

The Evolution of Government Support

Forced to fund AIG's immediate liquidity needs, the government structured its rescue financing as secured debt; that is, amounts outstanding under the FRBNY Facility have priority against the value of AIG's unrestricted assets. That structure protected taxpayers in the short term if AIG had proved not to be viable in the longer term. Fortunately, AIG is proving to be viable. In addition, the FRBNY took nearly 80% of AIG's fully diluted common equity[10] to provide additional compensation to taxpayers for their assistance, and to penalize the shareholders of the Company for the fact that the Company had no alternative but to ask the government for extraordinary assistance.

The FRBNY Facility solved AIG's immediate liquidity problems, but did not alleviate the pressure on its long term credit ratings. By having drawn down a substantial amount of the FRBNY Facility to meet its cash requirements, AIG's debt to equity ratio[11] became inconsistent with its investment grade rating. A further downgrade would have brought with it the potential of significant incremental collateral calls and termination payments at AIGFP. Similarly, given the link between the parent's and insurance subsidiaries' ratings, if the parent company was

[10] In the form of the Series C Preferred Stock placed into the Series C Trust for the benefit of the taxpayer, convertible into 79.8% of the fully-diluted AIG common equity.
[11] A company's debt to equity ratio is a fundamental metric by which credit rating agencies derive corporate credit ratings.

downgraded below investment grade, it could have been the death knell to the insurance subsidiaries' abilities to write new business. A substantial and immediate reduction in the amounts outstanding under the FRBNY Facility was required to avoid another downgrade. With TARP authority having become available in early-October 2008, the Treasury injected $40 billion of preferred equity into the Company in November 2008. This allowed AIG to reduce the outstanding debt under the FRBNY Facility and increase its equity by an equal amount. This avoided downgrade and was essential for protecting the taxpayers' investment in the Company.

At the same time, to protect AIG's balance sheet against further mark-to-market losses on the RMBS portfolio it had acquired as part of its securities lending activities, and to protect AIG's liquidity position against further collateral calls arising from the deterioration in the market prices of the CDOs on which AIGFP had written credit insurance, the FRBNY created Maiden Lane 2 and Maiden Lane 3, respectively.[12]

While the actions taken in November 2008 left AIG with sufficient liquidity to weather the continuing deterioration of the credit and equity markets, its record fourth quarter losses due to deterioration in its asset portfolio (in excess of $60 billion) prompted AIG's auditors and rating agencies to require incremental equity in order to ensure that it had sufficient liquidity. Failure to obtain such a commitment would have led to a "going concern" qualification on its annual audit opinion,[13] and with that qualification, the failure of the Company. To solve this problem, the Treasury committed in April 2009 to purchase nearly $30 billion of AIG preferred stock if and when such funds were needed in the future. Since that time, AIG has requested and the Treasury has purchased $7.5 billion of the Series F Preferred. At all points since April 2009, the Company's auditors have required the Treasury to reiterate its commitment to fund the Series F Preferred – up through and including the Company's first quarter 2010 financials.[14] Without this continuing support, the auditors would issue a "qualified opinion," the rating agencies would downgrade the Company, and the taxpayers' investment would be severely impaired.

The AIG Restructuring Plan

To protect the taxpayers' now substantial investment in AIG, the restructuring plan must ultimately ensure that public confidence in AIG is restored. The Company's policyholders must be confident that AIG will be able to pay claims. The people and firms that lend money to AIG must be confident that they will be paid back. All stakeholders must be confident that AIG can independently meet all of its obligations, in full, as they come due. This is the concept upon which "investment grade status" is built, and this why the restructuring plan is centered on the maintenance of this status.

---

[12] On January 27, 2010 Secretary Geithner testified before the House Committee on Oversight and Government Reform regarding the Maiden Lane investment vehicles. Please see that testimony for a more robust discussion of the formation of Maiden Lane 2 and Maiden Lane 3.

[13] The company's auditor must consider whether the use of the going concern assumption is appropriate, and whether there are material uncertainties about the entity's ability to continue to operate as a going concern that need to be disclosed in the financial statements. An auditor who concludes that substantial doubt exists with regard to the appropriateness of the going concern assumption is required to issue an opinion reflecting this – a "going concern qualification."

[14] Currently, there is approximately $12 billion of undrawn capacity under the FRBNY Facility and approximately $22 billion of undrawn capacity under the Treasury's Series F Preferred commitment.

The reason for this is simple: businesses and consumers do not buy insurance products from firms whose long-term viability is in question. Credit ratings are a short hand by which consumers and businesses alike evaluate an insurance companies' financial condition and its prospects. An investment grade rating represents a ratings agency's assessment, upon which businesses and consumers alike rely, that there is a very low probability that the entity will default on its long-term obligations. All of the Company's primary competitors in the property and casualty insurance market are rated "A-" or higher,[15] making it impossible to compete in this market without an investment grade rating.

The need to maintain an investment grade rating makes it extremely complicated, and perhaps impossible, to pursue the creditor negotiations that some have advocated should have been pursued with AIG's CDO counterparties in connection with the creation of Maiden Lane 3. The promise of full payment is the very essence of an investment grade credit rating. To act in any way inconsistent with that promise, such as by trying to coerce counterparties to give concessions on their credit insurance claims, as the agencies have made clear in their criteria governing "distressed exchanges," is a path to a downgrade.

As the last eighteen months have unfolded, the rating agencies have begun to clarify the interaction between their rating for AIG and the substantial government support it has received. Currently, as a result of the government's financial support, AIG enjoys an upward "notching" of its ratings above what it would otherwise receive on a standalone basis. Standard & Poor's has provided the most detailed public description of this relationship, specifying that the Company receives a five-notch uplift due to government financial support. In April 2010, S&P reaffirmed the Company's ratings and indicated that, absent government support, the Company would have a senior unsecured rating of BB, which is two notches below investment grade.

In order to regain a standalone "A" rating the Company needs to eliminate this gap. The elimination of that gap is a key objective of the government's resolution plan for AIG. Once AIG can maintain an investment grade rating without government support, the government can begin to sell down its equity interests in the Company. This requires substantial improvements to AIG's operations and to its leverage and capital profile. The essential elements of the resolution plan are as follows:

First, the Company will have to substantially reduce its debt. The two metrics by which this is measured are (i) "leverage," which is the amount of debt on a company relative to the amount of equity in a company, and (ii) "coverage," which is the amount of earnings or cash flow the company generates relative to the annual interest payments on its debt.

Next, the Company will have to demonstrate independent access to the capital markets and secure standby lines of credit. Policyholders, potential customers and investors must be confident that the Company has access to liquidity in times of potential stress. Finding a private market participant or facility to replace the government's support will be a key milestone.

Third, the risk profile of AIGFP will need to be reduced to the level where potential losses are inconsequential to the parent company's financial condition. More specifically, investors must

[15] Primary competitors include Ace Group, Chubb Group, Hartford, Liberty Mutual, Travelers, XL, and Zurich.

be satisfied that AIGFP does not pose a substantial threat to the Company's liquidity position, even in times of stress.

Fourth, AIG will need to divest those subsidiaries that are deemed to be non-core to its long-term strategy, and it will need to deconsolidate any businesses whose potential cash needs represent a potential drag on the AIG parent company.

Fifth, the Company will have to demonstrate that its core insurance subsidiaries are profitable, well capitalized, and have repaired the damage to the franchise caused by the financial crisis and the negative attention that the government's rescue has generated.

Finally, the Company will have to demonstrate that it has improved its risk management policies and procedures. In short, AIG will have to demonstrate that it can appropriately identify, monitor, manage and mitigate the risks inherent in its operating businesses.

Taxpayer Exit

Taxpayer exit from AIG will be in a series of steps. We expect that AIG will sell sufficient assets at fair prices to pay off obligations to the FRBNY, and the assets of Maiden Lane 2 and 3 will continue to generate cash flows sufficient to repay the loans FRBNY made to those entities. We expect that AIG will streamline its business portfolio and reduce its debt to a level that is consistent with an "A" rated company. This will enhance the value of the taxpayers' equity interests in AIG, and the Treasury will then seek to sell these interests as soon as practicable.

Asset Sales

In March 2010 the Company reached a substantial milestone, having signed separate definitive agreements to sell its two largest international life insurance subsidiaries – AIA to Prudential PLC and ALICO to MetLife. Prudential PLC is currently seeking shareholder and regulatory approvals for its $35.5 billion purchase of AIA, and MetLife is seeking regulatory approvals for its $15.5 billion purchase of ALICO. Combined with the additional financings and asset sales that the Company is currently pursuing, the proceeds from these two sales are expected to be sufficient to pay off the Company's obligations to the FRBNY in full: that is, the FRBNY Facility ($26.3 billion) and the AIA and ALICO Preferred Interests ($25.4 billion).

The consummation of the AIA and ALICO sale transactions will be a significant step on the path towards a standalone investment grade rating. First, the transactions will eliminate over $50 billion of "senior" debt, significantly reducing AIG's leverage. Second, by repaying the FRBNY Facility in full, the Company will free up assets that AIG can then use to secure new lines of credit with commercial banks — facilitating access to independent, non-governmental sources of liquidity.

AIGFP

While the Company works to close the divestitures of AIA and ALICO, it is also continuing to wind down AIGFP. The Company has reduced the notional amount of derivatives at AIGFP from $2.0 trillion in September of 2008 to $755 billion.[16] Similarly, AIGFP has reduced total number of trade positions from 44,000 to 14,300.

[16] As of March 31, 2010.

When you look specifically at credit derivatives, the notional amount of exposure has been reduced from nearly $400 billion to $136 billion. $109 billion of this remaining exposure relates to transactions with European banks, whereby AIGFP provided regulatory capital relief to these banks under the Basel I regime. Thus far, these positions have generally been eliminated at no cost to AIGFP.

With respect to AIGFP's other derivative exposures, the firm has made significant progress towards removing complex and illiquid positions – an important step because these positions would be the most challenging to manage over time. These removals ensure that the reductions in notional and trade count metrics are not achieved simply by closing out only the most "plain vanilla" derivatives exposures.

While several hundred billion dollars of notional amount of positions will remain on AIGFP's books at year-end, most will be hedged positions that do not pose a threat to the Company's rating profile or, more importantly, the financial system. Overall, the wind down of AIGFP's riskiest positions is expected to be largely completed by year-end 2010. The wind down of AIGFP has already significantly reduced the interconnectedness between the Company and other large financial institutions — reducing the risk that, in the future, AIG could pose a systemic threat.

Non-Core Asset Sales and Divestitures

The Company continues to explore opportunities to divest itself of its non-core businesses and deconsolidate subsidiaries that represent a drag on the parent company's ratings. These actions will reduce potential liquidity or capital drains from the parent company and strengthen AIG's independent credit profile. After the consummation of the AIA and ALICO sales and the divestiture of other non-core businesses and assets, the Company will be a streamlined version of the financial behemoth it once was. The largest remaining core businesses will be AIG's property and casualty insurance business (Chartis) and AIG's life and retirement services business in the United States (SunAmerica Financial). Overall, the reduction in both the number and diversity of its business units as well as the shrinking of its geographic footprint will make the Company easier to monitor and to manage.

Maiden Lane 2 and 3

The FRBNY loans to the Maiden Lane 2 and Maiden Lane 3 vehicles will be repaid over time as the assets in those vehicles generate income and are sold or otherwise retired. According to current projections, it is expected that cash inflows from those assets will significantly exceed the principal and interest due on the outstanding FRBNY loans to those entities. Even under a very adverse set of assumptions, it is expected that the loans made by the FRBNY to each of the entities will be paid in full. Currently, the fair value of the Maiden Lane 2 assets is $15.8 billion versus a FRBNY loan balance of $14.9 billion. The fair value of Maiden Lane 3 assets is $23.4 billion versus a FRBNY loan balance of $16.6 billion.

Taxpayer Recovery

Of course, the key question with respect to AIG is whether taxpayers will get all of their money back. Let me review the current prospects.

If the AIA and ALICO divestitures close as planned, proceeds of those sales are expected to be sufficient to repay the FRBNY Facility and redeem the AIA and ALICO Preferred Interests held by FRBNY almost in full. Any shortfall will be made up by other non-core asset sales that the Company is currently pursuing. It is likely that the FRBNY loans to Maiden Lane 2 and 3 will not only be fully repaid, but could also earn a profit. As a result, it seems likely that all of the credit extended by the FRBNY to AIG will be repaid in full.

At current market prices, the common stock that the Series C preferred shares represents has value.[17] Market conditions can change before the Series C Trustees have the opportunity to sell those shares and, given the number of shares that the Series C represents compared to shares currently held by the public, the sale itself may put some significant downward pressure on the trading price of AIG's common stock. That said, given today's market prices it seems that the Series C Preferred has value that will inure to the taxpayers' benefit.

That leaves the Treasury's Series E and Series F preferred equity interests (together, approximately $49 billion). The recovery on the Series E and F will largely depend on the performance of the then-remaining businesses in the AIG portfolio after it completes its asset sales and how they are valued in the stock market.

With AIA and ALICO divested, AIG's core businesses will be centered on Chartis (its global property and casualty insurance business) and SunAmerica Financial Group (its U.S. life and retirement services business). Chartis is one of the largest property and casualty insurers both in the U.S. and globally, and holds leading positions in both commercial insurance and specialty lines. SunAmerica Financial is a leading player in the U.S. life insurance and annuity sector, and a provider of comprehensive retirement services — primarily in the education and healthcare markets.

The Company has work to do in order to return these businesses to their previous levels of profitability, and it will take time to repair fully the damage to their franchises, particularly in the United States. That said the Company's progress to date is encouraging. At Chartis, first quarter 2010 operating income was $879 million (versus $710 million in the first quarter of 2009).[18] Premium retention has risen, pricing has stabilized and employee turnover has reverted to normal levels. At SunAmerica, first quarter 2010 operating income was $1.1 billion (versus a loss of $160 million in the first quarter of 2009).[19] Aggregate assets under management in the retirement services businesses have increased and premiums in the life insurance businesses have stabilized.

While it remains unclear what the Treasury's ultimate recovery on its Series E and F preferred interests will be, it is clear that the prospects for the recovery on those interests have improved, and the government remains committed to protecting the value of these taxpayer investments. The steps taken during the crisis were solely to prevent further financial contagion, and

[17] The Series C Preferred shares are convertible into 79.8% of AIG's common stock. At the closing price of $34.49 on May 25, 2010, the market capitalization of the publicly held AIG common stock, which represents 20.2% of the fully-diluted common equity (i.e., the amount not controlled by the Series C Trust), is approximately $5 billion.
[18] Before net realized capital gains and losses.
[19] Before net realized capital gains and losses.

ownership of AIG was a byproduct of these steps. As the government exits it seeks to do so in a manner that recoups as much money for the taxpayer as possible.

The timing of the Treasury's ability to monetize its investments in AIG will depend on the pace at which the other steps of the resolution plan outlined earlier in my testimony are accomplished. Whether the taxpayers ultimately recover all of their investment or make a profit will depend on the Company's operating performance and market multiples for insurance companies at the time the government seeks to monetize the taxpayers' stock interests. But AIG has made significant progress towards being able to garner standalone market confidence, without the government's continuing support. And as soon as we are confident that the stability is durable we will move to exit the taxpayers' investments as promptly as practicable.

Thank you very much for your time.

Chair WARREN. So let me just get started here, I want to walk through this. I'm hearing you say that it is very likely that the American taxpayer will be repaid in full from AIG?

Mr. MILLSTEIN. I think——

Chair WARREN. Is that what I heard you say?

Mr. MILLSTEIN. What I said is that the New York Fed, which has about $83 billion dollars outstanding today, is very likely to be paid in full. The asset values that we've seen in both Maiden Lane II and III, and the sales prices for AIA and ALICO, should be sufficient to pay them in full.

The Series——

Chair WARREN. That's not everyone though.

Mr. MILLSTEIN. No, that's not everyone. The Treasury Department has $49 billion dollars outstanding in Series E and F Preferred. And as I said in my testimony, the recovery on that will depend on the performance of the remaining businesses and how those businesses are valued in the market at the time.

Chair WARREN. So do you have any estimate at this point? You've heard the estimates——

Mr. MILLSTEIN. I have.

Chair WARREN [continuing]. We've referred to them multiple times——

Mr. MILLSTEIN. I have.

Chair WARREN [continuing]. From CBO.

Mr. MILLSTEIN. I have. I think that there are, you know, substantial—there's a lot of things that have to occur before we'll know the answer to that question. And I think if—as you heard from the KPW analyst today, if the common stock has a value of $5.00, the preferred is paid in full.

While that may be a lower stock price than the company is trading at today, that implies that the preferred is money good.

Chair WARREN. Okay.

Mr. MILLSTEIN. And even at that $5.00 stock price, the Series C Preferred held by the Series C Trust would have a value of $3 billion dollars. That's pure profit to the taxpayers.

Chair WARREN. But—since I see you wince and hesitate on the second number, that is you feel confident about the $83 billion repayment, a little less confident about the $49 billion.

Do you feel that Mr. Benmosche perhaps is a bit optimistic?

Mr. MILLSTEIN. No, in fact he knows his business better than I do. And if he can, in fact, drive——

Chair WARREN. You are principally responsible for overseeing him though——

Mr. MILLSTEIN. Yes, I am.

Chair WARREN. So I take it only a little bit better.

Mr. MILLSTEIN. Well no, he's a you know, an experienced insurance executive. I'm a financial restructuring professional. He knows his businesses better than I do. And his confidence that he can get Chartis and SunAmerica Financial to an $8 billion dollar net after tax earning. If he can do that, we're going to be paid in full.

Chair WARREN. All right, so what do you see as the biggest risk here that we won't get repaid? I know you've laid out some of the things that have to happen. But where do you see the biggest risk?

Mr. MILLSTEIN. I think the biggest risk——

Chair WARREN. You assess risks.

Mr. MILLSTEIN. The biggest risk for an insurance company are the state of the financial markets and the impact it has on their franchise values. Remember, an insurance company you know, writes long dated risk and it takes the premiums and invests in a variety of financial assets.

The markets go up, the assets perform. The markets go down, the assets are impaired, and so they vary. The fortunes of this company, like every other insurance company, in part ride on the performance of the financial markets. We're obviously in very volatile times still. And so to me, that is the greatest risk.

Chair WARREN. All right. So the American taxpayer is on this ride along with the up and down of the stock market?

Mr. MILLSTEIN. Yeah, I think——

Chair WARREN. Or the down of the stock market.

Mr. MILLSTEIN. There's no question we've made a substantial investment in the largest insurance company in the world. And we did that for, in my view, good and valid reasons to prevent a further catastrophe in the financial markets.

I think it's been very successful. We have stabilized AIG. And the returns on that investment and on that policy approach will depend on the future performance of the company, which in part, depends on the performance of the financial markets.

Chair WARREN. Actually, let me ask you about that performance since we're hearing a lot of good news here. The preferred stocks held by Treasury are not paying or accumulating dividends. And that means that we have, we the American taxpayers, have given up about $5 billion dollars in foregone cash?

Mr. MILLSTEIN. Actually——

Chair WARREN. Why has Treasury chosen this course of action?

Mr. MILLSTEIN. The math is a little more complicated than that. Remember, we own 80 percent of the common stock. So we really, the giving up of dividends on the preferred, was really just giving up 20 percent of them because the value of those, the value of that dividend would otherwise flow to the common stock if it doesn't go to the preferred. And we own 80 percent of the common stock.

Chair WARREN. Now wait, wait, wait though. But those pockets don't match. So you're saying that we gave away $1 billion of the $5 billion to the other——

Mr. MILLSTEIN. We haven't given it away.

Chair WARREN [continuing]. AIG shareholders——

Mr. MILLSTEIN. We haven't given it away.

Chair WARREN [continuing]. By not collecting the dividends that belong to the taxpayer?

Mr. MILLSTEIN. Chair Warren, with all due respect, we haven't given away anything. These are dividends the company could not afford to pay. And in its current——

Chair WARREN. Well I'm hearing so much optimistic news I——

Mr. MILLSTEIN. I know, but——

Chair WARREN. So they can't afford to pay their dividends.

Mr. MILLSTEIN. I understand.

Chair WARREN. And that's cost us $5 billion.

Mr. MILLSTEIN. It hasn't cost us anything. These are dividends they could not afford to pay.

Chair WARREN. All right. And you're saying but that's all right because we're still going to sit in the common shareholder position——

Mr. MILLSTEIN. Had they been able to pay the dividend, they would first have to bring the preferred dividends current before they could pay a dividend to the common stock, and that's where we are today. But at this point, at this point, the company's cash flows, its net income after taxes are insufficient to support a preferred dividend.

Chair WARREN. Okay, so where do you anticipate between this optimistic view of AIG repaying the American taxpayer in full, and the position where we are today, which is they can't pay the dividends owed.

Where are we going to cross that line where we don't continue——

Mr. MILLSTEIN. Okay.

Chair WARREN [continuing]. To lose money from a company that can't pay us dividends that it owes us.

Mr. MILLSTEIN. I laid out the six steps of the restructure plan.

Chair WARREN. I heard those.

Mr. MILLSTEIN. Okay, so if you just bear with me for a minute. What is going on is a resolution of a large financial company. And that resolution involves its downsizing, okay?

We're selling stuff to pay back debt. We're selling AIA and ALICO. We've got a sale transaction for the life insurance operations in Taiwan. We've sold buildings and real estate around the world. All of——

Chair WARREN. I understand all this.

Mr. MILLSTEIN. Wait, wait.

Chair WARREN. I've read the Treasury.

Mr. MILLSTEIN. Bear with me.

Chair WARREN. I've read your report.

Mr. MILLSTEIN. Bear with me. It takes time to take a company of this size and scope to get it down to a footprint where it's actually reduced its debt, reduced its leverage, reduced its risk——

Chair WARREN. I understand that. That's why I——

Mr. MILLSTEIN [continuing]. And can pay a dividend.

Chair WARREN [continuing]. Asked a time question.

Mr. MILLSTEIN. What was your—what time question?

Chair WARREN. And the time question was, I hear this enormous optimism which suggests that you have some kind of plan in mind and that AIG has a plan in mind for where it will end up. And what I see today, is that it is not able to pay the dividends owed on the preferred shares.

So what I'm asking is, when in this downsizing do we expect those two to cross over so that it can at least meet its obligations——

Mr. MILLSTEIN. Okay.

Chair WARREN [continuing]. Before the happy day comes that it pays us back in full?

Mr. MILLSTEIN. If the AIA and ALICO deals close, they'll likely close sometime in the third and fourth quarter of this year, okay?

So that's—that will result in an immediate pay down of the Federal Reserve facility—sorry, of the preferred interest at the—at AIA and ALICO, that's about $25 billion that will be immediately retired with the cash proceeds.

And the balance of the consideration can be sold, given the terms of the lock ups we've negotiated with MetLife and Prudential over the course of a year to a year-and-a-half. When those proceeds are realized, they should be sufficient to pay off the credit facility at the parent level in full.

So sometime, I would expect, in 2011, if those deals close, the Federal Reserve will be paid in full for all of its existing exposure to AIG.

Chair WARREN. Okay.

Mr. McWatters.

Mr. MCWATTERS. Thank you. Mr. Millstein, when the deal was struck in September, current shareholders of AIG stayed in place. It was not a bankruptcy, they weren't wiped out.

So today we have sort of an odd situation of pre-bailout shareholders that may live to collect dividends someday, may live to sell their stock for a profit even though the tax payers may lose, CBO $36 billion dollars, OMB $50 billion dollars, is that correct?

Mr. MILLSTEIN. Well let me just—if in fact, the preferred stock interests lose money. It's unlikely the common are going to get anything, right? In the way a balance sheet is constructed, the preferred stockholders are going to get paid first before the common stockholders get anything.

Now we have, it is true that the stock is trading. The common stock is trading and 20 percent of it was left outstanding. People are buying in and selling that every day. No dividends are being paid on that stock. So it's a bet on the company's future.

Mr. MCWATTERS. But given that it's trading for $33.00 a share today, there must be a lot of people, a lot of smart people, a lot of analysts who think the preferred stock will be repaid.

Mr. MILLSTEIN. That would be the inference you would draw, yes.

Mr. MCWATTERS. Yeah.

Mr. MILLSTEIN. So that's good news for the taxpayers. The common stock, the common—the people who are trading the common stock are suggesting the preferred stock is money good.

Mr. MCWATTERS. Okay, but the equity, the pre-bailout equity was not wiped out in this deal?

Mr. MILLSTEIN. It was substantially diluted.

Mr. MCWATTERS. Substantially diluted, but not wiped out.

Mr. MILLSTEIN. If I may though, again, just to take the market price of the common stock. The 80 percent of the stock that was represented by the Series C, if you valued that at the $33.00 a share, at which the common stock market is trading the outstanding float, that's an $18 billion dollar profit to the taxpayer for the privilege of having made all creditors whole, and for having put a wall up around this company to keep it from failing. You know, if that's how it plays out, I think all of you would agree that this was a very successful rescue.

Mr. MCWATTERS. It was only successful because the taxpayers got lucky. If we go back to September 16, 2008, and we start look-

ing at the CDOs, we start looking at the RMBS, that was junk, nobody wanted it. Because there was not a market. We had no idea what it was worth and it was simply purchased because it had to be purchased.

The fact that it appreciated, that's to our benefit, and that's great. But that was far from assured or guaranteed at the time.

Mr. MILLSTEIN. Listen, I was a private citizen at the time that this rescue occurred. So I had no greater involvement with it than you did. And I stood back at probably the same distance from it that you did.

But I think if you listen to the testimony of my colleagues, my now colleagues at the Federal Reserve, what you hear them tell you is, that this wasn't done to make a profit. It wasn't done for the protection of Goldman Sachs, or JP Morgan, or any of the other counterparties. It was for the protection of the financial system of this country, to try to prevent a panic. A panic that had already started that would have been worsened and exacerbated had this company failed. And I believe that.

Mr. MCWATTERS. I agree, but that's the reason I said in my opening statement that if you, if the supposition is, we need to save AIG to save the world financial system, well the world financial system is Goldman Sachs and JP Morgan and some others.

So if the world financial system had collapsed, these institutions would have collapsed. So it was certainly in their best interests to have AIG bailed out. And if they can be bailed out at 100 cents on the dollar, it's a happy day.

Mr. MILLSTEIN. Listen, I understand the ambivalence about—the view that AIG is a vehicle to pay other large financial institutions. But if you believe that its a collapse would have created fear and panic across all financial markets, and it wasn't just Goldman Sachs and JP Morgan who were being helped by this rescue.

It was you and I as depositors in our banks. It was the insurance policy holders across AIG and every other insurance company. It was the pensioners whose pension plans were racked by AIGFP. It was the holders of stable value funds, whose——

Mr. MCWATTERS. I agree. I totally agree with what you're saying. But none of those folks you just mentioned got the wire transfer that Goldman Sachs and the others did.

Mr. MILLSTEIN. In fact though, they did. In fact they did, because the 44,000 trades that Mr. Benmosche talked about include all those stable value insurance contracts that FP wrote that FP has honored. It includes the various transactions they did with pension funds to insure their assets too.

We've singled out, because they happen to have held very, very volatile assets on AIG's—that AIG had insured, and that the decline in the price of which were running through AIG's income statement and creating enormous losses in the fourth quarter of 2008.

So in order to try to mitigate the losses at AIG, and in order to try to stabilize its balance sheet, the Federal Reserve went after these two asset classes that were causing such losses and such instability. And tried to buy them in at those prices to terminate the losses going forward so as to try to keep this company from needing more money and it becoming even more unstable.

So yes, Goldman Sachs, and Société Généralé, and the other counterparties to those RMBS and to the CDOs, got paid, but it was part of a broader effort to stabilize this company so they could honor everybody's contracts in full. They weren't the only parties whose contracts were honored in full. Everybody since September of 2008, has had their contracts honored by AIG.

Chair WARREN. Mr. McWatters.

Mr. MCWATTERS. I understand.

Chair WARREN. Are you okay?

Mr. MCWATTERS. I'm done.

Chair WARREN. Are you through?

Mr. MCWATTERS. I'm done.

Chair WARREN. Mr. Silvers.

Mr. SILVERS. I wasn't planning to ask this, but I now feel compelled to do so. I notice Mr. McWatters didn't bring up Goldman Sachs or JP Morgan, so obviously it's on Treasury's mind.

Is it not the case that in the week of September 15, 2008, that the cash calls that the company could not meet were in two lines of business and two lines of business only. And but for those cash calls, none of this would have been necessary?

And those two lines of business were, and it depends on what—you know you can believe or not—you can argue I guess with the state insurance regulators, they certainly were the swaps business and they may have been the securities lending business.

And but for those two enterprises, none of this would have occurred? Is that not so?

Mr. MILLSTEIN. That is not so. So let me——

Mr. SILVERS. Are you seriously asserting that if you wipe those two pieces of business off the books, that AIG was nonetheless insolvent?

Mr. MILLSTEIN. Let me——

Mr. SILVERS. And are you accusing the New York State Insurance Commissioner of lying to this panel?

Mr. MILLSTEIN. Can I answer the question? I'm trying to be——

Mr. SILVERS. I'm just astounded at the lengths you will go to to defend something that may, in fact, be defensible in a perfectly straightforward way.

Mr. MILLSTEIN. No, I actually have sat through the entire hearing today.

Mr. SILVERS. I know.

Mr. MILLSTEIN. I've heard——

Mr. SILVERS. I'm impressed.

Mr. MILLSTEIN. And I've heard the testimony of all the expert witnesses and fact witnesses before you. And I've spent a year now with this company's balance sheet and understanding its liability structure. And I want to give you the benefit of my learning.

All of the contracts at AIGFP are guaranteed by the parent. The parent has a $100 billion dollar balance sheet of its own. On September 8th of 2008, with $15 billion dollars of commercial paper, we all know what happened to Lehman Brothers, to the commercial paper markets after Lehman Brothers filed and defaulted on $5 billion dollars of commercial paper.

Fifteen billion dollars of commercial paper at the parent company. Eighty billion dollars of repo. Again, the repo markets went

into seizure after the Lehman Brothers filing. And a much smaller amount of repo. Two trillion dollars of notional derivatives, $400 billion of credit derivatives, concentrated very much in the real estate part of the market.

Had AIGFP defaulted on the collateral posting requirements that it had on September 16, every counterparty, 44,000 trades could have terminated their trades, declared cross default——

Mr. SILVERS. You know Mr. Millstein, you've—you're not paying attention to what I was asking you.

Mr. MILLSTEIN. I'm sorry.

Mr. SILVERS. And you've actually agreed with me.

Mr. MILLSTEIN. Oh.

Mr. SILVERS. What you've said is, is that—you said that all kinds of terrible things would have happened had they defaulted on the collateral posting obligations. But it was, but it's the collateral posting obligations that were the triggering issue, right?

Mr. MILLSTEIN. The collateral posting obligations were actually triggered by the downgrade. The downgrade——

Mr. SILVERS. Yes, I know that. But that's where the cash need was that week.

Mr. MILLSTEIN. I'm sorry.

Mr. SILVERS. All the witnesses, all day long have said this.

Mr. MILLSTEIN. And the——

Mr. SILVERS. You're not disputing that.

Mr. MILLSTEIN. And the securities lending part——

Mr. SILVERS. Right, exactly.

Mr. MILLSTEIN. They refused to roll over——

Mr. SILVERS. Okay, so we all agree.

Mr. MILLSTEIN. Okay.

Mr. SILVERS. Let me move to the present. As my colleagues have expressed, there are these estimates from the government accounting bodies that $30 billion or $50 billion dollar losses is likely.

It appears from your testimony, that what that really means is that they believe that the preferred Series E is worthless. Or in the better case scenario, the $30 billion dollar loss, they believe that it is worth 60, no 40 percent, of the face.

Mr. MILLSTEIN. Right.

Mr. SILVERS. Am I understanding their point of view correctly? I know it's a little unfair to ask you what they think. But is that essentially what that means?

Mr. MILLSTEIN. Yeah, I mean there's $50 billion outstanding, if they think it's only worth $30, there's going to be a $20 billion dollar loss.

Mr. SILVERS. And we're not—explain to me why you think they are wrong, because clearly you do.

Mr. MILLSTEIN. Well no, I don't think any of us can predict the future.

Mr. SILVERS. Okay.

Mr. MILLSTEIN. I think that the Government Accountability Office and the OMB have to, under the regulations they're subject to, they have to make estimates of this for purposes of budgetary accounting.

Mr. SILVERS. Yes.

Mr. MILLSTEIN. And I suspect they're being conservative in their view. You know, I'm working to get the taxpayer's money back.

Mr. SILVERS. Right.

Mr. MILLSTEIN. I think we have a—or the company—has a restructuring plan that they've worked on with us that is going to take time to implement. But it should—and we've spent a lot of time on it, if they can implement it—should leave them as an investment grade company and if it can perform, if the two core businesses can perform the way that Mr. Benmosche suggested they can, the NEF should do very well.

Mr. SILVERS. My time is up. Thank you.

Chair WARREN. Professor Troske.

Dr. TROSKE. Maybe we'll continue on a related line. And you were here for Mr. Gallant's testimony as well and his estimate of what the stock price should be. And can you sort of respond to that a little.

And apparently you disagree with him as well. I don't know whether you've had a chance to look at his estimate. And there are widely different estimates out there. And I recognize that people are making—I understand how we come up with different estimates that we're making different assumptions about the outcome.

Mr. MILLSTEIN. Yeah I've seen his work and you know, an analyst report such as that is built on a number of assumptions. And——

Dr. TROSKE. Can you tell me which ones you would quibble with specifically?

Mr. MILLSTEIN. In part I'm constrained not to quibble with any particular assumption because I actually know more than he does. I have much more material non-public information and it is a publicly traded stock and it would be inappropriate for me to do so.

Dr. TROSKE. Okay.

Mr. MILLSTEIN. I mean I'm not—I'm not trying to——

Dr. TROSKE. No, I respect that. Can you give us some broad indication that you're comfortable with where you think that there are differences that you might have.

Mr. MILLSTEIN. From my point of view of representing the Series E and F, I take some comfort from his conclusion that the stock actually has positive value because it means the interests I'm trying to recover are going to be paid in full.

Dr. TROSKE. Okay.

Mr. MILLSTEIN. And it also means that the Series C stock has real value. And that's pure profit to the tax payers.

Dr. TROSKE. So I guess you—I believe you answered Chair Warren's question about when you thought the AIG will no longer need government support. Was that what your estimate was in 2011? Or I guess that's where you said it was going to cross the line.

Mr. MILLSTEIN. Yeah, I think the de-leveraging that is a predicate to its being able to garner a stand alone investment grade rating, is dependent upon these major asset sales closing and our monetizing the value of the stock that we're taking back on those deals.

And I see that occurring you know, sometime between year end this year and year end next year when we've fully monetized those interests.

Dr. TROSKE. Okay.

Mr. MILLSTEIN. And therefore, you know if its got its leverage profile, that is its debt down and its coverage to a point where it looks like an investment grade company. Then I think we can begin you know, assuming the other elements of the restructuring plan that I outlined.

Which, as I said, independent access to capital, that the parent company starts tapping the credit and capital markets again independent of the government. You know I think that's when we can start thinking about exiting the Series E and F.

Dr. TROSKE. Mr. Gallant also said that he thought the share price, the current share price reflected the trader's beliefs that the government was going to walk away leaving—you know, giving a gift, another gift to AIG.

Mr. MILLSTEIN. I think you can be certain that that is not going to occur.

Dr. TROSKE. Okay. Let me change gears just a little.

You are an expert in restructuring. If you're—and you were not in the room at the time, as you made clear. Had you been, would you have done anything different?

Mr. MILLSTEIN. Yeah, Mr. Bienenstock and I go a long way back together. We've been on opposite sides of the table, we've been on the same side of the table on numerous occasions.

I think that his confidence in the ability to actually have a discount negotiation with 16 counterparties is misplaced. In part because I think he's simplified some of the assumptions on which his analysis relies.

During the period from September to November, when he assumes we had that three months in the Federal Reserve and the government to conduct a negotiation, collateral was required to be posted almost every other day.

So the failure, while it—well he's right, having put the $85 billion dollar loan in place, bankruptcy was remote, but default was not remote. Every day, those 16 counter-parties or every week those 16 counter-parties were making demands for collateral.

So in order to have the dissident account negotiation, the company would have had to be prepared to say, I'm not paying. And to take the risk that anyone of those 16 counterparties or anyone who had cross-default rights, the other 44,000 claimants, or anyone at the parent who had cross-default rights, would not exercise their rights to cross-default.

So while we could—you could have gathered the 16 major counterparties in a room and had a negotiation. I can tell you at the time, I was actually concluding a very—the very similar negotiation to that which was urged upon AIG, after nine months of negotiating with that very same group over the extent of their discounts and how it would be done in another entirely different situation.

But most importantly for AIG, the company would have had to be prepared to take the risk of nonpayment, and have that nonpayment put at risk every other debt instrument that had a cross-default at the parent level and at FP.

And if I may, I know where you're going. If I may, that would have made that company completely unstable. Any creditor with

the right to declare a cross-default could have brought the house of cards down.

Chair WARREN. So if I can just follow-up on that. Is that—you were talking about you were negotiating the same thing. Were you negotiating something like that with a government back stop behind it? Where the government said, I will make sure that between us, we get you paid so long as you don't cross-default and bring this company down?

Mr. MILLSTEIN. No I——

Chair WARREN. Doesn't that change the negotiating dynamic somewhat? A carrot the size of Manhattan——

Mr. MILLSTEIN. Yeah.

Chair WARREN [continuing]. And a stick the size of——

Mr. MILLSTEIN. Right.

Chair WARREN [continuing]. The global economy.

Mr. MILLSTEIN. If—I mean I'm not sure I'm comfortable with, as a citizen, with the Federal Reserve using that power to pick and choose winners.

Chair WARREN. I'm sorry, were you uncomfortable with Long Term Capital Management?

Mr. MILLSTEIN. The government didn't put any money up in that situation.

Chair WARREN. The government had nothing to do with what happened in Long Term Capital Management?

Mr. MILLSTEIN. No, no. I think you heard——

Chair WARREN. I think we heard, they were in the room——

Mr. MILLSTEIN. We were both——

Chair WARREN [continuing]. And said nobody leaves the room until there's a deal done here.

Mr. MILLSTEIN. I know it's tempting to believe this, that the government could have made this possible and extracted discounts. But just assume with me for the moment that among the creditors who had cross-default rights with someone not within the territorial limits of the United States, who held a material claim and didn't care about the government of the United States or its policies wanted just to perfect its rights to payment.

Chair WARREN. And how exactly—you know this is—you weren't there—I wasn't there. This is a crazy conversation to have. But how exactly was that person going to enforce those rights? Either they had collateral, in which case they hang on to them or they've got to go to court. And I think you and I both have an idea of how long that takes. I just——

Mr. MILLSTEIN. I understand that. I understand that. But this is a huge balance sheet with numerous creditors on it.

Chair WARREN. This is what bankruptcy lawyers do for a living.

Mr. MILLSTEIN. I understand that. And I did this for a living. And I can tell you that I would have been very nervous——

Chair WARREN. Well who wouldn't have been nervous?

Mr. MILLSTEIN [continuing]. About creating—about threatening default or even defaulting on this without being prepared to put this company into bankruptcy. Because you would be putting holders of claims of $100 billion of debt and of $2 trillion of notional derivatives at the table on the first default.

Chair WARREN. So let me see, this may be an unartful pivot. But from that very point I want to go to another one that you made. And that's the question, it's ironic that AIG is in the insurance business because the American taxpayer ended up in the insurance business here. They ended up insuring, in effect, that AIG's creditors were going to get paid 100 cents on the dollar.

And so I'm wondering, what was the value of that insurance? What's the value of the guarantee that we won't let your company fail?

Mr. MILLSTEIN. Yeah.

Chair WARREN. You described potentially here an $18 billion profit. Except it treats that insurance policy that came from the American taxpayers as worth nothing.

Mr. MILLSTEIN. No, I think we're coming at this from two different frames of reference. And I think again, just having spent time with the Federal Reserve and understanding what they thought they were doing at the time, in 2008.

And I don't think they thought they were underwriting creditor recoveries at AIG. They thought they were preventing a meltdown of the financial system. And a consequence of that was that everybody at AIG had to get paid.

Because just imagine that the government had tried to extract concessions from major counterparties, other systemically significant firms who did business with AIG. What would the risk have been then? What would be the inference that other creditors of those institutions would draw——

Chair WARREN. I'm sorry Mr. Millstein, we've been around this before. But the question I started with is, what is the value of the guarantee that the American taxpayer put into this? You describe the profit here as $18 billion.

Mr. MILLSTEIN. No, I think——

Chair WARREN. Potentially $18 billion. And I just want to put it against—you treat the guarantee from the American taxpayers as if it costs nothing.

Mr. MILLSTEIN. No, I think the benefit to the American taxpayers is that the financial crisis we all have lived through, which has been—had horrible effects on the economy wasn't worse.

And if it turns out that the cost of this operation with AIG is—that there is some cost to it in the billions of dollars, I hope it won't be, that was money well spent in the sense of avoiding what could have been a much, much worse crisis.

Chair WARREN. I just have one small question to finish with this. And that is, you can't tell us why Mr. Gallant is wrong. And I understand the reason for that. Others agree with Mr. Gallant, others obviously don't. The market is trading somewhere else.

But I'd just like your advice for what you would offer to an oversight panel. Are we just supposed to take your word for it? That it's all going to work out fine? How do we evaluate these very differing points of view if you can't give us anything more specific?

Mr. MILLSTEIN. The question I think you need to ask yourself today is, as a result of the government's actions is the company today stable? The answer is yes. Is it improving? Yes. Is it executing against the restructuring plan? Yes. Is it moving to a posi-

tion where it can give up on its government support and stand alone? Yes. Are there risks? Certainly.

A company of this size and scope can't help but have risks to its outcomes and financial performance. But in terms of you know, where it was and where it's going, it's making progress. That's all that can be told.

Chair WARREN. So when people ask us whether or not the American taxpayer's going to get repaid, the answer is, we don't know and we don't have anything to look at.

Mr. MILLSTEIN. No I think I did answer it. I think you can say with confidence, as an oversight panel, that the Federal Reserve is going to be paid in full. You can say that the——

Chair WARREN. But——

Mr. MILLSTEIN. Wait. You can say that—it was a comma, not a period. You can say that an analyst, a well respected analyst, came in to your hearing and said that the—basically the E and F is going to be paid in full and that the government Series C is worth something.

Chair WARREN. But there will be losses——

Mr. MILLSTEIN. No.

Chair WARREN [continuing]. According to the——

Mr. MILLSTEIN. No, that's not what this gentleman is telling you.

Chair WARREN. You think he thinks we're going to get paid in full.

Mr. MILLSTEIN. If he's——

Chair WARREN. And that the CBO——

Mr. MILLSTEIN. If the stock is——

Chair WARREN [continuing]. Estimate is simply wrong.

Mr. MILLSTEIN. If he believes the stock has a positive value of $5.00, that means that what I'm trying to recover is going to get recovered.

Chair WARREN. Because we're going to be paid in full. Okay, thank you Mr. Millstein.

Mr. Silvers.

Mr. SILVERS. What——

Chair WARREN. No, Mark isn't finished. Oh, I'm sorry, Mr. McWatters.

Mr. MCWATTERS. So this means that AIG is solvent, in your opinion? In the opinion of the Department of the Treasury?

Mr. MILLSTEIN. It's a—you know solvent's a legal term. It has a positive net worth and it's paying its debts as they come due.

Mr. MCWATTERS. Okay, fair enough. AIG to me appears like it is still too big to fail. What are you doing, as the majority shareholder to lessen that risk?

Mr. MILLSTEIN. I think if the restructuring plan that we have worked with the company on designing and implementing is a plan that is downsizing this company relatively rapidly.

We're selling off its international life insurance operations. FP has—is not a shadow of its former self, but it's about a third of its former self. And those risks should be wound down substantially by the end of the year.

The aircraft leasing business and consumer finance businesses are now financing themselves, not drawing on the government to finance them. And as you heard Mr. Benmosche say, the inter-com-

pany loan that last year was necessary to finance ILFC, he hopes to be able to raise money to refinance it this year.

So the core business of AIG, at the end of this restructuring plan, will be Chartis and SunAmerica Financial, the largest property casualty company in the world and a very strong annuity and life insurance provider in the United States.

A much smaller, much simpler—and a company that he's confident he can manage with the help of his Board. And that is much smaller than the company that the Fed confronted on September of 2008.

Mr. MCWATTERS. So let's say a year from now, a year-and-a-half from now, after this had been implemented, if AIG was to fail again for whatever reason, then a filing under Chapter 11 followed by the insurance regulators doing whatever insurance regulators do.

In other words, would working the resolution of AIG in its bankruptcy—and its insurance subsidiaries through the normal protocol seem to work? In other words, there's nothing out there that would start triggering the dominoes that take down the other too big to fail institutions?

Mr. MILLSTEIN. Yeah, I mean if that plan that I just outlined has been implemented and the environment stays as relatively friendly as it is today, I think that you know, it's not up to me to make a systemic risk determination but it seems to me this will be much less of a risk to the system than it was in September of 2008.

Mr. MCWATTERS. What are the consequences on the competitors of AIG's insurance business who have received perhaps a subsidy, or at least AIG subsidiaries who have received a subsidy from the U.S. taxpayers. If you're competing against AIG in the insurance business, what's the consequence?

Mr. MILLSTEIN. It's a pretty competitive business. And in some sense, I think AIG's burdened by its government ownership in the competition it has with other insurance companies. I think you know, we're not a natural holder, we're a reluctant owner, but we're still a majority owner.

And you know when the government of the United States rolls over you know, you might not like being underneath it. So I think the answer is, that I think the sooner they can shed us the more competitive they will be.

Mr. MCWATTERS. Okay, so there's no indication to you that the rates or the underwriting standards of an AIG——

Mr. MILLSTEIN. You know there was some——

Mr. MCWATTERS [continuing]. Are considered different——

Mr. MILLSTEIN. There was some chat about—you heard some noise about that in the marketplace shortly after—you know in early 2009. You haven't heard that since.

Mr. MCWATTERS. Okay, I'm done.

Chair WARREN. Mr. Silvers.

Mr. SILVERS. Mr. Millstein, AIG is the only participant in the Treasury Department's SSFI program, Systemically Significant Failing Institutions program. What are the—this may seem silly after this day's worth of testimony, but it's not. What are the characteristics of AIG that made it an SSFI?

Mr. MILLSTEIN. You know, for a company you're going to take a majority ownership in and invest $132 billion to create a program called failing institution, you know, it's—it's a little contrary to the objective of getting your money back. I don't know who named it that. I myself don't tend to use it a lot as the program description. It's the—you know, it's the AIG program.

Mr. SILVERS. But the fact that it was the only participant in that program, the only institution—you know, my colleagues have made a big—Mr. McWatters was talking about how the Treasury left 20 percent of the common stockholders intact. That was actually pretty tough treatment in relation to what happened later with other people.

And Treasury at the time articulated to this panel—and I know this is a different administration, but, you know, there's some continuity—articulated to this panel that AIG was different. Do you disagree? Do you think AIG wasn't different?

Mr. MILLSTEIN. I really—I can't—I don't know what was in their minds in that regard. You mean in terms of taking their common stock?

Mr. SILVERS. Well, no, just in general. What made—what made AIG—why does AIG have a unique program all to itself?

Mr. MILLSTEIN. I don't know. I mean, you know, we have—we—the Federal Reserve was the lender of last resort here first.

Mr. SILVERS. And this comes back to my question this morning about sort of what's the—you know, when did things kind of get set in stone? You seem to be sort of saying that you guys—the Treasury—inherited a circumstance created by the Fed.

Mr. MILLSTEIN. Well, I think the sequence—actually in my written testimony I lay this out.

Mr. SILVERS. Yes.

Mr. MILLSTEIN. And—and if, you know, in September—and again, this is sort of an advertisement for a regulatory reform resolution regime because in September of 2008 the government really didn't have the tools to resolve an institution of this size. The Federal Reserve could make a loan. But you really didn't have the tools to put it to bed quietly.

Mr. SILVERS. Now, let me—I mean—you know, I think it's critical—the fact that there's not a—the fact that you can't give a clear answer to this—to the question of—and I understand why. It's not a criticism of you necessarily. But the fact that there's not a clear answer that can be articulated across administrations to why it was that AIG got unique treatment is a problem, I think. And I just leave that as an observation.

I wanted to shift to something you said earlier in response to one of my colleagues' questions. You said that you had to think about the impact on other systemically significant firms during the period, you know, in September 2008. What firms are you talking about?

Mr. MILLSTEIN. No, no, I was—I did say that, but I said it in the context of Chair Warren's questioning with regard to, you know, we insured all of AIG's creditors through this bailout. And again, what I was trying to convey there is that I don't think that was a consequence of what we did. I don't think that was the intent of policy.

Policy intent was to draw a line and try to prevent a further collapse of the system. And they drew the line at AIG. And the next point I was going to try to make was that if, as some have urged, the government rather in November or some time else along the way, should have tried to extract concessions from AIG's creditors, having intervened in AIG, what would that have communicated to the broad market about—about the government's role with regard to other firms that—you know, the other 20 large financial institutions, which by then it had made investments in? Would it have promoted financial stability to think—for the markets to think that the government was going to turn around for all of the large financial institutions in which it then owned preferred stock and demand creditor concessions?

Would that have encouraged financial intermediation or discouraged financial intermediation? Would it promote stability or promote instability? I submit that if that were official government policy that we were going to use our ownership stakes in these large institutions to demand concessions from their creditors, I think you would have had risk running away from those companies—the contagion associated with that government policy would have been enormous.

Mr. SILVERS. No, I'm sorry. I think my——

Mr. MILLSTEIN. You would have discouraged people from doing business with our large financial institutions.

Chair WARREN. But the point is about the debt that existed prior to the government putting its own money on the table. This is like post-petition financing. The haircut is for those who were dealing with the company so that you get some market discipline, so you keep some market discipline.

And the government says we're going to provide the backstop going forward. But we're not paying off the old people who understood the risks they were taking, at least not paying them off 100 cents on the dollar.

Mr. MILLSTEIN. But, Chair Warren, you know and I know the staff knows that these large financial institutions don't have near long-term debt. Their debt is coming in and out everyday. So once you communicate to the financial markets that these large institutions are going to be—have required haircuts, the people who are lending money on a short-term basis to them withdraw their credit.

Chair WARREN. No.

Mr. MILLSTEIN. They withdraw their credit.

Chair WARREN. Not from AIG. What you're now talking about are all the other participants in the financial market.

Mr. MILLSTEIN. No, AIG—that's——

Chair WARREN. Once the government says I am putting money on the table and the money will be available to backstop the creditors, there's been no indication the government has ever backed off from that. And indeed, we have heard repeatedly in every meeting we've had with the Fed that they could not back off.

Mr. MILLSTEIN. No.

Chair WARREN. That's why the decisions made in September had to be followed through in November in the way that they did.

Mr. MILLSTEIN. But, if I may, what you have been urging or at least inquiring about is whether or not they should have done something different.

Chair WARREN. Right. Yes.

Mr. MILLSTEIN. And what I'm suggesting to you——

Chair WARREN. That—that is——

Mr. MILLSTEIN. Had they done that, their short-term creditors would have run on them before you could have asked them may I have a discount.

Chair WARREN. I think we will simply have to agree to see the world differently on that. I apologize.

Professor Troske.

Dr. TROSKE. So as a professional economist, I don't deal in individual companies. I sort of look broader at the economy.

But I think when I hear the comments that my colleagues on the Panel are making, what I think about is the moral hazard problem going forward. The fact that when we make credit—when the government consistently makes creditors whole—creditors play an important regulatory role in a market economy in that they regulate the performance of the people that they're lending money to. If the creditors don't believe that that's important because the government's going to come in and bail them out, they no longer play that regulatory role.

And obviously then we have to create a government structure to regulate, which is incredibly challenging. And it's much cheaper for the taxpayers if creditors actually do the regulation for them.

And I would argue much more efficient. Can you sort of—I mean, so you've talked about this instance. Can you maybe expand a little on the moral hazard that's introduced by what we've done? Because I'm not sure I would agree with your statement that even if we get paid off and make a profit, we're better off once you consider the dynamic implications.

Mr. MILLSTEIN. I think if we fail to follow this episode in American economic history with strong regulatory reform, then we will have created—we will have compounded the problems that existed in early September of 2008 before AIG was bailed out. The system that allowed an AIG to run up $2 trillion of risk without really any capital behind it, that allowed it to lever itself up the way it had without any effective holding company regulator supervising it and demanding that it have both capital and liquidity to support the risks it was underwriting—that system, you could argue, created the moral hazard that certainly has been compounded by what occurred. So we need to have a regulatory reform package to counter what has occurred and to make sure this doesn't happen again.

Dr. TROSKE. You know, I think I would disagree with you. I think that if the government had consistently allowed creditors to fail in Long Term Capital Management, in—you know, back over the last 30 years, then we would have regulators. They would be called creditors.

And this problem wouldn't exist in the first place because the creditors to AIG would have taken a much more active role in ensuring the company didn't get into the problems in the first place. And the solution you're proposing is for the government to go out and hire creditors to do the job——

Mr. MILLSTEIN. No, not at all.

Dr. TROSKE. Excuse me—the government to go out and hire regulators to do the job that creditors should have been doing is going to produce a much more inferior solution to the one we would have if we actually allowed the market to function in an efficient fashion.

Mr. MILLSTEIN. No, I actually agree with what you've said.

Dr. TROSKE. Okay.

Mr. MILLSTEIN. But when firms of this size fail, they have spillover effects that are enormous. And so, when I say strong regulatory reform, I mean a resolution regime that can contain the spillover effects of a failure of the size of this firm.

Dr. TROSKE. And that offers me a good segue into my next question, which is, again, a fairly general question that I want to ask. I have heard the term systemic used more often since I've been appointed to this panel than I had, you know, in the last—in my entire previous life. Yet I have yet to see an operational definition that would allow me to know what a systemic firm looks like and what one doesn't look like.

And if you seem to be arguing that we need a regulatory regime that regulates systemic firms that offer a systemic risk—to do that, I think we need a definition. And I would love for someone to give me one. And you're sitting here, so I'm asking you. Sorry about that.

Mr. MILLSTEIN. And I would love to take the bait and join issue with you on that. But I think we don't have the time.

Dr. TROSKE. Okay.

Mr. MILLSTEIN. I mean, I think it's important. I agree with you. It's important. And if the regulatory reform bill passes, I think you'll see one emerge from the new systemic risk regulator that is——

Dr. TROSKE. So you think we're going to come up with a definition? Because, I mean, I would be happy if we did in which, you know, the government basically said these are the firms that we're going to backstop—and so, we know the moral hazard is here with these firms—and everybody else we're not. And we've got this dynamic definition. I guess I'm less confident than you are that that's going to arise in a——

Mr. MILLSTEIN. Well, I mean, I think the premise, though, is wrong, that—some people worry about that the systemic—the systemic designation means that no, we're not going to backstop you, you're in the resolution regime where, you know, you're going to be put to bed and you're going to have, you know, living wills or whatever you want to call it, but severe regulatory oversight to prevent us from having to do what we did with AIG again.

Dr. TROSKE. That's all.

Chair WARREN. Thank you very much, Mr. Millstein. I appreciate your being here today.

Mr. MILLSTEIN. Thank you all.

Chair WARREN. This hearing is concluded. We will hold the record open for questions and additional documentation from our various witnesses. Hearing adjourned.

[The Congressional Oversight Panel, at 3:45 p.m., was adjourned]

[The following written statement of Keith M. Buckley, Group Managing Director, Global Insurance, Fitch Ratings, was submitted for the record:]

FitchRatings

Statement of Keith M. Buckley, CFA
Group Managing Director, Global Insurance
Fitch Ratings
Before a hearing of the
Congressional Oversight Panel
on
May 26, 2010

Chairperson Warren and panel members Silvers and McWaters, Fitch Ratings (Fitch) is pleased to submit a written statement in connection with the panel's hearing today.

The team of financial analysts that I manage at Fitch has provided credit ratings on American International Group, Inc. (AIG) and certain of its subsidiaries since 1997. I understand that the panel is interested in our ratings activities with respect AIG from 2008 through today, which coincides with the emergence of financial difficulties at AIG that culminated in government assistance announced on September 16, 2008.

We understand your interests include any discussion Fitch analysts had with government officials during that time period, both as the government initially provided, and subsequently modified, the nature of its assistance. You are also interested in our views on possible government exit options, as well as certain aspects of our ratings criteria, especially those related to distressed debt exchanges.

As a point of background, Fitch first placed AIG's ratings on Rating Watch Negative in February 2008, implying a future downgrade was reasonably likely. This action related to problems that began to emerge in AIG's derivatives portfolio in its Financial Products subsidiary (AIG FP). Fitch never rated AIG FP, but at the time had an Issuer Default Rating (IDR) of AA on AIG, the ultimate parent company that guaranteed many of AIG FP's obligations.

AIG's IDR was subsequently downgraded to AA- on May 8, 2008, and Fitch's ratings remained on Rating Watch Negative, after AIG reported

mark-to-market losses on its derivatives portfolio, and plans to raise capital. On May 22, 2008 AIG's ratings were removed from Rating Watch Negative after AIG raised new capital of $20 billion.

On August 22, 2008 Fitch again placed its ratings of AIG on Rating Watch Negative recognizing mounting financial pressures including liquidity needs, as well as an announcement by AIG that it was conducting a strategic review of its business units. This was followed by a downgrade of AIG's IDR on September 15, 2008 to A.

The downgrade on September 15 recognized a need for AIG to raise funding to address growing liquidity needs, and our concerns that AIG's financial flexibility had grown quite limited due to declines in its stock price, widening credit spreads on its bonds and the impact of generally weakening capital market conditions. Financial flexibility and access to capital was a critical assumption historically embedded in our ratings of AIG. As a point of context, this downgrade occurred just after the announcement of the Lehman bankruptcy, which greatly acerbated problems for most companies in accessing the capital markets.

Over the next day and a half Fitch remained in contact with AIG management, as the company began indicating to Fitch increases in its estimates of possible liquidity needs, as well as possible remedies. Fitch also monitored news reports, including an announcement by the New York State Department of Insurance that it had tentatively approved an extraordinary payment from AIG's insurance subsidiaries of $20 billion to help AIG fund its liquidity needs. There were also varied reports of other possible sources of funding.

We also were concerned about the company's financial flexibility in the event of any negative rating actions by Standard and Poor's (S&P) and Moody's Investor Services (Moody's) as we recognized that a number of AIG FP's derivative contracts included rating triggers linked the ratings of these two agencies. Downgrades by S&P or Moody's would have potentially caused AIG FP to post additional collateral, furthering its liquidity challenges.

As Fitch continued to monitor these various developments, we received a call from government officials late in the afternoon of September 16, 2008. During this call, Fitch was informed that the government would later that

evening announce an $85 billion bridge loan facility for AIG. We convened a rating committee meeting that night to decide how we would react to the noted government assistance.

On September 17, 2008, Fitch announced that AIG's A IDR was unchanged, recognizing that while AIG's financial profile had deteriorated further due to mounting liquidity needs, this concern was largely offset by the favorable impact of government assistance. At the same time we changed our Rating Outlook on AIG from Negative to Evolving to communicate to the market that while government assistance removed much of the near-term downside pressure on AIG's ratings, material uncertainties remained.

Absent the provision of government assistance announced on September 16, I believe that Fitch would have downgraded AIG's rating to below investment grade given the seriousness of its financial difficulties. However, since government assistance was announced as these negative developments became known, Fitch's rating committee never formally reviewed its ratings of AIG in a context absent government assistance subsequent to our September 15 downgrade.

Subsequent to the initial call from the government on September 16 through late October of 2008, Fitch had a number of calls or meetings with AIG management, many of which included representatives from Treasury, the Federal Reserve Bank of New York, or both. These included:

a. Discussion of potential asset sales in order to repay the bridge loan (1st week of October),
b. Restructuring of the bridge loan (October 17),
c. Formation of the Maiden Lane Special Purpose Vehicles and discussions regarding the securities lending portfolio and CDS portfolio (October 29)

During this period, Fitch never advised AIG or government officials, or made suggestions as to how different restructurings of government assistance would impact AIG's ratings. However, consistent with our stated goals of transparency, Fitch did share with AIG and government officials its concerns with respect AIG and its creditworthiness. These concerns were the same as those included in Fitch's published commentary on AIG. It is important to note that there was never a discussion between Fitch and either AIG or government officials related to a prepackaged bankruptcy.

Fitch's next rating action on AIG was on May 15, 2009, at which time we downgraded AIG's IDR to BBB, and also lowered the insurer financial strength ratings of AIG's insurance subsidiaries to within the A category. These downgrades reflected deterioration in the financial condition of AIG's insurance subsidiaries due to both investment losses and deterioration in their competitive positions. This deterioration reflected both the impact of the financial crisis generally, as well as the tarnished reputation of AIG following the need for government assistance.

In taking the May 15 rating action, Fitch also reevaluated the appropriate level of its implied government "support floor" for AIG's ratings. By that time our view had evolved such that we believed that once the systemic risks that AIG posed ultimately abated, the government would be less likely to provide additional funding, if needed, simply to support AIG's ratings at their original pre-crisis levels. Fitch believed that the insurance companies that ultimately emerged from the restructuring could be competitive at A category financial strength ratings and BBB category parent debt and IDR ratings. This, in part, recognizes that following many downgrades taken during the financial crisis across the insurance industry by Fitch and the other rating agencies, many of AIG's competitors have ratings at these levels.

As part of its ratings assumptions for AIG, Fitch expects that AIG will likely ultimately emerge as an independent entity, though we do not yet view that as certain. Our ratings expectation is that debt-related government obligations will likely be repaid via proceeds from assets sales. With respect to government equity interests, Fitch assumes exiting these will require accessing either capital markets, private investors or both. Fitch assumes the government's equity interests will ultimately either be repurchased by AIG once it can again issue public equity, the government will themselves sell the equity to the public, or the government could sell its interests in AIG to another company. Under any of these exit options strategy, Fitch expects that the investing public (or an acquirer) would need to have confidence that AIG could remain viable and competitive.

Finally, Fitch understands the panel is interested in Fitch's ratings criteria with respect distressed debt exchanges. We believe that this question is posed in the context of how we may have hypothetically rated AIG if the government's assistance had included settlements with certain counterparties at less than 100 cents on the dollar.

First I must emphasize it is difficult to speak to a hypothetical because there are often subtle nuances in actual situations that can have a material impact on a ratings outcome.

With that caveat, generally, negotiated settlements at anything less that 100 cents, especially if the offer is accepted because Fitch believes that the counterparty fears (or is threatened) it may receive less if it does not accept the offer, would be viewed as a default under our criteria. Thus, it is likely if the provision of government assistance included negotiated settlements with either AIG FP's derivative counterparties or AIG's debt holders at less than 100 cents, we would have downgraded AIG's ratings to reflect a default, as applicable. It is important to again emphasize that Fitch has never held discussions with AIG or the government related to potential negotiated settlements with counterparties or debt holders.