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Testimony by Henry M. Paulson
Before the House Committee on
Oversight and Government Reform
January 27, 2010, 10:00 a.m.

Chairman Towns, Ranking Member Issa, and distinguished Members of the Committee.

I appreciate the invitation to testify before the Committee.

I was Secretary of the Treasury in 2008. In that role, I had the privilege to work with the many talented men and women in government and the private sector who labored to pull our nation back from the brink of disaster.

The decision to rescue AIG was correct, and I strongly supported it. An AIG failure would have been devastating to the financial system and the economy.

Today's hearing relates to payments to AIG's credit default swap counterparties. I was not involved in any of the decisions made with respect to those payments, nor was I involved in any of the decisions about AIG's public disclosure of those payments. Those matters were handled by the Federal Reserve Bank of New York and the Federal Reserve Board. They sought to make appropriate decisions on those matters, and I am confident that this review will show that they did.

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I have limited knowledge on the topic of immediate interest to the Committee, but I will share my observations.

The basic facts of the government's involvement with AIG are well known. I will recount them only in brief. On September 16, 2008, the Federal Reserve Board, with the full support of Treasury, announced that it was authorizing the Federal Reserve Bank of New York to lend up to $85 billion to AIG pursuant to its authority under the Federal Reserve Act. This loan was secured by AIG's ownership interest in its subsidiaries, and the U.S. government received a 79.9% equity interest in AIG. Simultaneously, the CEO of AIG was replaced. In early October, the New York Fed extended AIG another $37.8 billion in credit.

Unfortunately, these actions did not sufficiently abate the problems at AIG. The company faced mounting losses, and it faced potential ratings downgrades which would trigger tens of billions of dollars in collateral calls which, without an equity infusion, would have led to its failure—a failure that would have collapsed our financial system and devastated millions of Americans.

To address these problems, on November 10, 2009, Treasury and the Federal Reserve announced plans to restructure AIG's finances. Treasury announced that it would provide $40 billion from its TARP funds to stabilize AIG's capital structure, in return for senior preferred shares in AIG and stringent restrictions on golden parachutes and executive bonuses. At the same time, the Federal Reserve announced that it had authorized the New York Fed to set up two facilities which would handle certain AIG assets that were subject to the greatest risk of a devastating collateral call in the event of ratings downgrades.

The combined actions of Treasury and the Fed were effective. Despite AIG's breathtaking third-quarter losses, the company did not fail, and we avoided the disastrous consequences that would have accompanied such a failure. Although the road to complete recovery is slow and unemployment is still high, had AIG failed I believe we would have seen a complete collapse of our financial system, and unemployment easily could have risen to the 25% level reached in the Great Depression.

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The rescue of AIG was necessary, and I believe that we in government who acted to rescue it—including Secretary Geithner, Chairman Bernanke, and me—acted properly and in the best interests of our country. The reasons the rescue of AIG was necessary are well worth examining. I believe they are representative of the causes of other aspects of the crisis and indicate where regulatory reform is necessary. There are three reasons we needed to intercede to save AIG that stand out in my mind.

<u>First</u>, AIG was incredibly large and interconnected. It had a $1 trillion dollar balance sheet; a massive derivatives business that connected it to hundreds of financial institutions, businesses, and governments; tens of millions of life insurance customers; and tens of billions of dollars of contracts guaranteeing the retirement savings of individuals. If AIG collapsed, it would have buckled our financial system and wrought economic havoc on the lives of millions of our citizens.

<u>Second</u>, AIG was seriously under-regulated. Although, many of AIG's subsidiaries—including its insurance companies—were subject to varying levels of regulation, the parent entity was, for all practical purposes, an unregulated holding company. Consequently, there was no one regulator with a complete picture of AIG or a comprehensive understanding of how it was run. It was not until AIG started to fail, that regulators began to understand how badly managed it had been and how much the toxic aspects of parts of its business had infected otherwise healthy parts.

<u>Third</u>, AIG could not be effectively wound down. Unlike failed depository institutions which can be taken over by the FDIC with little or no harm to depositors, or the GSEs which were seamlessly placed into conservatorship by Treasury and the Federal Housing Finance Agency, there was—and is—no resolution authority available to wind down a failing institution like AIG. The only option is bankruptcy, a process that is simply not capable of protecting the millions of Americans whose finances are intertwined with AIG's.

The government rescue of AIG in the Fall of 2008 was directly shaped by these realities. We had to protect the economy and the finances of millions of Americans; we could not have anticipated the magnitude of AIG's problems; and we had no way of letting it fail without disastrous collateral consequences. We had to intervene, and I am thankful that we did.

I do not mean to say that I am happy that we needed to intervene. Taxpayer money should not have to be spent to save a mismanaged and misguided enterprise. But the fundamental problem lies not in *how* we intervened, but in *why* we needed to intervene. We need to modernize our regulatory structure by creating a systemic risk regulator and resolution authority so any large firm that fails can be liquidated without de-stabilizing the system. Large financial enterprises in this country will always play a role that is essential to our economic growth, but they must only be permitted to grow and interconnect throughout our economy under careful oversight and with a mechanism for allowing those connections to be broken safely.

Thank you, and I would be happy to answer any questions.