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HOUSE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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**FOR THE TROUBLED ASSET RELIEF PROGRAM**

BEFORE THE  
HOUSE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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Chairman Towns, Ranking Member Issa, and Members of the Committee, I am honored to appear before you today to discuss SIGTARP's audit examining the factors affecting efforts to limit payments to American International Group ("AIG") counterparties that was released back in November,<sup>1</sup> as well as to discuss several troubling issues that have come to light since the audit was released that relate to whether the Government has been fully transparent with the American people with respect to the AIG transactions.

Before I begin, I would like to thank the Committee for both its strong support and its leadership on this issue. SIGTARP's audit was commenced as the result of a letter request made by Congressman Cummings and 26 other Members of Congress, including several members of this Committee, and the tenacity and leadership demonstrated by the Chairman, Ranking Member and many other members of this Committee has been crucial in continuing the drive for transparency and accountability on the AIG bailout in general and the counterparty payments in particular.

## **FACTUAL BACKGROUND**

In September 2008, AIG was on the brink of collapse, unable to access credit in the private markets and bleeding cash. On September 16, 2008, the Federal Reserve Bank of New York ("FRBNY"), pursuant to the authorization of the Board of Governors of the Federal Reserve System ("Federal Reserve Board," and, collectively with FRBNY, "Federal Reserve") provided AIG with an \$85 billion loan. On November 10, 2008, the Federal Reserve and the Department of the Treasury ("Treasury") announced the restructuring of the Government's financial support to AIG. As part of this restructuring, the Federal Reserve Board authorized FRBNY to lend up to \$30 billion to Maiden Lane III, a newly formed limited liability company. Pursuant to this authorization, FRBNY lent \$24.3 billion to Maiden Lane III, which, in

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<sup>1</sup> A copy of the audit is appended hereto for the Committee's reference.

combination with a \$5 billion equity investment from AIG, was used to fund the purchase of assets from counterparties of American International Group Financial Products (“AIGFP”) having a fair market value of about \$27.1 billion. In exchange for that payment and being permitted to retain \$35 billion in collateral payments that had been previously made by AIG (including billions in collateral payments made possible by the FRBNY loan), the counterparties agreed to terminate their credit default swap contracts—insurance-like contracts intended to protect the underlying assets—with AIGFP. Because the counterparties were both paid the fair market value of the assets underlying the credit default swap contracts and permitted to keep the collateral that had previously been posted, the counterparties were effectively paid the par value of the underlying assets.

In light of this factual context, and consistent with the issues raised by Congressman Cummings and others, SIGTARP’s audit addressed (1) the decision-making processes leading up to the creation of Maiden Lane III, (2) why AIG’s counterparties were paid effectively at par value, and (3) AIG’s current exposure to credit default swaps outside Maiden Lane III.

### **SIGTARP’S AUDIT FINDINGS**

SIGTARP’s audit, which was issued on November 17, 2009, found that, when first confronted with the liquidity crisis at AIG, the Federal Reserve Board and FRBNY, who were then contending with the demise of Lehman Brothers, turned to the private sector to arrange and provide funding to stave off AIG’s collapse. Confident that a private sector solution would be forthcoming, FRBNY did not develop a contingency plan, and, when private financing fell through, FRBNY was left with little time to decide whether to rescue AIG and, if so, on what terms. Having witnessed the dramatic economic consequences of Lehman Brothers’ bankruptcy just hours before, senior officials at the Federal Reserve and Treasury determined that an AIG

bankruptcy would have far greater systemic impact on the global financial system than Lehman's bankruptcy and decided to step in to prevent that result.

Not preparing an alternative to private financing, however, left FRBNY with little opportunity to fashion appropriate terms for the support, and, believing it had no time to do otherwise, it essentially adopted the term sheet that had been the subject of the aborted private financing discussions (an effective interest rate in excess of 11 percent and an approximate 80 percent ownership interest in AIG), albeit in return for \$85 billion in FRBNY financing rather than the \$75 billion that had been contemplated for the private deal. In other words, the decision to acquire a controlling interest in one of the world's most complex and most troubled corporations was done with almost no independent consideration of the terms of the transaction or the impact that those terms might have on the future of AIG.

The impact of those terms, however, soon became apparent to FRBNY. In a matter of days, FRBNY officials recognized that, although the \$85 billion credit line permitted AIG to meet billions of dollars of collateral calls and thus avoid an immediate bankruptcy, its terms were unworkable. Among other things, the interest rate imposed upon AIG was so onerous that, if unaddressed, the burden of servicing the FRBNY financing greatly increased the likelihood that there would be further credit rating downgrades for AIG, a result that FRBNY officials believed would have "devastating" implications for AIG. For this and other reasons, modification of the original terms thus became inevitable. One example of such modification was Treasury's \$40 billion investment in AIG in November 2008 through the Troubled Asset Relief Program ("TARP") — which was used to pay down the FRBNY loan in part. Another was termination of a portion of AIG's credit default swap obligations made possible through the creation of Maiden Lane III.

A significant cause of AIG's liquidity problems stemmed from its obligations to post collateral (cash payments that equaled the drop in value of the underlying securities) in connection with AIGFP's credit default swap contracts. To avoid the necessity for AIG to continue to post collateral and to reduce the danger of further rating agency downgrades, by early November 2008, FRBNY decided to create Maiden Lane III, a special purpose vehicle, to retire a portion of AIG's credit default swap portfolio by purchasing the underlying CDOs from the swap counterparties, which eased pressure on FRBNY's credit line and transferred the issues with these contracts off of AIG's balance sheet and on the Federal Reserve's.

When considering the amount of payment for the underlying CDOs for the Maiden Lane III transaction, FRBNY decided to attempt to seek concessions, or "haircuts," from the counterparties. FRBNY contacted by telephone eight of AIG's largest counterparties over a two-day period and attempted to obtain such concessions from the counterparties. Although one counterparty, UBS, was willing to make a modest 2 percent concession if the other counterparties did so, FRBNY's attempts to obtain concessions from the others were completely unsuccessful, and FRBNY decided to pay the counterparties the full market value of the CDOs, which, when combined with the already posted collateral, meant that the counterparties were effectively paid full face (or par) value of the credit default swaps, an amount far above their market value at the time.

On November 7th, 2008, FRBNY employees involved with the negotiations reported to then-FRBNY President Geithner on the efforts to convince AIG counterparties to accept haircuts on their claims against AIG in return for unwinding the CDS contracts. Noting both the willingness of UBS to negotiate a small haircut and the generally negative reactions from the other counterparties, these FRBNY officials recommended that FRBNY cease negotiations and

proceed with paying the counterparties the market value of their underlying CDOs and permitting them to keep the collateral already posted, effectively paying them par for securities that collectively had a market value, based on the amount of the collateral payments, of approximately 48 cents on the dollar. According to these FRBNY executives, then-President Geithner “acquiesced” to the executive’s proposal. When asked by SIGTARP if the executives felt they had received their “marching orders” from then-FRBNY President Geithner to pay the counterparties par, one FRBNY official responded “yes, absolutely.”

The decision to pay effective par value was then brought before the Board of Directors of the FRBNY and the Board of Governors of the Federal Reserve. Each body gave its approval. According to the General Counsel for FRBNY, officials from Treasury were not involved in the negotiations of concessions with AIG’s credit default swap counterparties. The Chief Compliance Officer for Treasury’s Office of Financial Stability at the time also told SIGTARP that Treasury was not involved with the Maiden Lane III transaction and, when asked about who at Treasury SIGTARP should speak with regarding the transactions, he responded that Secretary Geithner was the appropriate official.

In pursuing the counterparty negotiations, FRBNY made several policy decisions that severely limited its ability to obtain concessions. FRBNY officials told SIGTARP that: FRBNY determined that it would not treat the counterparties differently, and, in particular, would not treat domestic banks differently from foreign banks — a decision with particular import in light of what FRBNY officials recounted was the reaction of the French bank regulator which, according to FRBNY, refused to allow two French bank counterparties to make concessions; FRBNY refused to use its considerable leverage as the regulator of several of these institutions to compel haircuts because FRBNY was acting on behalf of AIG (as opposed to in its role as a

regulator); FRBNY was uncomfortable interfering with the sanctity of the counterparties' contractual rights with AIG, which entitled them to full par value; FRBNY felt ethically restrained from threatening an AIG bankruptcy because it had no actual plans to carry out such a threat; and FRBNY was concerned about the reaction of the credit rating agencies should imposed haircuts be viewed as FRBNY backing away from fully supporting AIG. Although these were certainly valid concerns, these policy decisions came with a cost — they led directly to a negotiating strategy with the counterparties that even then-FRBNY President Geithner acknowledged had little likelihood of success.

FRBNY's decision to treat all counterparties equally (which FRBNY officials described as a "core value" of their organization), for example, gave each of the major counterparties effective veto power over the possibility of a concession from any other party. This approach left FRBNY with few options, even after one of the counterparties indicated a willingness to negotiate concessions. It also arguably did not account for significant differences among the counterparties, including that some of them had received very substantial benefits from FRBNY and other Government agencies through various other bailout programs (including billions of dollars of taxpayer funds through TARP), a benefit not available to some of the other counterparties (including the French banks). It further did not account for the benefits the counterparties received from FRBNY's initial bailout of AIG, without which they would have likely suffered far reduced payments as well as the indirect consequences of a potential systemic collapse. It also did not recognize that each bank's portfolio of assets were different and had different market values, meaning that certain counterparties (such as Goldman Sachs, the market value of whose securities, based on the collateral payments made by AIG, was approximately 40

cents on the dollar) arguably received a greater benefit than others (such as UBS, whose securities had a comparable market value of approximately 66 cents on the dollar).

Similarly, the refusal of FRBNY and the Federal Reserve to use their considerable leverage as the primary regulators for several of the counterparties, including the emphasis that their participation in the negotiations was purely “voluntary,” made the possibility of obtaining concessions from those counterparties extremely remote. While there can be no doubt that a regulators’ inherent leverage over a regulated entity must be used appropriately, and could in certain circumstances be abused, in other instances in this financial crisis regulators (including the Federal Reserve) have used overtly coercive language to convince financial institutions to take or forego certain actions. As SIGTARP reported in its audit of the initial Capital Purchase Program investments, for example, Treasury and the Federal Reserve fully used their leverage as regulators, just weeks before the negotiations with AIG’s counterparties, to persuade nine of the largest financial institutions (including some of AIG’s counterparties) to accept \$125 billion of TARP funding. In stark contrast to those negotiations, in the case of the AIG counterparty payments, Mr. Geithner and Mr. Bernanke did not participate; nor did the CEO’s of the counterparties; and the counterparties were not gathered together and told that they should, together, voluntarily concede to concessions because of the importance of this issue to the United States government. Instead, the negotiations were generally conducted through a series of telephone calls from executives at FRBNY to executives at the counterparties. Ultimately, in the CPP negotiations, there was no need for the Federal Reserve to impose the CPP investments on the participants using its regulatory authority because it obtained voluntary agreements based on an aggressive negotiating strategy. It is impossible to determine now, given the policy choices



made by the FRBNY, whether a similarly proactive strategy with the AIG counterparties would have resulted in taxpayer savings.

Moreover, subsequent to the issuance of the audit report, SIGTARP was informed that the French regulator was in fact open to further negotiations with the Federal Reserve to discuss the possibility of such concessions. While they viewed the transactions proposed by the Federal Reserve as being violative of French law, the regulators informed SIGTARP that they believed that an exception was possible and that they were willing to further discuss potential concessions. The French regulators noted that such negotiations would have been unprecedented, would have likely required universal agreement among counterparties to make concessions, and would have had to be conducted in a transparent manner and at a high level, but that continued negotiations were possible. While the French regulators would not clarify to SIGTARP what specific statements were made to the Federal Reserve during the actual negotiations, they did inform SIGTARP that they did not “slam the door” to such continued discussions.

Questions have been raised as to whether the Federal Reserve intentionally structured the AIG counterparty payments to benefit AIG’s counterparties — in other words that the AIG assistance was in effect a “backdoor bailout” of AIG’s counterparties. Then-FRBNY President Geithner and FRBNY’s general counsel deny that this was a relevant consideration for the AIG transactions. Irrespective of their stated intent, however, there is no question that the *effect* of FRBNY’s decisions — indeed, the very *design* of the federal assistance to AIG — was that tens of billions of dollars of Government money was funneled inexorably and directly to AIG’s counterparties. Although the primary intent of the initial \$85 billion loan to AIG may well have been to prevent the adverse systemic consequences of an AIG failure on the financial system and

the economy as a whole, in carrying out that intent, it was fully contemplated that such funding would be used by AIG to make tens of billions of dollars of collateral payments to the AIG counterparties. The intent in creating Maiden Lane III may similarly have been the improvement of AIG's liquidity position to avoid further rating agency downgrades, but the direct effect was further payments of nearly \$30 billion to AIG counterparties, albeit in return for assets of the same market value. Stated another way, by providing AIG with the capital to make these payments, Federal Reserve officials provided AIG's counterparties with tens of billions of dollars they likely would have not otherwise received had AIG gone into bankruptcy.

Any assessment of the costs of these decisions to the Government and the taxpayer necessarily must look beyond FRBNY's loan to Maiden Lane III to also take into account both the funds that FRBNY previously loaned to AIG and the subsequent TARP investments. All of these infusions to AIG are linked inextricably: more than half the total amounts paid to counterparties in connection with the credit default swap portfolio retired through Maiden Lane III did not come about through the Maiden Lane III CDO purchases, but rather from AIG's earlier collateral postings that were made possible in part by the original FRBNY loan, which was, in turn, paid down with TARP funds. Because of this linkage, the ultimate costs to the Government and the taxpayer cannot be measured in isolation. Stated another way, irrespective of whether FRBNY is made whole on its loan to Maiden Lane III, we will only be able to determine the ultimate value or cost to the taxpayer after the likelihood of AIG repaying all of its assistance can be more readily determined.

The remarkable narrative surrounding the AIG loans and the creation of Maiden Lane III set forth in SIGTARP's audit gives rise to two additional lessons learned. First, AIG stands as a stark example of the tremendous influence of credit rating agencies upon financial institutions

and upon Government decision making in response to financial crises. In the lead-up to the crisis, the systemic over-rating of mortgage-backed securities by rating agencies was reflected in the similarly over-rated CDOs that underlied AIGFP's credit default swaps. Once the financial crisis had come to a head, the credit rating agencies' downgrades of AIG itself and of the underlying securities played a significant role in AIG's liquidity crisis as those downgrades and the related market declines in the securities required AIG to post billions of dollars in collateral. The threat of further rating agency downgrades due to the onerous terms of the initial FRBNY financing, among other things, led to further Government intervention, including the TARP investment in AIG and the necessity to do something with the swap portfolio, *i.e.*, Maiden Lane III. And the concern about the reaction of the credit rating agencies played a role in FRBNY's decision not to pursue a more aggressive negotiating policy to seek concessions from counterparties. All of these profound effects were based upon the judgments of a small number of private entities that operate, as described in SIGTARP's October 2009 Quarterly Report to Congress, on an inherently conflicted business model and that are subject to minimal regulation. Without drawing any conclusions about the particular actions taken by the rating agencies in the case of AIG, this report further demonstrates the dramatic influence of these entities on our financial system.

Second, the now familiar argument from Government officials about the dire consequences of basic transparency, as advocated by the Federal Reserve in connection with Maiden Lane III, once again simply does not withstand scrutiny. Federal Reserve officials initially refused to disclose the identities of the counterparties or the details of the payments, warning that disclosure of the names would undermine AIG's stability, the privacy and business interests of the counterparties, and the stability of the markets. After public and Congressional

pressure, AIG disclosed the identities. Notwithstanding the Federal Reserve's warnings, the sky did not fall; there is no indication that AIG's disclosure undermined the stability of AIG or the market or damaged legitimate interests of the counterparties. The lesson that should be learned — one that has been made apparent time after time in the Government's response to the financial crisis — is that the default position, whenever Government funds are deployed in a crisis to support markets or institutions, should be that the public is entitled to know what is being done with Government funds. While SIGTARP acknowledges that there might be circumstances in which the public's right to know what its Government is doing should be circumscribed, those instances should be very few and very far between.

## **ONGOING TRANSPARENCY ISSUES**

Since the release of the audit, three broad issues have come to light that call into question whether the Government has been and is being as transparent as possible with the American people.

The first relates to public statements recently made by Treasury about the AIG transactions. For example, on January 7, 2010, in response to press inquiries regarding the role of Secretary Geithner in the decisions concerning AIG, a Treasury spokesperson stated the following via email to reporters:

In the transaction at the heart of this dispute (Maiden Lane III's purchase of CDO's), the FRBNY made a loan of \$25 billion which is on track to be paid back in full with interest *so that taxpayers will be made whole*. Somehow that fact that the government's loan is "above water" gets lost in all the consternation despite its mention on page 2 of the SIGTARP report and weekly updates on the FRBNY's web site. (Emphasis added.)

This statement simply does not advance the cause of transparency. As noted in the audit, it is clear that all of the infusions to AIG are linked: more than half the total amounts paid to counterparties in connection with the swap portfolio retired through Maiden Lane III did not

come about through the Maiden Lane III purchases, but rather from AIG's earlier collateral postings that were made possible in part by the original \$85 billion FRBNY loan; that loan, in turn, was paid down with \$40 billion of TARP funds. Treasury's own TARP financial statement estimates that Treasury will *not* be made whole, but is rather projected to lose more than \$30 billion on its AIG investments. Again, the various AIG infusions are directly linked: (a) the counterparties terminated their credit default swap agreements with AIG after they were *both* paid the fair market value of the underlying assets through Maiden Lane III and permitted to keep the collateral payments made by AIG; (b) many of those collateral payments were only made possible by the FRBNY loan; and (c) that loan was paid back in part by the initial \$40 billion TARP investment. Narrowly asserting that taxpayers will be "made whole" on Maiden Lane III — just one part of the AIG counterparty transactions — without mentioning the huge losses Treasury expects to suffer on other, inextricably linked parts of *the very same* transactions is simply unacceptable; the American people deserve better.

The second issue relates to a series of documents that have recently been disclosed — as the direct result of the tenacity of the members of this Committee — about the Maiden Lane III transactions. As has been widely reported, these newly disclosed documents, among other things, relate to discussions about the public disclosure by AIG of the Maiden Lane III transactions in filings with the Securities and Exchange Commission. In light of these documents, we have initiated an investigation into whether there was any misconduct relating to the disclosure or lack thereof concerning the Maiden Lane III transactions.

Third, additional documents and facts have come to light that have caused SIGTARP to initiate an investigation to review the extent of the Federal Reserve's cooperation with SIGTARP during the course of the audit. For example, in connection with the recent document productions

to this Committee, documents have come to light that were not provided to the SIGTARP audit team during the course of the audit. FRBNY's outside counsel has told SIGTARP that FRBNY will cooperate fully with SIGTARP's investigation.

With respect to these investigations, it is SIGTARP's policy not to comment publicly on non-public, ongoing criminal or civil investigations, and thus we cannot comment further at this time, other than to note that these assertions do not at this time constitute a factual finding by SIGTARP. At the conclusion of the investigations, however, we anticipate that the details of our findings will be reported to Congress, as appropriate, either through formal court filings or in the form of Investigative Reports.

Chairman Towns, Ranking Member Issa and Members of the Committee, I want to thank you again for this opportunity to appear before you, and I would be pleased to respond to any questions that you may have.

If you are aware of fraud, waste, abuse, mismanagement or misrepresentations affiliated with the troubled asset relief program, please contact the SIGTARP Hotline.

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