Congressional Oversight Panel Hearing on TARP and Other Assistance to AIG

Testimony of Sarah Dahlbergh

May 26, 2010

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[redacted]

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.

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[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.

[redacted]

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 American 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 September 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 Federal 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 organization 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 specific 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 capital 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.