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Chairman Towns, Ranking Member Issa, members of the Committee on Oversight and Government Reform, thank you for the opportunity to testify today.

Let me begin by saying how important it is that the government's decisions regarding American International Group, Inc. (AIG), as well as our broader strategy to address this financial crisis, are subject to careful, independent review and analysis.

The decisions regarding AIG have already been the focus of thoughtful examinations by the Government Accountability Office (GAO) and the Treasury Special Inspector General for the Troubled Asset Relief Program (SIGTARP). They have also been the focus of many hearings by this and other committees in Congress. And recently, with my full support, Chairman Bernanke asked the GAO to conduct another review.

I welcome the Committee's attention to this issue. And the Administration will continue to work closely with all relevant oversight bodies to make sure they have the information they need to properly assess the government's actions.

The decision to rescue AIG was exceptionally difficult and enormously consequential.

At that time, our economy stood at the brink. The financial institutions that Americans rely on to protect their savings, help finance their children's education, and help pay their bills were at risk in ways few had ever experienced. The institutions and markets that businesses rely on to make payroll, build inventories, fund new investments, and create new jobs were threatened like at no time since the Great Depression. Across the country, people were rapidly losing confidence in our financial system and in the government's ability to safeguard their economic future.

Action was required. The world was watching. And the government did not have the luxury of time.

The steps the government took to rescue AIG were motivated solely by what we believed to be in the best interests of the American people. We did not act because AIG asked for assistance. We did not act to protect the financial interests of individual institutions. We did not act to help foreign banks. We acted because the consequences of AIG failing at that time, in those circumstances, would have been catastrophic for our economy and for American families and businesses.

The government responded to this crisis in a coordinated way. The Federal Reserve Bank of New York (FRBNY) did not act alone. It did not have the authority to do so. Every action it took was under the direction of the Board of Governors of the Federal Reserve and in cooperation with the Department of the Treasury and the Executive Branch.

Almost a year and a half removed from that terrible week in September 2008, I believe that the government's strategy regarding AIG was essential to our success in confronting the worst financial crisis in generations. Government support for AIG and our financial system more broadly will ultimately cost taxpayers far less than many feared. And importantly, if Congress adopts the President's proposed Financial Responsibility Fee, American taxpayers will not have to pay one cent for the rescue of our financial system.

The government has not yet repaired all the extensive damage caused by this crisis. For every American out of work, for every family facing foreclosure, and for every small business facing a credit crunch, this recession remains acute. But everyone should realize that because of the actions of the Treasury and the Federal Reserve, the American financial system is now in a position where it can provide the credit necessary for economic growth, not stand in its way. That is an important achievement necessary to lay the foundation for job growth and long-term economic stability.

AIG and the Great Recession

The extraordinary events surrounding AIG took place during what was already the most severe financial crisis the United States and the global economy had seen since the Great Depression. This context is critical to understanding the decisions we made.

Over the two decades preceding the crisis, the financial system had grown rapidly in an environment of economic growth and stability. Ample credit and accommodative monetary policy around the world fueled an unsustainable housing boom in the first half of the last decade, and when the housing market inevitably turned down, starting in early 2006, the pace of mortgage defaults accelerated at an unprecedented rate. By mid-2007, rising mortgage defaults were undermining the performance of many investments held by major financial institutions.

The current financial crisis began in the summer of 2007, gradually increasing in intensity and momentum over the course of the following year. A series of major institutions, including Countrywide Financial, Bear Stearns, and IndyMac collapsed; and Fannie Mae and Freddie Mac, the largest players in the mortgage market, came under severe stress.

By September 2008, for the first time in 80 years, the United States risked a complete collapse of our financial system. Americans were starting to question the safety of their money in the nation's banks, and a growing sense of panic was producing the classic signs of a generalized run. Peoples' trust and confidence in the stability of major institutions, such as AIG, and the capacity of the government to contain the damage was vanishing.

AIG is one of the largest and most complex financial firms in the world. At its peak, AIG had more than $1 trillion in assets, with its core businesses divided into two parts. AIG was the largest provider of conventional insurance in the world, with approximately 75 million individual and corporate customers in over 130 countries. Those insurance activities were organized in separate subsidiaries that were regulated and supervised independently.

More ominously, AIG's parent holding company, which was largely unregulated, engaged in a broad range of financial activities that strayed well beyond the business of life insurance and property and casualty insurance. Operating in Wilton, Connecticut, and in London and Paris, AIG's Financial Products subsidiary (AIGFP) expanded rapidly into some of the newest, riskiest, and most complex parts of the financial system.

AIG used its strong credit rating, which was based on the strength and profitability of its insurance subsidiaries, to become one of the largest providers of credit and rate-of-return protection for other financial products. Imprudent risk-taking in better times meant that, when the financial cycle turned, AIG had hundreds of billions of dollars in commitments without the capital and liquid assets to back them up.

Such excessive risk-taking should not have been allowed. But it was. Despite regulators in 20 different states being responsible for the primary regulation and supervision of AIG's U.S. insurance subsidiaries, despite AIG's foreign insurance activities being regulated by more than 130 foreign governments, and despite AIG's holding company being subject to supervision by the Office of Thrift Supervision (OTS), no one was adequately aware of what was really going on at AIG.

It is important to remember that the Federal Reserve, under the law, had no role in supervising or regulating AIG, investment banks, or a range of other institutions that were at the leading edge of crisis. But Congress gave the Federal Reserve authority to provide liquidity to the financial system in times of severe stress. Given that responsibility, the Federal Reserve had to act. The Federal Reserve was the only fire station in town.

Three Days in September

On Friday, September 12, 2008, AIG officials informed the Federal Reserve and the Treasury that the company was facing potentially fatal liquidity problems.

As we obtained more details about AIG's financial condition, it became clear they had massive liquidity needs and faced huge losses. Moreover, neither AIG's management nor any of AIG's principal supervisors -- including the state insurance commissioners and the OTS -- understood the magnitude of risks AIG had taken or the threat that AIG posed to the entire financial system.

That weekend, we brought together a team of people from the Federal Reserve, the New York State Insurance Department, and other experts to consider how to respond to AIG's problems. We addressed two basic questions:

1. How would the failure of AIG affect the financial system and the broader economy?
2. What were the options for containing the damage from an AIG failure?

By Sunday night, it became clear that we did not have a willing buyer for Lehman Brothers and that it would have to file for bankruptcy. At that moment, we knew the crisis was about to intensify and spread more broadly. We also knew AIG was highly vulnerable. Nonetheless, even with those new complications, it still seemed inconceivable that the Federal Reserve could or should play any role in preventing AIG's collapse.

The pressures that had caused the failure of Lehman Brothers and had brought AIG to the edge of collapse were symptoms of a broader adjustment moving swiftly through the financial system. In mid-September 2008, virtually all financial institutions were aggressively shedding risk that had been acquired over the long run-up to the crisis. Confidence was fragile and financial firms were trying to shore up their balance sheets by selling risky assets, reducing exposure to other financial institutions, and hoarding cash.

The impending Lehman bankruptcy added to that destructive cycle. Starting Sunday night, we saw not just an escalating run on banks, but also a broad withdrawal of funds from money market funds. These funds, always thought of as one of the safest investments for Americans, had begun trading at a discount. The run on these funds, in turn, severely disrupted the commercial paper market, which was a vital source of funding for many brick and mortar businesses.

The panic spread. Major institutions such as Washington Mutual and Wachovia experienced debilitating deposit withdrawals, eventually collapsed, and were acquired by competitors. These pressures spilled over to virtually all credit markets. Markets for instruments backed by consumer loans, such as auto loans, credit card receivables, and home-equity lines of credit collapsed, and in response banks tightened standards and sharply curtailed the issuance of new loans.

These events had real and immediate economic consequences. State and local governments halted public works projects because they couldn't obtain financing. School construction and renovation projects stopped. Hospitals postponed plans to add beds and equipment. Universities across the nation faced difficulty paying employees. High school students changed plans for college education, which suddenly appeared much more expensive. Ships that transport goods sat empty, in part because trade credit was simply unavailable. Factories were closing and millions of Americans were losing their jobs.

That was the world we were facing as the team of officials from the Federal Reserve and the New York State Insurance Department, working through the weekend, sought to answer those two basic questions about AIG.

How would the failure of AIG affect the financial system and the broader economy?

The team concluded that AIG's failure would be catastrophic. AIG was much larger than Lehman, it was spread across more countries than Lehman, and while it posed many of the same basic risks as Lehman, they were actually greater because of AIG's role as an insurance company.

AIG was one of the largest life and health insurers in the United States. AIG was also one of the largest property and casualty insurers in the United States, providing insurance to 180,000 small businesses and other corporate entities, which employ about 100 million people. History suggests that the withdrawal of a major underwriter from a particular market can have large, long-lasting effects on the households and businesses that rely on basic insurance protection.

AIG's failure directly threatened the savings of millions of Americans in ways that the Lehman bankruptcy did not. AIG had provided financial 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.

More broadly, if AIG had failed, the crisis almost certainly would have spread to the entire insurance industry. Life insurance posed a particular threat. Many life insurance products are effectively a form of long-term savings. In the wake of a failure of AIG, policy holders could have sought to liquidate life insurance policies underwritten by AIG. Doubts about the value of AIG life insurance products could have generated doubts about similar products provided by other life insurance companies, opening up an entirely new channel of contagion.

And, at that time, with the world economy under severe stress, the failure of a large, global, highly-rated financial institution that had written hundreds of billion dollars of insurance on a range of financial instruments would have dramatically amplified the crisis. Investors around the world would have pulled back from funding, out of fear that other financial institutions would fail as well. Investors would have completely lost confidence in their ability to evaluate the financial sector and distinguish between firms that were viable and those that were not. Financial firms would have been forced into even more dramatic selling of assets.

This damage would have rapidly spread beyond Wall Street. Borrowing costs for businesses would have increased dramatically, the value of pension funds would have fallen even more sharply, and job losses would have skyrocketed. We were witnessing these effects in the wake of Lehman's failure. The effects of the failure of AIG would have been much worse.

What were the options for containing the damage from an AIG failure?

As they were trying to evaluate the potential systemic risk of AIG, the team also explored, at my direction, a range of questions pertaining to containing the damage of AIG's failure: Was there a private sector solution that could have avoided putting taxpayer dollars at risk? Were there effective existing mechanisms for limiting the damage from the failure of an insurance company like AIG? If AIG were to fail, did we have the ability to limit contagion by providing support to other vulnerable institutions?

Because of the scale of AIG's losses and its financial needs, and because of the force of the storm enveloping the rest of the financial system, there was no capacity for a consortium of private firms to find the resources necessary to solve this without government assistance.

The team concluded that there was no effective existing mechanism to limit the damage of an AIG failure. There was no legal tool available to handle the failure of AIG, comparable to the one available to the Federal Deposit Insurance Corporation for managing the orderly wind-down of a troubled bank. In particular, we did not have the ability to quickly separate the stable underlying insurance businesses from the complex and dangerous financial activities carried out primarily by the parent holding company. Experts suggested that achieving that separation would take several years.

Without assistance, the AIG parent holding company would have been forced to file for bankruptcy protection like Lehman Brothers, resulting in default on over $100 billion of debt, as well as trillions of dollars of derivatives. Such a filing would have caused insurance regulators in the United States and around the world to take over AIG’s insurance subsidiaries, potentially disrupting households’ and businesses’ access to basic insurance. And since many of the insurance products that AIG sold were a form of long-term savings, the seizure by local regulators of AIG’s insurance subsidiaries could have delayed Americans’ access to their savings, potentially triggering a run on other institutions.

Finally, the team concluded that the tools then available to the government to limit contagion in the wake of a failure of AIG to other insurance companies were not likely to be effective.

The Choice

On Monday, September 15, 2008, Fitch Ratings, Moody's Investors Service, and Standard and Poor’s downgraded AIG’s credit rating, which generated new demands for AIG to post $20 billion in additional collateral at a time when raising new cash was virtually impossible for the company.

It was clear to everyone that AIG did not have the resources to meet such obligations.

That left us with probably the most difficult choice we faced in this entire financial crisis: whether to rescue AIG by putting billions of taxpayer dollars at risk, or to let AIG fail and accept potentially catastrophic damage to the economy.

It is worth repeating that this choice fell to the Federal Reserve because Congress had given it unique responsibility and policy tools to protect the stability of the financial system. No one else could act in the same manner as the Federal Reserve. The only authority the President of the United States had, before Congress authorized the Emergency Economic Stabilization Act (EESA), was to close markets or declare a bank holiday. None of the agencies with supervisory authority over AIG -- the OTS, insurance commissioners, or regulators in Connecticut, London or Paris -- had any tools to help directly meet the funding requirements of AIG. And no one in the federal government had a mechanism, as we do for banks, to provide for the orderly unwinding, dismantling, selling, or liquidating of a global, non-bank financial institution like AIG.

Aware that we were the only ones capable of acting, and convinced that the failure of AIG would be catastrophic for a financial system already in free fall, the Federal Reserve and the Treasury determined that it was in the best interests of the United States to rescue AIG in order to slow the panic and prevent further damage to our economy.

In that moment, making that wrenching decision, we could not be certain it would work. We could not be confident, given the significant risks, that our actions would be enough or that our initial investment would be our last.

But we knew that not acting would have caused enormous damage, putting the country and the savings of millions of Americans and businesses in greater economic jeopardy. Congress granted the Federal Reserve emergency authority precisely so that the government had some capacity to act to contain a systemic financial crisis. Not to have used that authority at that time would have been deeply irresponsible.

The Restructuring of AIG

On the afternoon of September 16, 2008, the Federal Reserve extended AIG an $85 billion line of credit, secured by a substantial proportion of the assets of AIG. In addition to that collateral, U.S. taxpayers received a 79.9% ownership stake in what was still the world's largest insurance company.

The government's offer required AIG's CEO to step down. Immediately after AIG agreed, the government began the process of changing the Board of Directors. In designing our intervention, the government made sure that there were appropriately tough conditions that put the burden of failure on AIG's existing equity holders and management and started the process of designing a comprehensive restructuring plan.

From the beginning, it was clear that AIG needed a durable restructuring of its balance sheet and operations. The credit provided on September 16th stemmed the bleeding by satisfying AIG's immediate liquidity needs, but that was not enough. The problems at AIG were so deep that we had to design and implement a more permanent restructuring.

Of course, as Federal Reserve and Treasury officials were considering options for AIG in the second half of September and October, we were facing escalating challenges on many fronts. The actions we took to meet these challenges were without precedent. They were exceptionally complicated to design and execute.

Between September 16th and November 10th, the following actions were taken:

- To provide liquidity in U.S. dollars to overseas markets, the Federal Reserve expanded the scope and scale of its swap lines with central banks (Sep. 18, 24, 26; Oct. 14, 29).
- To stop the run on money market funds—key providers of short-term credit in our economy and investment vehicles for millions of Americans—Treasury established the Money Market Guarantee Program (Sep. 19).
- To protect the critical commercial paper market, the Federal Reserve established Asset-Backed Commercial Paper Money Market Fund Liquidity Facility (Sep. 19) and the Commercial Paper Funding Facility (Oct. 7).
- Washington Mutual was closed by the Office of Thrift Supervision and taken over by the FDIC (Sep. 25).

- Congress passed EESA (Oct. 3). EESA provided Treasury with the authority to purchase or guarantee assets in financial institutions. EESA also increased the limit on FDIC deposit insurance to $250,000 per account.
- As part of an unprecedented coordinated action, the Federal Reserve and other central banks lowered short-term rates (Oct. 8).
- Treasury announced a plan to inject up to $250 billion of capital into U.S. financial institutions using EESA authority (Oct. 14). As the first step of this plan, nine of the largest U.S. banks received $125 billion.
- To stabilize and restore confidence in U.S. financial institutions, the FDIC established the Temporary Liquidity Guarantee Program to guarantee senior bank debt and transaction accounts above $250,000 (Oct. 14).
- To provide additional liquidity for short-term credit markets, the Federal Reserve established the Money Market Investor Funding Facility (Oct. 21).
- The Federal Reserve lowered the Federal Funds rate further, to 1.0 percent (Oct. 29).

In this chaotic environment, AIG remained extremely vulnerable to the ongoing and intensifying financial crisis. Falling asset prices 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. These factors undermined market confidence in AIG and put its investment-grade credit rating again at risk.

Avoiding any downgrade of AIG's credit rating was absolutely essential to sustaining the firm's viability and protecting the taxpayers' investment. Under credit protection contracts that AIG had written and the terms of various funding arrangements, further downgrades would have forced additional payments to AIG's counterparties.

In addition, further rating downgrades of the AIG parent holding company would have significantly undermined confidence in its insurance subsidiaries. People do not buy insurance products from firms they do not believe have the financial capacity to make good on those commitments over the long term – firms that they do not believe will pay out a life insurance policy or compensate a business if a factory burns down. Credit ratings are central to how people judge that viability.

As Federal Reserve and Treasury staff considered options for AIG, it became clear that two things were needed. First, AIG needed capital, not just a line of credit. Second, the vulnerability of AIG's balance sheet to further deterioration in financial conditions generally, and in AIG's own financial position, had to be reduced.

On November 10, 2008, the Federal Reserve and the Department of the Treasury jointly announced a package of actions designed to achieve these goals.

To address AIG's need for capital and to reduce its leverage, the Treasury Department agreed to invest $40 billion in senior preferred stock of AIG under the authority recently granted by EESA. This investment provided new equity capital to AIG, a tool not available to the U.S. government at the time the initial credit line was provided in September 2008.

To reduce potential demands on AIG's balance sheet, the FRBNY helped establish and fund two new companies. The purpose of these companies was to purchase troubled assets that AIG had either acquired or insured, and to manage those assets for the benefit of the taxpayer. Purchasing those assets removed significant exposure from AIG's balance sheet and helped prevent the company from being downgraded and failing. One company, Maiden Lane II, purchased assets from AIG's insurance subsidiaries. The other company, Maiden Lane III, purchased securities from third parties and insured by AIG's Financial Products subsidiary. This vehicle is described in more detail later.

The Board of Governors of the Federal Reserve and the FRBNY worked closely together in establishing these vehicles. We believed then, and I continue to believe today, that without these transactions, AIG would have failed.

AIG Counterparties

This brings me to the question that has been the source of so much understandable concern and frustration among the American people: the question of how we treated AIG's counterparties when we purchased securities in establishing Maiden Lane III.

While the financial contracts involved were complex, basically, AIG had agreed to insure the value of certain risky securities called multi-sector CDOs. The value of these securities was tied to pools of other assets, mostly subprime mortgages. As the financial crisis intensified, the value of the securities fell sharply and AIG incurred losses on these contracts and had to post collateral or make payments on the insurance.

To help understand this kind of contract, imagine AIG had provided insurance on the value of a tangible asset, such as a house, to the homeowner. If the price of the house fell, AIG would be required to post collateral, or essentially make a payment to the owner, equal to the decline in the value of the house. So, if the house was originally worth $200,000, and fell to $125,000, AIG had to give $75,000 to the homeowner as collateral and would incur a loss of the same amount. In addition, if AIG's credit rating fell, it would have to post even more collateral because the homeowner would be concerned about whether AIG could ultimately pay on the insurance.

The problem was AIG had written billions of dollars of such insurance without sufficient capital. AIG was fine as long as the prices of the assets they were insuring -- housing prices, in the example -- didn't fall, and their own credit rating didn't fall. But if either happened, it would be in trouble. In the fall of 2008, both events occurred. The value of the assets and AIG's credit rating fell, bringing AIG to the brink of bankruptcy.

By August, AIG had already paid out over $16 billion on contracts similar to the ones that Maiden Lane III was designed to address. When the Federal Reserve established the credit facility on September 16th, it knew that there would be substantial further demands of this sort. In the midst of the ongoing financial crisis, the underlying securities were likely to continue to fall in value.

We faced the following options: let AIG default on these contracts; continue to lend AIG money so it could meet its obligations; or restructure these contracts so that we could stop the hemorrhaging, and potentially recover value for the taxpayers in the future.

If we had let AIG default, it would have gone into bankruptcy, triggering all the disastrous economic consequences we had feared since September.

If we had simply continued to lend AIG money, it could have made these payments, but this would have increased AIG's debt at a time when the rating agencies felt AIG already had too much leverage. Again, any downgrade by the rating agencies would have threatened AIG's viability, driving more uncertainty and panic through the entire financial system. And simply lending AIG the money to make payments could have been an open-ended commitment by taxpayers and would not have given them any assets in return.

Instead, we sought to restructure the contracts. In order to cancel the insurance, we purchased the assets. We paid the fair market value at that time for the assets. Going back to the housing example, we paid $125,000 for a house that AIG had insured at $200,000. The counterparties kept what they already had -- in our example, the $75,000 cash collateral. Taken together, these two amounts essentially equaled par value.

This simple example does not capture the complexity of the transactions. But, essentially what the Federal Reserve did was to purchase these securities (CDOs) with a par value of $62 billion for the purchase price of $27 billion. In designing and implementing this transaction our objective was, as it always is, to get the best deal for the taxpayer. We made judgments about these transactions carefully with the advice of outside counsel and financial experts.

However, we faced constraints. The counterparties held insurance entitling them to full or par value of the contract. We could not credibly threaten not to pay. That meant putting AIG into bankruptcy. At the time, we were working desperately to rebuild confidence in the financial system. Any suggestion that we might let AIG fail would have worked against that vital aim. We could not risk a protracted negotiation. AIG's financial position was deteriorating rapidly and the prospect of a downgrade was imminent.

Some have suggested that the FRBNY should have used its regulatory authority, or some other means, to effectively coerce AIG's counterparties to accept concessions. This was not a viable option either. Once a company refuses to meet its full obligations to a customer, other customers will quickly find other places to do business. If we had sought to force counterparties to accept less than they were legally entitled to, market participants would have lost confidence in AIG and the ratings agencies would have downgraded AIG again. This could have led to the company's collapse, threatened our efforts to rebuild confidence in the financial system, and meant a deeper recession, more financial turmoil, and a much higher cost for American taxpayers.

Operating with these constraints, the FRBNY and AIG initiated discussions with the major counterparties about whether they would be prepared to accept concessions on the prices of the securities. We knew that the likelihood of success was modest. Relatively quickly, and not unexpectedly, we discovered that most firms would not, on any condition, provide such a concession. One said that it was willing, but only if everybody else would agree to equal concessions on their prices.

In the end, the prices paid for the securities were their fair market value. Because of the way the contracts worked, those prices were essentially equal to the difference between the par value of the CDOs and the payments that counterparties had already received.

Since Maiden Lane III purchased these securities, they have generated significant cash flows that have been used to pay down the FRBNY's loan by more than 25 percent. We expect Maiden Lane III to pay the FRBNY back in full and to generate a substantial profit for U.S. taxpayers.

I strongly believe that strategy that the Federal Reserve and the Treasury pursued in establishing Maiden Lane III will generate a better outcome than any alternative.

Disclosure

I had no role in making decisions regarding what to disclose about the specific financial terms of Maiden Lane II and Maiden Lane III, and payments to AIGs counterparties.

On November 24th, President-elect Barack Obama announced that he intended to nominate me to be Secretary of the Treasury. And after consulting with the Chairman of the Federal Reserve Board, the General Counsel of the Federal Reserve Board, the General Counsel of the FRBNY, the Chairman of the Board of Directors of the FRBNY, and the President-elect's advisers, I was asked to stay on as President of the Federal Reserve Bank of New York on an interim basis. We made this judgment, in part, to protect the independence of the Federal Reserve, and, in part, because I was going to be spending the bulk of my time helping shape the President-elect's economic strategy.

Starting on November 24, I withdrew from involvement in monetary policy decision, policies involving individual institutions, and day-to-day management of FRBNY. In accordance with established practice, my colleagues at the Federal Reserve Bank of New York, led by the First Vice President, Christine Cumming, carried out the day-to-day management decisions in close cooperation with their colleagues in at the Federal Reserve Board.

The Broad Strategy

More than a year has passed since the Federal Reserve and Treasury decided to rescue AIG, and substantial challenges remain for our financial system. The economic crisis is not over. Too many Americans face unemployment and too many families face the risk of foreclosure. Many small banks are still experiencing significant losses. That is contributing to a contraction in bank lending, which hurts small businesses especially. Many parts of the financial system remain impaired.

But the broad strategy that the government adopted to contain the financial crisis has been remarkably effective at stemming the crisis and repairing the damage. This has been achieved at a much lower cost in terms of taxpayer resources than many people anticipated. I want to highlight some important facts that I don't think are well understood in the Congress or among the American people.

We have already recovered two-thirds of TARP investments in banks that my predecessor appropriately made in the fall of 2008. And we have earned $17 billion on those investments through dividends and warrants. That means that the American government has a dramatically smaller stake in banks than it had when I came into office, and the taxpayer is earning a profit on those investments. The rapid repayment and income from TARP investments in banks are the direct result of government financial policies. In February, the Administration announced a strategy to get private capital to replace public investments and carry the burden of repairing our financial system. The stress tests of our largest financial institutions provided the transparency and confidence necessary for those institutions to raise substantial capital in private markets. Since the results of the stress tests were announced in May, these institutions have raised over $140 billion in high-quality capital and over $60 billion in non-guaranteed unsecured debt.

The Government is terminating the exceptional guarantee programs that were put in place during the darkest days of the fall of 2008. In September, Treasury closed its Money Market Fund Guarantee Program at a profit. At its peak, the program guaranteed $3.2 trillion in assets. October was the last month to issue new debt under the FDIC's Temporary Liquidity Guarantee Program (TLGP). That program has generated roughly $10 billion in net income. The FDIC's TLGP transaction account guarantee program is scheduled to terminate in June. In sum, guarantees through these exceptional programs have been reduced by more than 75 percent since this Administration took office. The Capital Purchase Program, under which the bulk of support to banks was provided, has been closed.

The expected cost of financial stabilization efforts has fallen sharply since last year. In President Obama's February Budget, the projected impact of financial stabilization efforts on the deficit was over $550 billion, including TARP and a reserve in case of continued instability. Today, the Treasury expects that impact will be less than $120 billion. If Congress adopts the President’s proposed Financial Responsibility Fee, American taxpayers will not have to pay one penny of loss for the financial rescue.

Over the past year and a half, credit conditions for American consumers and businesses have improved. Rates on consumer and business loans have fallen substantially. Securities markets have reopened. The housing market is more stable.

AIG Today

The situation of AIG today is substantially better than it was six or twelve months ago. AIG’s insurance subsidiaries are open for business and generating positive returns. A number of those subsidiaries are attracting attention from external investors. We anticipate that AIG will generate substantial proceeds from the sale of some of those entities. Under the terms of the support we have provided, the first call on the proceeds from any sales of AIG’s subsidiaries will be to repay the support that the U.S. government has provided to AIG.

It is also important to note that AIG has made substantial progress in winding down its Financial Products subsidiary, the division where AIG's problems were concentrated. The gross value of AIGFP derivatives positions are down by more than half since September of 2008, and the company actually generated a profit in the last two quarters for which public information is available.

The U.S. government is still exposed to substantial risk of losses on its investments in AIG. That risk was inevitable, was unavoidable and we cannot know at this point what the scale of those looses will be. While the Federal Reserve's investments in Maiden Lane II and Maiden Lane III are likely to earn a profit, based on what we know now, the government is unlikely to fully recover the direct costs of Treasury's capital investments in AIG. But, today, on the basis of a range of measures, those losses are likely to be substantially lower than we expected even just a few months ago. And I want to emphasize if Congress adopts the President's proposed Financial Responsibility Fee, American taxpayers will not have to pay one cent for the rescue of our financial system.

Our latest audited financial statements show that, as of September 30, 2009, Treasury had invested $43 billion in AIG under TARP. At that time, the "market value" of that investment was $13 billion, implying an expected loss of about $30 billion. We believe that, depending on market conditions and the future performance of AIG's businesses, the actual recovery on the Treasury's Preferred stock could be significantly higher. We are confident that the FRBNY Credit Facility, its loans to Maiden Lane II and Maiden Lane III, and its preferred interests in certain of AIG's subsidiaries will be fully repaid, and FRBNY should earn a profit on its financial support of AIG.

Financial Reform

There are two central lessons from this crisis, both applicable to AIG, that have guided the President's proposals and the legislation now working through Congress to reform our financial system.

First, we need the ability to limit risk-taking for institutions that threaten the overall stability of the system and can cause extraordinary damage to the American economy. We need this ability not just for banks, but for institutions that operate like banks. These non-bank financial institutions have existed alongside banks and yet were not subject to those constraints in this crisis. We also need to make sure that regulators have clear accountability and enforce sensibly-designed constraints on risk.

As I underscored earlier in my testimony, AIG, one of the largest and most complex financial institutions in the world, was allowed to take on an enormous level of risk that eventually threatened our entire financial system. None of the regulators overseeing AIG or any of its subsidiaries understood anything close to the complete scope or scale of that risk. And they clearly failed to contain it. That failure of oversight must not happen again.

Second, the federal government must have the ability to resolve failing major financial institutions in an orderly manner, with losses absorbed not by taxpayers but by equity holders, unsecured creditors and, if necessary, other large financial institutions.

Under our proposed special resolution authority, a failing firm, such as AIG, would be placed into an FDIC-managed receivership. The purpose of the receivership would be to unwind, dismantle, sell, or liquidate the firm in an orderly way that protects the financial system at the lowest cost to taxpayers.

Shareholders and other providers of regulatory capital of the failing firm would be forced to absorb losses, and managers responsible for the failure would be replaced. Such an approach allows the government to reduce the risk that failure would result in panic by creditors and shareholders of other firms and helps maximize recovery of the value of the firm's assets.

I join the American people and Members of Congress in feeling a deep sense of outrage over this crisis, and over the fact that better tools were not available for the government to confront it. For that reason, we should be working as hard as possible to make sure we put in place a set of financial reforms that would create a safer, more stable financial system, where opportunity can rise, risk can be mitigated, and where there are stronger protections for consumers, investors, and taxpayers.

Conclusion

It is very hard to judge a decision through the prism of hindsight and on the basis of the events that followed. The crisis that unfolded was so severe, damaging the lives of so many Americans, that it's hard for people to imagine how things could have been dramatically worse if AIG had been allowed to default. But I am personally very confident that if we not acted, the crisis would have caused more devastation and would have cost far more money.

Many Americans look at what happened with AIG, and the rest of the financial rescue, and simply ask: Why was it necessary? Why was it fair for the government to take taxpayer money and put it into an institution that had mismanaged itself to the edge of collapse?

The answer is that it was not fair, and it was not something our government should ever have to do. But those Americans, those families and business owners who played by the rules and played no role in giving rise to this recession, should understand that if the government had failed to act, that failure would have unleashed substantially greater damage upon them.

There is an adage the President cites, that if your neighbor's house is burning, even if they've acted irresponsibly, your first priority is to put out the fire before it spreads to your own house.

If we had not put out the fire that was AIG, it would have spread. And if you have any doubt, look at what happened after the failures of Lehman Brothers, Washington Mutual, Wachovia and Countrywide. Look at the impact not just on the savings of Americans, which fell by over 10 trillion dollars, but on the thousands of businesses that had to close, and the millions of workers who were laid off.

Some people have criticized the actions of the Federal Reserve and Treasury. They argue that we should have done nothing and that government intervention would sow the seeds for an even greater crisis.

I suspect such critics would have agreed with one of my predecessors, who eight decades ago, facing another moment of severe crisis said, "Liquidate labor, liquidate stocks, liquidate the farmer, liquidate real estate. It will purge the rottenness out of the system."

That crisis, of course, was the Great Depression. And the Great Depression became the Great Depression because Andrew Mellon was not alone in his beliefs. In 1930, many people thought that the financial system was going through a necessary adjustment, that the healthy process was to let the fire burn itself out, and that the best thing the government could do was to do nothing.

Today, few believe that. Today, we know that when confronting a severe economic crisis the government must respond with overwhelming force. That is the basic lesson of the Great Depression. That is the basic insight that informed every judgment we made. And that is the reason we are now emerging from a recession and not still in the midst of a second Great Depression.

In confronting this crisis, we learned from the past. Now we must learn from more recent failures, especially those that required AIG's rescue.

If we had stronger supervision and regulation in place, the government could have acted sooner to avert the crisis. If we had better crisis management tools in place, the government would have had better options. If we could have done it any differently, we would have done it differently.

Instead, we had no other choice. That is the basic lesson of this great recession.

In the future, when another generation of Americans confronts a new crisis born of new risks, the question will be whether we provided them the tools we did not have, whether we turned our collective outrage into concrete action, whether we passed comprehensive financial reform.

I hope we will.

Thank you.