As Revised

United States House of Representatives
Committee on Oversight and Government Reform

"Factors Affecting Efforts to Limit Payments to AIG Counterparties"
Prepared Testimony of Stephen Friedman
January 27, 2010

Mr. Chairman, Ranking Member Issa, and Members of the Committee,

I am here today because of my great respect for Congress and the essential role that it plays in the United States Government. It was my recent privilege to serve my country in the Executive Branch as Assistant to the President for Economic Policy and Director of the National Economic Council from 2002 to 2004, and as Chairman of the President's Foreign Intelligence Advisory Board from 2006 to 2009, and I developed a renewed appreciation of our Constitutional system of checks and balances.

Despite my recognition of the importance of the Committee's inquiry, I cannot provide the Committee with any insight into the principal subject of today's hearing—the transaction that paid AIG's credit default swap counterparties at par.

The questions raised about these transactions reflect understandable confusion about the role that a Reserve Bank's Chairman and Board of Directors play in a Reserve Bank's operations. Consistent with the structure created by the Federal Reserve Act, the Board of Directors of the New York Federal Reserve Bank has no role in the regulation, supervision, or oversight of banks, bank holding companies, or other financial institutions. Such responsibilities are instead carried out by the officers of the New York Federal Reserve Bank acting at the direction of the Board of Governors of the Federal Reserve System here in Washington.

A Reserve Bank's Board of Directors in many respects is more akin to an "Advisory Board" than it is to the Board of Directors of a corporation. Reserve Bank Directors "make recommendations on monetary policy," including approving the recommended discount rate subject to Board of Governors approval, and are responsible for approving the Bank's budget, reviewing the Bank's internal controls and policies and procedures, and overseeing personnel matters, including assisting in the selection of the Bank President and other senior Bank officers. But the Board of Directors of a Reserve Bank has no authority over, and is walled-off from, regulatory and supervisory policies and actions involving banks, bank holding companies, and other financial institutions.

Accordingly, as I explained to Committee staff, whether as Chairman of the New York Federal Reserve Board or otherwise, I was not involved in the initial decision to bail out AIG, the decision to repay the AIG counterparties at par, or the decision not to publicly disclose those counterparties' names. I did not ratify those decisions; and I do not know who made those decisions.

Not only was I not involved in the Reserve Bank's decisions regarding the supervision and management of AIG, but my actual knowledge of those decisions is extraordinarily limited. I did receive summary briefings from senior Reserve Bank officers regarding both the initial September 16, 2008 rescue of AIG and the November 10, 2008 transaction to repay AIG's counterparties at par, although in both instances the briefing occurred after the transactions already had been negotiated. In the case of the November 10 transaction, I have been advised that on the evening of November 9, 2008, Charles Wait—the Chair of the Bank's Audit Committee—and I received a telephonic summary briefing from Bank officials about the transaction. At that point the deal had been signed up and was to be announced by the Board of Governors the next morning. As to the decision not to disclose the names of AIG's counterparties, I do not recall receiving any briefings on that subject.

* * *

The Committee also has inquired about my purchases of Goldman Sachs stock on December 17, 2008 and January 22, 2009, subsequent to the decision to repay AIG's counterparties at par on November 10, 2008.

As is shown in the attached chronology, at the time of my purchases, it was widely known and reported – through various public statements by Goldman Sachs officials, in numerous contemporaneous newspaper articles, in multiple investment analysts' reports, and in the November 10 Federal Reserve Board and AIG press releases – that Goldman Sachs was a counterparty to AIG and had been repaid at par on November 10. Indeed, the December 17, 2008 purchase occurred the day after Goldman Sachs' quarterly earnings release and an earnings call statement by its CFO that its exposure to AIG "has been immaterial" and "is still immaterial."

Consistent with company policy to ensure that statutory "insiders" do not trade in Goldman Sachs securities while in possession of any undisclosed material information, I consulted with and received the approval of the Goldman Sachs General Counsel's office prior to executing the December 17 and January 22 trades, as being within a "window" during which Goldman Sachs Directors were permitted to trade. These purchases promptly were publicly disclosed in filings with the Securities and Exchange Commission.

In addition, my purchases, in the words of the General Counsel of the New York Reserve Bank, "did not violate any Federal Reserve statute, rule or policy." When I was appointed in January 2008 to the New York Reserve Board of Directors as Chairman and as a Class C Director, the New York Reserve Bank and the Board of the Governors of the Federal Reserve System were aware that I was a Director of Goldman Sachs, that I held a significant amount of Goldman Sachs stock, and that I was scheduled annually to receive additional Goldman Sachs restricted stock by virtue of my service as a Goldman Sachs Director. When Goldman Sachs became a bank holding company on September 21, 2008, I became technically ineligible to serve as Class C Director because Class C Directors cannot own bank holding company stock (Class A and Class B Directors can own bank holding company stock) and because Class C Directors cannot serve as officers or directors of banks (Class A Directors can serve as officers and directors of banks). At that point, the Board of Governors either could request my resignation as a Class C Director, or, as subsequently occurred, could "waive" the eligibility requirements with respect to my ownership of Goldman Sachs stock and service on the Goldman Sachs Board.

At the time of my selection and appointment as Reserve Board Chairman, I had been forewarned that I would be expected to spend considerable time leading the search for Mr. Geithner's replacement as President of the New York Reserve Bank in the event he accepted another position. I therefore was not surprised that, a month before the November 2008 election and at a time of great stress in the financial markets, the New York Reserve Bank requested such a waiver, following consultation with the Board of Governors staff. I thereafter continued to serve as Board Chairman and a Director, with the understanding that I was permitted to do so by Federal Reserve policies and precedents until the expected waiver was granted.

Immediately upon Mr. Geithner's selection by President-elect Obama as Secretary of the Treasury-Designate on November 24, 2008, the New York Reserve Bank Board, under my leadership, commenced a thorough and expedited search process for his replacement, in close coordination with the Board of Governors, which concluded in late January 2009. In early December, I inquired about the status of the Bank's waiver request, and, as has been publicly reported, I was informed by the General Counsel of the New York Reserve Bank that I should consider the eligibility requirements to be in abeyance while the request for a waiver was pending. The waiver was issued on January 21, 2009, without any conditions upon my increasing my ownership of Goldman Sachs stock.

I am advised that the Board of Governors three months ago published a new policy regarding the eligibility, qualifications, and rotation of Reserve Bank Directors, which expressly addresses the situation I faced and now provides a 60-day period for resolving (whether through waiver, divestiture, or resignation) a situation where a Director becomes ineligible to serve because of a change in the status of a financial institution. I note that if this policy had been in place in September 2008, it would have abbreviated the delay that occurred in the processing of the Reserve Bank's waiver request on my behalf.

When I was appointed by the President of the United States as Director of the National Economic Council in 2002, I divested all of my ownership interests in individual companies and entities, including my Goldman Sachs holdings, to avoid any possibility of a potential conflict of interest. I approached my appointment as Director and Board Chairman of the New York Federal Reserve Bank with the same public service mindset. By statutory design, the Reserve Bank Board is comprised of Members with intentionally diverse financial interests and affiliations that theoretically would present potential conflicts of interest, if the Board of Directors had any authority over or role in individual supervisory matters – matters like the New York Reserve Bank's rescue of AIG. But the Board does not have such authority and it did not play such a role.

I stand ready to answer any questions that the Committee may have.

Attachment – Chronology of Selected Events and Disclosures

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Chronology of Selected Events and Disclosures

Attachment to the Prepared Testimony of Stephen Friedman
January 27, 2010

Jan. 1, 2008	Mr. Friedman appointed Chairman and "Class C Director" of New York Fed by the Board of Governors of the Federal Reserve; at the time of his appointment, the Board of Governors is made aware of Mr. Friedman's financial interests in Goldman Sachs (including expected annual awards of restricted stock) and his position as Director of The Goldman Sachs Group.
Sept. 16, 2008	The Federal Reserve Board (through the New York Fed) pledges $85 billion to AIG. FRB Press Release, *Federal Reserve Board, with full support of the Treasury Department, authorizes the Federal Reserve Bank of New York to lend up to $85 billion to the American International Group (AIG)*, Sept. 16, 2008, *available at* http://www.federalreserve.gov/newsevents/press/other/20080916a.htm.
Sept. 16, 2008	In response to a question about Goldman Sachs' exposure to AIG, Goldman Sachs CFO David A. Viniar tells investors: "The way we do business with financial institutions is by having appropriate daily margin terms. … That is how we manage our risk. In addition to the margin terms, we augment our risk management with appropriate hedging strategies. … [W]hatever the outcome at AIG, I would expect the direct impact of our credit exposure to both of them to be immaterial to our results." Goldman Sachs Q3 2008 Earnings Call.
Sept. 16, 2008	A Bank of America equity research report notes: "While both LEH & AIG are large, important counterparties to GS, mgmt expects the direct impact of outcomes at both firms to be immaterial to results given hedging strategies and the firm's commitment to avoiding large concentrated positions." Michael Hecht, *The Goldman Sachs Group, Inc.: You Can Run But You Can't Hide; No Immunity from Cyclical Challenges*, Bank of America Equity Research (Sept. 16, 2008).
Sept. 17, 2008	Sandler O'Neill & Partners reports that "A point of management emphasis was on the firm's desire to avoid large concentrated exposures. To this effect, management successfully mitigated its risk to LEH and AIG. While both important counterparties, conservative daily margin terms reduced the risk of doing business with these institutions as well as other counterparties. With that said, management expects that the direct impact of GS's credit exposure to these firms will be 'immaterial' to results." *Goldman Sachs Group, Inc.: 3Q08 Earnings Review*, Sandler O'Neill & Partners, L.P. (Sept. 17, 2008).
Sept. 17, 2008	William Blair reports: "Lehman Holdings (LEH $0.30) and AIG (AIG $3.75) are certainly both important counterparties to Goldman Sachs; although Goldman has worked hard to avoid large direct exposures to any single counterparty by managing margin terms and hedging strategies. Management commented that Goldman Sachs' 'direct' impact to the unwinding of both Lehman and AIG would not be material. The Fed-led bailout of AIG certainly reduces any potential strain from any credit exposure to the company or exposure to others that may have outsized exposures to AIG." Mark Lane and Katherine McCauley, *The Goldman Sachs Group, Inc.: Highlights of Fiscal Third-Quarter Results; No Surprises in The Face of Subdued Expectations in Very Challenging Environment*, William Blair & Company, L.L.C. (Sept. 17, 2008).
Sept. 21, 2008	Board of Governors of the Federal Reserve approves applications of The Goldman Sachs Group, Inc. and Goldman Sachs Bank USA Holdings LLC to convert to bank holding companies. Goldman Sachs Press Release, *Goldman Sachs To Become The Fourth Largest Bank Holding Company*, Sept. 21, 2008, *available at* http://www2.goldmansachs.com/our-firm/press/press-releases/archived/2008/bank-holding-co.html.

Chronology of Selected Events and Disclosures

Sept. 23, 2008	Berkshire Hathaway agrees to purchase $5 billion in Goldman's preferred stock, and also received warrants to buy another $5 billion in Goldman's common stock, exercisable for a five-year term. Susanne Craig, Matthew Karnitschnig and Aaron Lucchetti, *Buffett to Invest $5 Billion in Goldman*, WALL STREET JOURNAL, Sept. 24, 2008.
Sept. 24, 2008	Goldman Sachs announces a public offering of $5 billion in common shares. Goldman Sachs Press Release, *Goldman Sachs Prices $5 Billion Public Offering of Common Equity*, Sept. 24, 2008.
Sept. 28, 2008	The NY Times reports that "Goldman Sachs was a member of A.I.G.'s derivatives club … It was a customer of A.I.G.'s credit insurance and also acted as an intermediary for trades between A.I.G. and its other clients." The article further reports that Goldman Sachs had $20 billion of transactions with AIG, and also includes statements from several Goldman Sachs executives that its exposure to AIG was "immaterial" because of hedges. Gretchen Morgenson, *Behind Insurer's Crisis, Blind Eye to a Web of Risk*, NY TIMES, Sept. 28, 2008.
Sept. 28, 2008	Reuters reports that Goldman was AIG's "largest trading partner" and had $20 billion of transactions with AIG, but disputes Goldman's level of exposure. Lucas van Praag, a Goldman Sachs spokesman, is quoted in the article, noting that: "we have said many times on the record that our exposure to AIG was, and is, not material … For the avoidance of doubt, our exposure to AIG is offset by collateral and hedges and is not material to Goldman Sachs in any way." *Goldman Sachs faults NY Times story on AIG risk*, REUTERS, Sept. 28, 2008.
Sept. 29, 2008	Goldman Sachs completes its public offering, which is oversubscribed. Total proceeds are $5.75 billion. Goldman Sachs 2008 Fourth Quarter Earnings Report, *available at* http://www2.goldmansachs.com/our-firm/press/press-releases/archived/2008/pdfs/2008-q4-earnings.pdf; *See also Goldman Sachs raises $5b with public stock offering*, AP, Sept. 25, 2008.
Oct. 6, 2008	New York Fed (via letter from Timothy Geithner) seeks waiver of Fed rules against board members owning stock or being a director of bank holding companies; letter specifies that Mr. Friedman is a Director of and holds financial interests in The Goldman Sachs Group.
Oct. 8, 2008	The Federal Reserve Board (through the New York Fed) pledges an additional $37.8 billion to AIG. FRB Press Release, *Board authorizes Federal Reserve Bank of New York to borrow securities from certain regulated U.S. insurance subsidiaries of AIG*, Oct 8, 2008, *available at* http://www.federalreserve.gov/newsevents/press/other/20081008a.htm.

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Oct. 31, 2008	The Wall Street Journal reports that AIG has posted "about $50 billion in collateral to its trading partners" and that these payments "have continued to balloon after the bailout." The story notes that "Goldman Sachs Group Inc., for instance, has pried from AIG $8 billion to $9 billion, covering virtually all its exposure to AIG -- most of it before the U.S. stepped in." The Journal reported further that Goldman had become concerned about exposure to AIG in 2007 and had hedged its exposure: AIG's trading partners were worried. Goldman Sachs held swaps from AIG that insured about $20 billion of securities. In August 2007, Goldman demanded $1.5 billion in collateral, arguing that the assets backing the securities were falling in value. AIG argued that the demand was excessive, and the two firms eventually agreed that AIG would post $450 million to Goldman, this person says. Late last October, Goldman asked for even more collateral, $3 billion. Again, AIG disagreed, and it ultimately posted $1.5 billion. Goldman hedged its exposure by making a bearish bet on AIG, buying credit-default swaps on AIG's own debt, according to one person knowledgeable about this move. Carrick Mollenkamp, Serena Ng, Liam Pleven and Randall Smith, *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, WALL STREET JOURNAL, Oct. 31, 2008 at A1.
Nov. 9, 2008	Mr. Friedman, as Board Chairman, together with the Audit Committee Chairman, receives a courtesy telephonic briefing from NY Fed officers the evening of November 9, after the transaction has been structured, signed, and approved by the Board of Governors of the Federal Reserve System. The transaction is scheduled to be announced the following morning.
Nov. 10, 2008	FRB Press Release, *Federal Reserve Board and Treasury Department announce restructuring of financial support to AIG*, Nov. 10, 2008*, available at* http://www.federalreserve.gov/newsevents/press/other/20081110a.htm.
Nov. 10, 2008	AIG Press Release, U.S. Treasury, Federal Reserve And AIG Establish Comprehensive Solution For AIG, Nov. 10, 2008, *available at* http://media.corporate-ir.net/media_files/irol/76/76115/releases/111008.pdf.
Nov. 12, 2008	Wall Street Journal reports: "The banks that have sought and received collateral from AIG include Goldman Sachs Group Inc., Merrill Lynch & Co., UBS AG, Deutsche Bank AG and others." It also notes that these banks "will be compensated for the securities' full, or par, value in exchange for allowing AIG to unwind the credit-default swaps it wrote." Serena Ng and Liam Pleven, *New AIG Rescue Is Bank Blessing – Buyers of Insurer's Default Swaps Would Recover Most of Their Money*, WALL STREET JOURNAL, Nov. 12, 2008 at C1.
Nov. 14, 2008	ProPublica reports that "Under the government's latest deal, the Fed has helped AIG pay its obligations to those counterparties. The identity of those banks remains officially under wraps, but the Wall Street Journal has named a number of them: Goldman Sachs, Merrill Lynch, UBS, Deutsche Bank, Barclays, Credit Agricole, Royal Bank of Scotland, CIBC and Bank of Montreal." The article reports that billions of dollars in collateral payments were made by AIG to Goldman Sachs dating back to 2007. Paul Kiel*, AIG's Spiral Downward: A Timeline*, PROPUBLICA, Nov. 14, 2008.
NOV. 17, 2008	Reuters reports that of the 21 analysts covering Goldman Sachs, eight rated it a "buy" and only one analyst recommended selling the stock. Anurag Kotoky, *More analysts see bleak fourth quarter at Goldman, M. Stanley,* REUTERS, NOV. 17, 2008.
Nov. 20, 2008	Regularly Scheduled meeting of the Board of Directors of the NY Fed takes place. The Board minutes do not reflect any discussion of the AIG transaction.

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Nov. 24, 2008	President-Elect Obama announces New York Fed President Timothy Geithner to be Treasury Secretary. Press Release, *Geithner, Summers among key economic team members announced today*, Nov. 24, 2008 *available at* http://change.gov/newsroom/entry/geithner_summers_among_ key_economic_team_members_announced_today/.
Nov. 25, 2008	Sterne Agee analyst Ada Lee gives Goldman Sachs a "buy" rating, saying the banks' shares were undervalued. Lee notes that Goldman's current stock price "reflects an unrealistically high probability of failure in light of the fresh capital raised from deep pockets and government funding programs." *Analyst rates Goldman, Morgan Stanley a 'buy*,' AP, Nov. 25, 2008.
Early Dec. 2008	Mr. Friedman asks about the status of the waiver and he is informed by New York Fed general counsel Tom Baxter that Fed rules as a matter of practice should be considered in abeyance while waiver decision is pending.
Dec. 10, 2008	Audit Committee of the NY Fed discusses the assets received from the bailout of AIG. Mr. Friedman did not attend the meeting.
Dec. 16, 2008	Goldman Sachs releases its 2008 Fourth Quarter Earnings Report, *available at* http://www2.goldmansachs.com/our-firm/press/press-releases/archived/2008/pdfs/2008-q4-earnings.pdf. The report includes detailed information about the Firm's revenue, expenses, and capital.
Dec. 16, 2008	During Goldman Sachs' Q4 2008 Earnings Call, Meredith Whitney of Oppenheimer & Co. notes that Goldman Sachs' "stated exposure to AIG has been immaterial," but asked whether the Federal Reserve's purchase of AIG securities had impacted Goldman Sachs' exposure. Goldman Sachs CFO David Viniar explained: "Our exposure has been immaterial. It is still immaterial. So there's been no change."
Dec. 16, 2008	Michael Wong, an equity analyst at Morningstar says: "We believe that Goldman Sachs is currently undervalued." *Goldman Sachs' Public Progress Report*, PBS, Dec. 16, 2008.
Dec. 17, 2008	Stephen Friedman purchases 37,300 shares of Goldman Sachs stock. Mr. Friedman also receives an award of 3,906 shares by virtue of his position as a Goldman Sachs director. The shares will convert to common stock following Mr. Friedman's retirement from the Goldman Sachs board. Stephen Friedman, Statement of Changes in Beneficial Ownership (Form 4) (Dec. 19, 2009).
Jan. 21, 2009	Federal Reserve Board Vice Chairman Donald Kohn grants Mr. Friedman a 1-year waiver allowing him to own stock in and be a Director of The Goldman Sachs Group.
Jan. 21, 2009	Mr. Friedman is reappointed Chairman and "Class C Director" of New York Fed by the Board of Governors of the Federal Reserve.
Jan. 22, 2009	Stephen Friedman purchases 15,300 shares of Goldman Sachs stock. Stephen Friedman, Statement of Changes in Beneficial Ownership (Form 4) (Jan. 26, 2009).
Jan. 27, 2009	Barron's reports Friedman's stock purchases. Teresa Rivas, *Goldman Director Makes $1 Million Buy*, BARRON'S, Jan. 27, 2009.
Jan. 27, 2009	Public announcement made that Mr. Friedman is reappointed Chairman and "Class C Director" of New York Fed by the Board of Governors of the Federal Reserve.
Jan. 29, 2009	Formal announcement made that William Dudley will replace Timothy Geithner as President of New York Fed.