Testimony

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Chairman Frank, Ranking Member Bachus, and other members of the Committee, I appreciate having this opportunity to discuss the Federal Reserve's involvement with American International Group, Inc. (AIG). In my testimony, I will describe why supporting AIG was a difficult but necessary step to protect our economy and stabilize our financial system. I will also discuss issues related to compensation and note two matters raised by this experience that merit congressional attention.

Reasons for Our Original Lending Decision

We at the Federal Reserve, working closely with the Treasury, made our decision to lend to AIG on September 16 of last year. It was an extraordinary time. Global financial markets were experiencing unprecedented strains and a worldwide loss of confidence. Fannie Mae and Freddie Mac had been placed into conservatorship only two weeks earlier, and Lehman Brothers had filed for bankruptcy the day before. We were very concerned about a number of other major firms that were under intense stress.

AIG's financial condition had been deteriorating for some time, caused by actual and expected losses on subprime mortgage-backed securities and on credit default swaps that AIG's Financial Products unit, AIG-FP, had written on mortgage-related securities. As confidence in the firm declined, and with efforts to find a private-sector solution unsuccessful, AIG faced severe liquidity pressures that threatened to force it imminently into bankruptcy.

The Federal Reserve and the Treasury agreed that AIG's failure under the conditions then prevailing would have posed unacceptable risks for the global financial system and for our economy. Some of AIG's insurance subsidiaries, which are among the largest in the United States and the world, would have likely been put into rehabilitation by their regulators, leaving policyholders facing considerable uncertainty about the status of their claims. State and local government entities that had lent more than $10 billion to AIG would have suffered losses. 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 have seen that insurance disappear. Global banks and investment banks would have suffered losses on loans and lines of credit to AIG, and on derivatives with AIG-FP. The banks' combined exposures exceeded $50 billion.[1] Money market mutual funds and others that held AIG's roughly $20 billion of commercial paper would also have taken losses. In addition, AIG's insurance subsidiaries had substantial derivatives exposures to AIG-FP that could have weakened them in the event of the parent company's failure.

Moreover, as the Lehman case clearly demonstrates, focusing on the direct effects of a default on AIG's counterparties understates the risks to the financial system as a whole. Once begun, a financial crisis can spread unpredictably. For example, Lehman's default on its commercial paper caused a prominent money market mutual fund to "break the buck" and suspend withdrawals, which in turn ignited a general run on prime money market mutual funds, with resulting severe stresses in the commercial paper market. As I mentioned, AIG had about $20 billion in commercial paper outstanding, so its failure would have exacerbated the problems of the money market mutual funds. Another worrisome possibility was that uncertainties about the safety of insurance products could have led to a run on the broader insurance industry by policyholders and creditors. Moreover, it was well known in the market that many major financial institutions had large exposures to AIG. Its failure would likely have led financial market participants to pull back even more from commercial and investment banks, and those institutions perceived as weaker would have faced escalating pressure. Recall that these events took place before the passage of the Emergency Economic Stabilization Act, which provided funds that the Treasury used to help stem a global banking panic in October. Consequently, it is unlikely that the failure of additional major firms could have been prevented in the wake of the failure of AIG. At best, the consequences of AIG's failure would have been a significant intensification of an already severe financial crisis and a further worsening of global economic conditions. Conceivably, its failure could have resulted in a 1930s-style global financial and economic meltdown, with catastrophic implications for production, income, and jobs.

The decision by the Federal Reserve on September 16, 2008, with the full support of the Treasury, to lend up to $85 billion to AIG should be viewed with this background in mind. At that time, no federal entity could provide capital to stabilize AIG and no federal or state entity outside of a bankruptcy court could wind down AIG. Unfortunately, federal bankruptcy laws do not sufficiently protect the public's strong interest in ensuring the orderly resolution of nondepository financial institutions when a failure would pose substantial systemic risks, which is why I have called on the Congress to develop new emergency resolution procedures. However, the Federal Reserve did have the authority to lend on a fully secured basis, consistent with our emergency lending authority provided by the Congress and our responsibility as central bank to maintain financial stability. We took as collateral for our loan AIG's pledge of a substantial portion of its assets, including its ownership interests in its domestic and foreign insurance subsidiaries. This decision bought time for subsequent actions by the Congress, the Treasury, the Federal Deposit Insurance Corporation, and the Federal Reserve that have avoided further failures of systemically important institutions and have supported improvements in key credit markets.

The Federal Reserve's Ongoing Involvement with AIG

Having lent AIG money to avert the risk of a global financial meltdown, we found ourselves in the uncomfortable situation of overseeing both the preservation of its value and its dismantling, a role quite different from our usual activities. We have devoted considerable resources to this effort and have engaged outside advisers. Using our rights as creditor, we have worked with AIG's new management team to begin the difficult process of winding down AIG-FP and to oversee the company's restructuring and divestiture strategy. Progress is being made on both fronts. However, financial turmoil and a worsening economy since September have contributed to large losses at the company, and the Federal Reserve has found it necessary to restructure and extend our support. In addition, under its Troubled Asset Relief Program (TARP), the Treasury injected capital into AIG in both November and March. Throughout this difficult period, our goals have remained unchanged: to protect our economy and preserve financial stability, and to position AIG to repay the Federal Reserve and return the Treasury's investment as quickly as possible.

In our role as creditor, we have made clear to AIG's management, beginning last fall, our deep concern surrounding compensation issues at AIG. We believe it is in the taxpayers' interest for AIG to retain qualified staff to maintain the value of the businesses that must be sold to repay the government's assistance. But, at the same time, the company must scrupulously avoid any excessive and unwarranted compensation. We have pressed AIG to ensure that all compensation decisions are covered by robust corporate governance, including internal review, review by the Compensation Committee of the Board of Directors, and consultations with outside experts. Operating under this framework, AIG has voluntarily limited the salary, bonuses, and other types of compensation for 2008 and 2009 of the CEO and other senior managers. Moreover, executive compensation must comply with the most stringent set of rules promulgated by the Treasury for TARP fund recipients. The New York Attorney General has also imposed restrictions on compensation at AIG.

Many of you have raised specific issues with regard to the payout of retention bonuses to employees at AIG-FP. My reaction upon becoming aware of these specific payments was that, notwithstanding the business purposes that might be served by this action, it was highly inappropriate to pay substantial bonuses to employees of the division that had been the primary source of AIG's collapse.

I asked that the AIG-FP payments be stopped but was informed that they were mandated by contracts agreed to before the government's intervention. I then asked that suit be filed to prevent the payments. Legal staff counseled against this action, on the grounds that Connecticut law provides for substantial punitive damages if the suit would fail; legal action could thus have the perverse effect of doubling or tripling the financial benefits to the AIG-FP employees. I was also informed that the company had been instructed to pursue all available alternatives and that the Reserve Bank had conveyed the strong displeasure of the Federal Reserve with the retention payment arrangement. I strongly supported President Dudley's conveying that concern and directing the company to redouble its efforts to renegotiate all plans that could result in excessive bonus payments. I have also directed staff to work with the Treasury and the Administration in their review of whether the FP bonus and retention payments can be reclaimed. Moreover, the Federal Reserve and the Treasury will work closely together to monitor and address similar situations in the future.

Lessons Learned from AIG

To conclude, I would note that AIG offers two clear lessons for the upcoming discussion in the Congress and elsewhere on regulatory reform. First, AIG highlights the urgent need for new resolution procedures for systemically important nonbank financial firms. If a federal agency had had such tools on September 16, they could have been used to put AIG into conservatorship or receivership, unwind it slowly, protect policyholders, and impose haircuts on creditors and counterparties as appropriate. That outcome would have been far preferable to the situation we find ourselves in now. Second, the AIG situation highlights the need for strong, effective consolidated supervision of all systemically important financial firms. AIG built up its concentrated exposure to the subprime mortgage market largely out of the sight of its functional regulators. More-effective supervision might have identified and blocked the extraordinarily reckless risk-taking at AIG-FP. These two changes could measurably reduce the likelihood of future episodes of systemic risk like the one we faced at AIG.

Footnotes

1. In addition, many of these same banks had borrowed securities from AIG's securities lending program for which they had given AIG cash as collateral. Upon an AIG bankruptcy, the banks would have taken possession of the securities instead of receiving back their cash, exposing them to possible losses on those securities. Return to text

▲ Return to top