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Testimony of Martin J. Bienenstock

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Congressional Oversight Panel

Good morning Chair Warren and panel members, Mr. Silvers, Mr. McWatter, and Dr. Troske. Thank you for the opportunity to testify today.

I was asked to address whether in my judgment the rescue of AIG could have incorporated some shared sacrifice by AIG creditors who were otherwise made whole with U.S. taxpayer money loaned or invested under the Troubled Asset Relief Program ("TARP") and by the Federal Reserve Bank of New York ("FRBNY") pursuant to the authorization of the Board of Governors of the Federal Reserve System.

For the reasons I am about to explain, my conclusion is that it was very plausible to have obtained material creditor discounts from some creditor groups as part of that process without undermining its overarching goal of preventing systemic impairment of the financial system and without compromising the Federal Reserve Board's principles. I do not think any material creditor discounts from creditor groups associated with AIG's profitable businesses were remotely practicable. I do not believe any prepackaged chapter 11 plan for AIG was remotely possible within the acutely short time available.

I have done my best to undertake this analysis without using hindsight to engage in Monday morning quarterbacking. Equally important when engaging in this analysis is to appreciate the trauma, extremis, and for those new to the world of distressed companies, the unexpectedly rapid onslaught of the death spiral whereby AIG's traditional lifelines – commercial paper, sale of stock, institutional borrowing and the like – suddenly disappeared. I have great empathy for those involved, and I think it is appropriate to use Monday morning quarterbacking to acknowledge that the mission of avoiding a systemic market collapse was accomplished, and those responsible, including then President of the Federal Reserve Bank of New York, Timothy Geithner, and Federal Reserve Chairman Bernanke deserve much credit for sparing our nation a devastating outcome that likely would have shattered the financial market that was rattled and rendered fragile in the immediate aftermath of Lehman Brothers' unrescued implosion and bankruptcy on September 15, 2008.

Before developing my own analysis, I had the benefit of reading Treasury Secretary Geithner's answers to Chair Warren's questions at the Congressional Oversight Panel's hearing on December 10, 2009. I've also reviewed, among other things, numerous AIG Forms 10-Q and 10-K filed with the Securities and

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Exchange Commission, the report dated November 17, 2009 of the Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP Report"), and the very thoughtful statement dated January 27, 2010 of Mr. Thomas C. Baxter, Jr., Executive Vice President and General Counsel of the Federal Reserve Bank of New York regarding factors affecting efforts to limit payments to AIG counterparties before the Committee on Government Oversight and Reform of the United States House of Representatives.

Finally, I understand that downgrades of AIG by the rating agencies would have exacerbated certain of AIG's problems by triggering requirements for AIG to post additional collateral for the credit default swaps ("CDS") that AIG Financial Products ("AIGFP") had written, and possibly by impairing AIG's other businesses. The impact of downgrades on posting collateral is largely or completely now eliminated by AIGFP's buyout of its CDS exposure held by the counterparties holding most of AIGFP's liability.

The Special Inspector General for the Troubled Asset Relief Program ("SIGTARP") concluded the "negotiating strategy to pursue concessions from counterparties offered little opportunity for success…"[2] The effectiveness of a restructuring depends heavily on the process and strategy used to attain it. The most effective process for AIG would have to yield the desired result consensually, without going into court, let alone through a trial and judgment.

The unique facts bearing on the best process for AIG were that AIG was current on its debt obligations and was granting the Federal Reserve Bank of New York ("FRBNY") a lien against all available assets to secure a revolving loan of up to $85 billion. On September 16, 2008, AIG's state insurance regulators notified AIG that AIG was "no longer permitted to borrow bunds from its insurance company subsidiaries under a revolving credit facility that IAG had maintained with certain of its insurance subsidiaries acting as lenders. Subsequently, the insurance regulators required AIG to repay an outstanding loans under that facility and to terminate it…."[3] These facts give rise to two very significant consequences.

First, no creditor obtaining a judgment for any subsequent default would necessarily be able to collect because the FRBNY's lien would rank higher than any judgment lien and AIG's source of funds from insurance company subsidiaries was cut off. Second, AIG's status as generally paying its debts as they matured, meant that anyone filing an involuntary bankruptcy petition against AIG would be unable to sustain its burden to show that AIG was not generally paying its debts as they became due. On a consolidated basis, AIG had over

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[2] SIGTARP Report at page 1 under Conclusions and Lessons Learned.
[3] AIG Form 10-Q for Q3 2008, at p. 50.

$800 billion of liabilities,[4] which FRBNY clearly believed could be serviced with the help of the $85 billion facility it extended. The credit default swaps and securities lending liabilities were a small fraction of AIG's liabilities.

Accordingly, AIG was in a position to advise certain creditor groups such as the credit default swap counterparties, as follows:

1. State law recovery actions against AIG would be unlikely to yield any benefits due to the prior lien held by FRBNY;

2. AIG would not voluntarily file bankruptcy;

3. Creditors would be unable to file involuntary petitions in good faith because AIG was generally paying its debts as they became due, even if AIG were not to post additional collateral or pay certain other debts of the entities that caused its losses.[5]

4. If creditors nevertheless filed involuntary bankruptcy petitions against AIG, they would render themselves liable for compensatory and punitive damages if the court found AIG was generally paying its debts as they became due and the creditors had been warned in advance of that fact;[6]

5. FRBNY was saving AIG with taxpayer funds due to the losses sustained by the business divisions transacting business with these creditor groups, and a fundamental principle of workouts is shared sacrifice, especially when creditors are being made better off than they would be if AIG were left to file bankruptcy.

The impact of the foregoing on the creditors, would include:

1. The knowledge that enforcement action would be unlikely to yield recoveries;

2. The knowledge that an involuntary bankruptcy petition would be a 'bet-the-ranch' venture by the creditors because of the risk of suffering compensatory and punitive damages for knowingly bankrupting AIG when it was generally paying its debts as they became due;

3. The knowledge that any creditor enforcement action would be highly publicized and would isolate the creditor in the public as

[4] AIG Form 10-K for year ended December 31, 2008, at p. 193.
[5] *See* 11 U.S.C. § 303(h).
[6] *See* 11 U.S.C. § 303(i)(2).

working against the efforts of the United States and its taxpayers to save AIG and the financial system; and

4. The knowledge by some of the creditors that working against the United States would be singularly unwise after the United States either provided them rescue funds or helped them buy a company such as Lehman Brothers for $250 million plus the appraised value of the Manhattan office tower it owned.

The foregoing strategy maximizes forces on creditors to grant debt concessions, while yielding them very few alternatives to granting concessions and no alternatives lacking delay, expense, and uncertainty. Unlike the negotiating strategy that SIGTARP described as having had little opportunity for success, this strategy is not based on bluffing bankruptcy. It is based on straight talk and acknowledging there would be no bankruptcy. Additionally, FRBNY retained an outstanding law firm and attorney for its work. But, the law firm is identified with representing Wall Street institutions such as JP Morgan and it would be awkward for it to devise strategies to obtain concessions from those institutions.

Significantly, the foregoing strategy eliminates or at least answers many of the reasons that ultimately caused FRBNY not to obtain concessions.[7] For instance, all lenders are justified in requiring shared sacrifice. Therefore, FRBNY would not have been using its regulatory status to demand concessions. It could do so in its lender status. Most importantly, FRBNY was not required to bluff about bankruptcy. The correct strategy was the opposite – to show there would be no bankruptcy and no real opportunity for the creditor to do better. The foregoing process is carried out in conference rooms, not in the public.

While the FRBNY might still be concerned about the sanctity of contract, fairness in debtor-creditor relations exists when creditors share the pain, not when taxpayers bail out contracts they did not make. I acknowledge this is often counterintuitive. We all grow up learning to carry out all our promises. In debtor-creditor relations, however, once a debtor cannot carry out one promise to one creditor, it is more fair to break more promises so similarly situated creditors share the pain, rather than having one take all the pain, or worse yet, having innocent taxpayers take all the pain.

I understand there was also a concern about ratings downgrades following any concessions. Intuitively, it should be illogical that AIG would be viewed as a lesser credit risk once it procured concessions from creditors which would reduce the amount AIG needed to borrow from FRBNY and would reduce future debt service expense. To be sure, the ratings protocols may not always appear

[7] SIGTARP Report at pp. 18-19.

logical to the layperson, but given the singular unique aspects of the AIG rescue, it is hard to figure out why the ratings agencies would believe AIG would be less credit worthy without creditor concessions.

The argument exists that creditor concessions could signal that FRBNY may not continue to provide AIG funds to satisfy all debt. The answer to that is that FRBNY has not provided that assurance. Indeed, I received many phone calls in September 2008, asking whether it was safe to buy or hold AIG bonds after FRBNY provided the $85 billion facility. The market clearly understood that FRBNY did not provide any guaranties to creditors for the future. Therefore, it would be illogical for a downgrade to turn on whether AIG already obtained concessions. The risk of a future default is the same or less if prior concessions were granted.

Recent experiences with workouts of the monoline insurance companies help corroborate the likelihood of concessions. I have had limited involvement in those negotiations, but my firm has been very involved on behalf of the insurance companies. In those restructurings, institutional lenders, including French institutions, were similarly owed additional collateral to secure credit default swaps and other derivatives. Consensual discounts were and are being granted in very material amounts. Additionally, there is litigation pending today over whether certain credit default swaps qualify for any priorities in payment afforded insured contracts under state law. Accordingly, there are many uncertainties causing counterparties to grant consensual discounts.

Thank you for allowing me the opportunity to provide this analysis. I am anxious to try to answer any questions.

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