

## **William C Dudley: Oversight of the Federal Government's intervention at American International Group**

Testimony of Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the Committee on Financial Services, US House of Representatives, Washington DC, 24 March 2009.

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Good morning, Chairman Frank, Ranking Member Bachus, and other members of the Committee. Thank you for giving me the opportunity to appear before you today. As you know, on January 27, 2009, I became the president of the Federal Reserve Bank of New York. Before I assumed that position, I served as the head of the Markets Group at the New York Fed. I appreciate having this opportunity to discuss the Federal Reserve Bank of New York's involvement with American International Group, Inc. (AIG).

### **Role of the Federal Reserve Bank of New York**

At the outset, it is important to note that before the New York Fed became involved with AIG as a lender on September 16, 2008, the Federal Reserve lacked any kind of authority to oversee AIG. The lack of effective consolidated supervision over AIG was a critical contributing factor to the debacle that occurred at the company.

The Federal Reserve made its decision to lend based on a judgment that a failure of AIG would cause dramatically negative consequences for the financial system and the economy – consequences worse than what occurred in the aftermath of the failure of Lehman Brothers. We stand by that judgment today. In the case of Lehman, some of the most severe repercussions related to the difficulties in coordinating cross-border insolvency regimes and in coordinating the insolvency regimes among different types of institutions within the organization's corporate structure. In light of AIG's unparalleled global footprint – operating in more than 130 countries around the globe – and the multiplicity of different types of financial services entities within its structure – including insurance providers, foreign banks, consumer lending companies and OTC derivatives affiliates – the factors that proved unmanageable in the Lehman insolvency threatened to be much more severe in AIG's case. The fact that no effective emergency resolution procedures exist under U.S. law to reconcile these difficulties heightened the need for quick, effective action by the Federal Reserve, in consultation with and supported by the U.S. Treasury.

From the outset, the New York Fed has been sharply focused on addressing two overarching goals with respect to AIG: (1) the stabilization of the company so that it no longer poses a disruptive threat to our financial system and economy and (2) obtaining full repayment of the government funds that have been extended to AIG. In light of the exceptional size and scope of AIG's operations, with over 110,000 employees in more than 130 countries, spanning hundreds of legal entities, it was clear from the beginning that the New York Fed – which had never been engaged in any regulatory oversight of the company – was not in a position to exert day-to-day management control over the company. Rather, the New York Fed's actions have consistently been directed at securing its objectives as lender. As any lender in our position would do, the New York Fed has put into place a loan agreement that contains covenants designed to help ensure ultimate repayment of the loan – but these creditor's rights do not create an ability to manage AIG.

Responsibility for AIG's day-to-day affairs continues to rest with AIG's chief executive officer, Edward Liddy, under the oversight of AIG's board of directors. Mr. Liddy, who has only become involved with AIG in a public-spirited attempt to resolve its troubled affairs, has

made strides in dealing with AIG's opaque corporate structure, lack of centralized controls and complex risk exposures, but much remains to be done.

In light of the inherent conflicts that would arise from either the U.S. government or the Federal Reserve exerting ownership control over the world's largest insurer, the Federal Reserve, with the support of the Treasury Department, directed in the loan agreement that an approximately 77.9 percent equity interest in AIG be issued to an independent trust established for the sole benefit of the United States Treasury. The trust, which now holds that controlling equity interest, is overseen by three independent trustees who are of the highest integrity and who have considerable experience leading major companies. These trustees have a legally binding obligation to exercise all of their rights as majority owner of AIG in the best interests of the U.S. taxpayer, with the proceeds of any ultimate sale of shares going directly to the Treasury of the United States.

### **Efforts to reduce risk at AIG Financial Products**

As has been widely noted, the activities at AIG's Financial Products unit (FP) were a principal cause of the losses that drove AIG to the brink of bankruptcy in September 2008. Risks of substantial magnitude – including derivatives positions with a current total notional value exceeding one trillion dollars – still remain in force at FP, meaning that not millions but billions of taxpayer dollars are potentially at stake as the orderly wind-down of FP continues to progress. The winding down of these risk positions at FP is a delicate and complex matter with systemic implications for the U.S. and global economy. Our oversight of this risk-reduction process remains a top priority.

With respect to the retention awards owed to FP employees under their pre-existing contracts, we believe that Mr. Liddy weighed a number of factors in deciding not to attempt to prevent payment, including:

- the likely negative effects of disruption in staffing at FP in managing its multi-billion dollar exposures;
- legal advice that the contracts were valid – meaning that breaking them would likely increase the amount of company funds ultimately paid to the covered employees; and
- the negative consequences to AIG's business that could result from the public abrogation of contracts.

In conducting our oversight as lender, the New York Fed did not see reason to disagree with Mr. Liddy's judgment from a risk perspective. Equally important, we did not think it was legally permissible – or within the proper role of the New York Fed – to attempt to substitute our judgment for that of Mr. Liddy in this circumstance, even though we found the payment of the retention awards extremely distasteful.

The broad public disapproval of sizeable retention payments being directed toward the unit most responsible for last fall's downfall of AIG is understandable. Americans naturally feel outraged when confronted with news of such payments to an entity that worsened the financial crisis and that is dependent on taxpayer funds to stay out of bankruptcy court where these contracts would not have been fully honored. Moreover, the payments occurred during a time when so many Americans are struggling to find jobs, seeing their wages reduced or watching their retirement savings plummet as a result of a crisis they had no hand in creating. This feeling of outrage underscores the urgent need to reform the system of compensation at our financial institutions to more closely align the incentives of executives, owners and taxpayers. Congress saw fit to impose appropriate compensation restrictions on recipients of Troubled Asset Relief Program (TARP) funding, and we think it is crucial for Congress and the U.S. Department of the Treasury to continue to craft effective and sensible policies in this area.

Although oversight of TARP-related compensation matters rests with the Treasury Department, the New York Fed has played a role since September in reviewing the adequacy of AIG's corporate governance procedures. This review has helped to identify longstanding deficiencies with respect to compensation committee governance, compensation benchmarking and lack of centralized control over compensation policy. We will continue to work with our colleagues at Treasury and the independent trustees to ensure that AIG's management properly addresses these deficiencies.

### **Ongoing involvement with AIG**

The total package of assistance that the Federal Reserve and Treasury Department have committed to AIG has established a more durable capital structure for the company that gives AIG greater time and flexibility to execute its asset disposition plan to repay government funds. Notably, we have recently agreed in principle to accept preferred interests in two of AIG's large foreign life insurance subsidiaries, AIA and ALICO, in order to make repayment of our loan less dependent on forced divestitures into a depressed acquisition market. Although it will take time, we still expect that the proceeds from asset sales should enable AIG to repay the New York Fed in full.

In all that we have done, we have been motivated by two goals: to preserve the stability of the U.S. economy and to protect the U.S. taxpayer. The threat of a major systemic risk event has been averted by honoring all of AIG's contractual obligations around the globe – from insurance policy obligations owed to individuals, municipalities and businesses across the U.S., to the posting of collateral under credit default swap arrangements with the full range of counterparties recently disclosed. As unattractive as certain aspects of this treatment may be, these negative aspects have followed unavoidably from the decision to avert a systemically destructive bankruptcy. I look forward to your questions today and, in the longer term, to working with you and your staffs on the broader public policy questions – such as formulation of a resolution regime for institutions like AIG and consideration of the appropriate supervisory structure for OTC derivatives – that are posed by the events at AIG.

Thank you.