Testimony

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American International Group

Vice Chairman Donald L. Kohn

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Chairman Dodd, Ranking Member Shelby, and other members of the Committee, I appreciate having this opportunity to discuss the role of the Federal Reserve in stabilizing American International Group, Inc. (AIG). In my testimony, I will detail the support the Federal Reserve, working alongside the Treasury, has given AIG and the reasons for each of our actions. Before I go into the extended narrative, however, I think it would be useful to briefly put our decisions in their broader context.

Over the past year and a half, we have all been dealing with the ongoing disruptions and pressures engendered by an extraordinary financial crisis. The weaknesses at financial institutions and resulting constraints on credit, declines in asset prices, and erosion of household and business confidence have in turn led to a sharp weakening in the economy. The Federal Reserve has employed all the tools at its disposal to break this spiral and help address the many challenges of the crisis and its effects on the economy. One of the most important of these tools is the Federal Reserve's authority under section 13(3) of the Federal Reserve Act to lend on a secured basis under "unusual and exigent" circumstances to companies that are not depository institutions. Since last fall, in order to foster the stability of the financial system and mitigate the effects of ongoing financial stresses on the economy, we have used that authority to help to stabilize the financial condition of AIG.

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AIG is a widely diversified financial services company that, as of September 30, 2008, which is the reporting date closest to the date we first provided it assistance, reported consolidated total assets of more than $1 trillion. AIG was at that time, and continues to be, one of the largest insurance companies in the world and, in terms of net premiums underwritten, is both the largest life and health insurer in the United States and the second largest property and casualty insurer in the United States. It conducts insurance and finance operations in more than 130 countries and jurisdictions and has more than 74 million individual and corporate customers and 116,000 employees globally. In the United States, it has approximately 30 million customers and 50,000 employees. AIG is the leading commercial insurer in the United States, providing insurance to approximately 180,000 small businesses and other corporate entities, which employ approximately 106 million people in the United States. It is also a major provider of protection to municipalities, pension funds, and other public and private entities through guaranteed investment contracts and products that protect participants in 401(k) retirement plans.

AIG has also been a major participant in many derivatives markets through its Financial Products business unit (Financial Products). Financial Products is an unregulated entity that exploited a gap in the supervisory framework for insurance companies and was able to take on substantial risk using the credit rating that AIG received as a consequence of its strong regulated insurance subsidiaries. Financial Products became the counterparty on hundreds of over-the-counter derivatives to a broad range of customers, including many major national and international financial institutions, U.S. pension plans, stable value funds, and municipalities. Financial Products also provided credit protection through credit default swaps it has written on billions of dollars of multi-sector collateralized debt obligations (CDOs). Financial Products did not adequately protect itself against the effects of a declining economy or the loss of the highest ratings from the credit rating agencies, and thereby was a source of weakness to AIG. While Financial Products has been winding down and exiting many of its trades, it continues to have a very large notional amount of derivatives contracts outstanding with numerous counterparties.

It is against this background that the Federal Reserve and the Treasury Department have taken a series of unusual actions to stabilize the company. These have entailed very difficult and uncomfortable decisions for a central bank. These decisions were particularly difficult and discomforting because they involved addressing systemic problems created largely by poor decisionmaking by the company itself. Moreover, many of these decisions involved an unregulated business entity that exploited the strength, and threatened the viability, of affiliates that were large, regulated entities in good standing. However, uncomfortable as this was, we believe we had no choice if we are to pursue our responsibility for protecting financial stability.

Our judgment has been and continues to be that, in this time of severe market and economic stress, the failure of AIG would impose

unnecessary and burdensome losses on many individuals, households and businesses, disrupt financial markets, and greatly increase fear and uncertainty about the viability of our financial institutions. Thus, such a failure would deepen and extend market disruptions and asset price declines, further constrict the flow of credit to households and businesses in the United States and in many of our trading partners, and materially worsen the recession our economy is enduring. To mitigate these risks, the Treasury provided equity capital to AIG and the Federal Reserve provided liquidity support backed by the assets of AIG.

The Federal Reserve's involvement in AIG began in mid-September of 2008. AIG's financial condition had been deteriorating for some time. The financial and credit markets were experiencing severe stress due to various economic problems arising out of the broad-based decline in home prices, rise in delinquencies and foreclosures, and substantial drop in values of mortgages as well as mortgage-backed securities and other instruments based on such assets. In short-term funding markets, very high spreads between lending rates and the target federal funds rate and very illiquid trading conditions in term money markets had come to prevail. AIG was exposed to these problems because of the protection Financial Products had written on mortgage-related securities, because of investments AIG had made in mortgage-related securities in connection with its securities lending program, and because its counterparties had begun to withdraw funding. These pressures mounted through September. The private sector worked through the weekend of September 13-14 to find a way for private firms to address AIG's mounting liquidity strains. But that effort was unsuccessful in a deteriorating economic and financial environment in which firms were not willing to expose themselves to risks--a risk aversion that greatly increased following the collapse of Lehman Brothers on September 15.

Under these circumstances, on September 16, 2008, acting with the full support of the Treasury, the Board authorized the Federal Reserve Bank of New York (New York Reserve Bank) pursuant to section 13(3) to lend up to $85 billion to AIG through a revolving credit facility (Revolving Credit Facility) in order to ease the liquidity strain on AIG. The liquidity pressures experienced by AIG during that time of fragile economic markets threatened its ability to continue to operate, and the prospect of AIG's disorderly failure posed considerable systemic risks in various ways as a consequence of its significant and wide-ranging operations. Such a failure would also have further undermined business and household confidence and contributed to higher borrowing costs, reduced wealth, and general additional weakening of the economy. Moreover, at the time the Board extended the Revolving Credit Facility, there was no federal entity that could provide capital to AIG to help stabilize it. The Troubled Asset Relief Program (TARP) legislation was requested in part to fill that void and authorized by Congress on October 3, 2008.

The Revolving Credit Facility was established with the purpose of assisting AIG in meeting its obligations when due and facilitating a

restructuring whereby AIG would sell certain businesses in an orderly manner, with minimal disruption to the overall economy. AIG would repay the Revolving Credit Facility over a period of two years as it sold assets. Importantly, the Revolving Credit Facility was (and remains) secured by a pledge of a substantial portion of the company's assets, including AIG's ownership interests in its domestic and foreign insurance subsidiaries. As additional compensation for the Revolving Credit 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. With these protections, the Board believed that the authorization of the Revolving Credit Facility would not result in any net cost to taxpayers.

In connection with the extension of credit, AIG's CEO was replaced. In addition, the New York Reserve Bank established a team to review the financial condition of AIG, and monitor the implementation of AIG's plan to restructure itself and repay the Revolving Credit Facility. Furthermore, as an ongoing condition of the Revolving Credit Facility, the New York Reserve Bank staff established an on-site presence to monitor the company's use of cash flows and progress in pursuing its restructuring and divestiture plan. The Federal Reserve does not have statutory supervisory authority over AIG or its subsidiaries as we would over a bank holding company or state chartered bank that is a member of the Federal Reserve System. Rather, the rights of the Federal Reserve are those typical of a creditor and are governed by the credit agreement for the Revolving Credit Facility. Using these rights, the Federal Reserve works with management of AIG to develop and oversee the implementation of the company's business strategy, its strategy for restructuring, and its new compensation policies, monitors the financial condition of AIG, and must approve certain major decisions that might reduce its ability to repay its loan.

The Federal Reserve has a team of about 15 staff members, led by senior officials, who conduct oversight of the company pursuant to the credit agreement. The team has frequent on site contact at the company to make sure the Federal Reserve is adequately informed on funding, cash flows, liquidity, earnings, asset valuation, and progress in pursuing restructuring and divestiture. Federal Reserve staff is also assisted by qualified advisers in its monitoring and coordinates with officials of the Treasury.

We routinely make our views known on key issues, such as major incidents of corporate spending and executive compensation. For example, we pressed for the company to ensure that robust corporate governance surrounds all compensation actions and worked with AIG management on limits to executive compensation that restrict salary and bonuses for 2008 and 2009. The Treasury has also imposed standards governing executive compensation that are broader than the general restrictions under the TARP Capital Purchase Program. The Treasury has also required a comprehensive written policy on corporate expenses that may be materially amended only with the Treasury's prior consent.

Following the establishment of the Revolving Credit Facility, AIG

accessed its funds to meet various liquidity needs and by October 1, 2008, the company had drawn down approximately $61 billion. In part these draws were used to settle transactions with counterparties returning securities they had borrowed from AIG entities under a securities lending program used by AIG insurance subsidiaries. The cash collateral received by AIG in these lending programs was used to purchase a portfolio of residential mortgage-backed securities (RMBS). As the value of RMBS declined, these transactions became a significant source of liquidity strain on AIG. When securities borrowing counterparties chose to terminate their securities borrowing transactions with AIG, AIG was unable to immediately dispose of the illiquid and price-depressed RMBS as a source of repayment to securities borrowers without realizing substantial losses. As a result, AIG had to supply cash from its own resources to repay the securities borrowing counterparties.

To reduce these liquidity pressures, the Board approved an additional credit facility (the Secured Borrowing Facility) that permitted the New York Reserve Bank 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. The Secured Borrowing Facility was designed to provide the company additional time to arrange and complete the orderly sales of RMBS and other assets in a manner that would minimize losses to AIG and disruption to the financial markets. AIG borrowed approximately $20 billion under the Securities Borrowing Facility by November of 2008. State insurance authorities of AIG's regulated insurance subsidiaries participating in the securities lending program supported the Board's action.

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. As of February 18, 2009, the AIG-affiliated CPFF participants had borrowed approximately $14 billion in the aggregate from the facility.

During the month of October, credit markets continued to be severely stressed and liquidity pressures on AIG did not abate even with access to government credit. The company was negatively affected by the decline in market value of many assets owned by AIG entities or to which AIG entities were exposed through derivatives. Losses on the RMBS portfolios in the securities borrowing program and credit default swap protection Financial Products had written on multi-sector CDOs together accounted for approximately $19 billion of the $24.5 billion in losses announced by the company for the third quarter of 2008. The losses experienced through the third quarter, and the consequent capital erosion placed in jeopardy the credit ratings of AIG. Had the credit ratings agencies downgraded AIG in November, AIG would have been

required to find additional funds to meet collateral calls and termination events on the exposures held by Financial Products alone.

The Board and Treasury therefore took a series of actions, announced on November 10, 2008, to mitigate the effect of third quarter losses and liquidity drains on AIG and its subsidiaries, and provide for a more stable capital structure. These actions were designed to facilitate AIG's execution of its divestiture plan in an orderly manner, and thereby protect the interests of the taxpayers, both by preserving financial stability and by giving AIG more time to repay the Federal Reserve and return the Treasury's investment.

As part of the set of actions, Treasury invested $40 billion in newly issued Senior Preferred Stock of AIG under its recently granted TARP authority. In connection with that investment, the Federal Reserve modified the terms of the Revolving Credit Facility to be more sustainable: The maturity of loans extended under the 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 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 Reserve Bank extended approximately $19.5 billion in secured, non-recourse credit to a special purpose limited liability company in which AIG would hold a $1 billion first-loss position (Maiden Lane II). 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 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 Financial Products on multi-sector CDOs. The New York Reserve Bank made a secured, non-recourse loan in the amount of $24.3 billion to another special purpose limited liability company (Maiden Lane III). Maiden 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 Financial Products 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 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 company. The Federal Reserve reports the amount of the loans to these facilities and

the value of the supporting collateral regularly on its website. The investment manager to the New York Reserve Bank for these entities projects that, even under very stressed scenarios, the loans to Maiden Lane II and Maiden Lane III will be repaid over time with no loss to the taxpayer.

On Monday, March 2, 2009, AIG announced a loss of approximately $62 billion for the fourth quarter of 2008, ending a year in which AIG suffered approximately $99 billion in total net losses. As a consequence of increased economic weakness and market disruption, the insurance subsidiaries of AIG, like many other insurance companies, have recorded significant losses on investments in the fourth quarter of 2008. Commercial mortgage-backed securities and commercial mortgages have experienced especially severe impairment in market value, requiring a steep markdown on the companies' books, despite a lack of significant credit losses on these assets to date.

The loss of value in the company's investment portfolios, which totaled approximately $18.6 billion pre-tax, was primarily attributable to the insurance subsidiaries' holdings. This loss was a substantial contributor to AIG's fourth quarter loss. The remainder of the fourth quarter loss was significantly associated with the mark to market of assets transferred to Maiden Lane II and Maiden Lane III during the middle of that quarter, losses due to accounting on securities lending transactions that occurred during the fourth quarter, impairment of deferred tax assets and goodwill, and other market valuation losses. At the same time, general economic weaknesses, along with a tendency of the public to pull away from a company that it viewed as having an uncertain future, hurt AIG's ability to generate new business during the last half of 2008 and caused a noticeable increase in policy surrenders.

In addition, these extreme financial and economic conditions have greatly complicated the plans for divestiture of significant parts of the company in order to repay the U.S. government for its previous support. Would-be buyers themselves are experiencing financial strains and lack access to financing that would make such purchases possible.

To address these weaknesses, the Federal Reserve and Treasury, in consultation with management of AIG and outside advisers retained by the Federal Reserve, announced on March 2, 2009, a plan designed to provide longer-term stability to AIG while at the same time facilitating divestiture of its assets and maximizing likelihood of repayment to the U.S. government. The plan involves restructuring the current obligations of AIG to the Federal Reserve and Treasury, additional capital contributions by Treasury, and continued access to Federal Reserve credit on a limited basis for ongoing liquidity needs of AIG.

Under the plan, Treasury will create a new capital facility that would allow AIG to issue to the Treasury up to $30 billion over five years in new preferred shares under the TARP as liquidity and capital needs arise. This brings the total equity support of the Treasury to $70 billion.

Additionally, Treasury will restructure the $40 billion in preferred equity

AIG issued to the Treasury in connection with the actions taken to aid the company in November. This restructuring, along with the injections of capital from the new preferred shares, will bolster AIG's capital position and reduce its leverage, bolstering confidence in the company.

Under the plan, the Federal Reserve also has agreed to reduce and restructure AIG's outstanding debt under the Revolving Credit Facility. Capacity under the Revolving Credit Facility will be reduced from $60 billion to $25 billion. The current outstanding debt of $39.5 billion will be restructured in several ways. First, up to about $26 billion will be satisfied by providing the Federal Reserve with preferred equity interests in AIG's two largest life insurance subsidiaries, American Life Insurance Company (ALICO) and American International Assurance Company (AIA). The actual amount will be a percentage of the fair market value of AIA and ALICO based on valuations acceptable to the Federal Reserve. This action would be a positive step toward preparing these two valuable AIG subsidiaries for sale to third parties or disposition through an initial public offering, the proceeds of which would return to the Federal Reserve through its preferred equity interest stake in these two companies.

Another component of the debt restructuring involves the use of an insurance industry tool to monetize cash flows on a specified block of life insurance policies already in existence. Under the plan, the Federal Reserve would extend up to $8.5 billion in credit to special purpose vehicles (SPV) that would repay the obligation from the net cash flows of identified blocks of life insurance policies previously issued by certain AIG domestic life insurance subsidiaries. The total amount of principal and interest due to the Federal Reserve on this credit would represent a fixed percentage of the estimated net cash flow from the underlying policies that would flow to the borrowing SPVs. This "buffer" between the amount of the credit and the net cash flow would provide the Federal Reserve with security and provide reasonable assurance of repayment.

Each of the decisions to provide assistance to AIG has been difficult and uncomfortable for us. However, the Federal Reserve and the Treasury agree that the risks and potential costs to consumers, municipalities, small businesses and others who depend on AIG for insurance protection in their lives, operations, pensions, and investments, as well as the risks to the wider economy, of not providing this assistance during the current economic environment are unacceptably large. The disorderly failure of systemically important financial institutions during this period of severe economic stress would only deepen the current economic recession. We have been and will continue to work alongside the Treasury and other government agencies to avoid this outcome. At the same time, in exercising the tools at our disposal, we are also committed to acting only when and to the extent that our assistance is necessary and can be effective in addressing systemic risks and we are committed to protecting the interests of the U.S. government and taxpayer.

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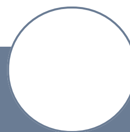

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