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Statement by

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U. S. Secretary of the Treasury

before the

Committee on Financial Services

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Good morning, Chairman Frank, Ranking Member Bachus, and other members of the Committee. Thank you for the opportunity to testify about the federal government's dealings with the American International Group, Inc. (AIG). I am pleased to be here with Chairman Bernanke and President Dudley.

AIG highlights broad failures of our financial system. Our regulatory system was not equipped to prevent the build up of dangerous levels of risk. Compensation practices encouraged risk-taking and rewarded short-term profits over long-term financial stability, overwhelming the checks and balances in the system. The U.S. government does not have the legal means today to manage the orderly restructuring of a large, complex, non-bank financial institution that poses a threat to the stability of our financial system.

I share the anger and frustration of the American people, not just about the compensation practices at AIG and in other parts of our financial system, but that our system permitted a scale of risk-taking that has caused grave damage to the fortunes of all Americans.

We must ensure that our country never faces this situation again. To achieve that goal, the Administration and Congress have to work together to enact comprehensive regulatory reform and eliminate gaps in supervision. All institutions and markets that could pose systemic risk will be subject to strong oversight, including appropriate constraints on risk-taking. Regulators must apply standards, not just to protect the soundness of individual institutions, but to protect the stability of the system as a whole. Finally, we must create a new resolution authority so that the federal government has the tools it needs to unwind an institution of the size and complexity of AIG.

Before the financial crisis, AIG was one of the largest insurance companies in the world with operations in 130 countries and a trillion dollar balance sheet. AIG's businesses provide insurance and retirement services for millions of individuals and businesses. AIG directly guarantees over $30 billion of 401(k) and pension plan investments and is a leading provider of retirement services for teachers and educational institutions.

AIG's Financial Products division (AIGFP) was a counterparty on thousands of over-the-counter derivatives contracts to major financial institutions and other entities across the globe. This division was an unregulated entity operating in unregulated markets.

In September, at a time of unprecedented financial market stress, losses on derivatives contracts entered into by AIG's Financial Products group forced the entire company to the brink of failure.

The U.S. Department of the Treasury (Treasury), the Federal Reserve Board, and the Federal Reserve Bank of New York agreed that the collapse of AIG could cause large and unpredictable global losses with systemic consequences -- destabilizing already weakened financial markets, further undermining confidence in the economy, and constricting the flow of credit. A disorderly failure of AIG risked deepening and prolonging the current recession.

There is no effective legal mechanism to unwind a non-bank financial institution like AIG. Therefore, on September 16th, the Federal Reserve Board authorized an $85 billion revolving credit facility to provide liquidity and avoid default. As a condition of government assistance, the government installed new management at AIG and began the process of restructuring the board. We initiated a strategy to return AIG to its core insurance business by winding-down its derivatives trading operation and selling non-core businesses. This loan was the beginning of a sustained effort to stabilize the company, which required additional commitments of capital in November and March.

In November, as part of the government's infusion of capital, Treasury imposed the strictest level of executive compensation standards required under the Emergency Economic Stabilization Act. When we were forced to take additional action in March, we required AIG to also apply the Treasury rules that will be promulgated based on the executive compensation provisions in the American Reinvestment and Recovery Act.

On March 10th, I received a full briefing on the details of AIGFP's pending retention payments, including information on the payments to individual executives.

I found these payments deeply troubling. After consulting with colleagues at the Fed and exploring our legal options, I called Ed Liddy and asked him to renegotiate these payments. He explained that the contracts for the retention payments were legally binding and pointed out the risk that, by breaching the contracts, some employees might have a claim under Connecticut law to double payment of the contracted amounts.

I demanded that Liddy reduce future payments by hundreds of millions of dollars. He committed to renegotiate the remaining retention awards on terms consistent with the American Recovery and Reinvestment Act, and the Administration's compensation guidelines.

Additionally, Treasury is now working with the Department of Justice to determine what legal avenues may be available to recoup retention bonuses that have already been paid. Treasury will also impose on AIG a contractual commitment to pay the Treasury, from the operations of the company, the amount of the retention awards just paid. Finally, Treasury will deduct from the $30 billion in recently committed capital assistance an amount equal to the amount of those payments.

The issue of excessive compensation extends beyond AIG and requires reform of the system of incentives and compensation in the financial sector.

On February 4th, the President and Treasury announced new restrictions on executive compensation for financial institutions that are receiving government assistance as part of the Financial Stability Plan. These measures are designed to ensure that public funds are focused on the public interest and that the compensation of top executives in the financial community is aligned not only with the interests of shareholders and financial institutions, but with the interests of taxpayers providing assistance to those companies.

On February 17th, the President signed additional limits on executive compensation into law as part of the American Reinvestment and Recovery Act. These limits included a requirement to recoup bonuses already paid in cases of misrepresentation or malfeasance. Treasury is currently working to promulgate rules to implement these provisions and to develop a program under the original TARP legislation to review certain bonus awards already paid. We will work with Congress on any new legislation proposed in this area.

We need to strike the right balance between encouraging investment and prudent risk-taking to get our financial system moving again, and, on the other hand, placing limits on executive compensation to avoid taxpayer funded rewards for failure. The objective is to promote long-term value and growth for shareholders, companies, workers and the economy at large, and to reduce the risk of financial crises like the current one from occurring again.

In addition to problems with executive compensation, the financial crisis has revealed systemic gaps in the regulatory structure governing our financial markets. The lack of an appropriate regulatory regime and resolution authority for large non-bank financial institutions contributed to this crisis and will continue to constrain our capacity to address future crises. I will testify before this committee on Thursday to discuss our regulatory reform proposals – particularly those relating to mitigating systemic risk – in more detail.

As we have seen with AIG, distress at large, interconnected, non-depository financial institutions can pose systemic risks just as distress at banks can. The Administration proposes legislation to give the U.S. government the same basic set of tools for addressing financial distress at non-banks as it has in the bank context.

The proposed resolution authority would allow the government to provide financial assistance to make loans to an institution, purchase its obligations or assets, assume or guarantee its liabilities, and purchase an equity interest.

The U.S. government as a conservator or receiver would have additional powers to sell or transfer the assets or liabilities of the institution in question, renegotiate or repudiate the institution's contracts (including with its employees), and prevent certain financial contracts with the institution from being terminated on account of the conservatorship or receivership.

This proposed legislation would fill a significant void in the current financial services regulatory structure with respect to non-bank financial institutions. Implementation would be modeled on the resolution authority that the FDIC has under current law with respect to banks.

Before taking any emergency action, the Treasury Secretary would need to determine that resolution authority is necessary upon the positive recommendations of the Federal Reserve Board and the appropriate federal regulatory agency.

This is an extraordinary time and the government has been forced to take extraordinary measures. We will do what is necessary to stabilize the financial system, and with the help of Congress, develop the tools that we need to make our economy more resilient and our system more just. Financial crises contain a basic and tragic unfairness – that those who were prudent and responsible in their personal and professional judgments are harmed by the actions of those were less careful and less prudent.

The actions that we take will help restore confidence in our markets and revive the flow of credit to households and businesses. They will create an environment where it is safe to save and invest and where all Americans can trust the rules governing their financial decisions. The process of repair will take time, but our actions will succeed. For all the challenges that we face, we still have a diverse and resilient financial system. Together we will help prevent future crises and the costs they would impose.