

## **Grano Series- Risk and the Next Global Crisis**

The sixth annual speakers series held at Grano Restaurant in Toronto, Ontario explores the key issues facing the economy.

April 8, 2010

### **Risk & the U.S. Economy: What went wrong**

Hank Greenberg

The following is an edited transcript of remarks made by Mr. Greenberg at Grano Restaurant. Mr. Greenberg is the former chairman and CEO of AIG. He is currently CEO and Chairman of C.V. Starr and Company.

I've been in the risk business for all my business life -- you might even say for all my military life. But risk starts with the CEO of a company. You can't delegate it all the way down the line. You've got to be very active in risk. If you're in an insurance company you are in a risk business. And so you, by nature, have to have not only a feeling

for it but you have to know how to manage it.

We were the only company that I know of in the insurance industry that had an enterprise risk management system. Now what is that? It's a system where you take both market risk and credit risk, and you're managing both of those at all times.

I'll go into what happened in the United States in a couple of minutes. But one of the things that I would recommend, going forward, is that every public company has a risk committee of their board, with people who understand risk. You can't leave it just to management, because management changes. I can tell you that one of the tragedies that happened to the company that I left in 2005, is that the risk management system broke down.

So there has got to be continuity. I would think that a board of directors ought to have qualified people on a committee. I think that would be essential and I think it would eliminate a lot of future problems.

Now onto what happened in the United States -- many of you read the article that I published in the National Interest, but let me

just say a few more words about that. What happened started during the Clinton administration when President Clinton decided that housing would be made more available to people who otherwise wouldn't have access to a mortgage. So Fannie Mae and Freddie Mac were loosened up and they began writing mortgages and gradually increased the tempo so that more and more people who were not qualified to get a mortgage got a mortgage, nonetheless.

Historically, mortgages were handled throughout the United States by regional banks and local banks. The local banker knew who the person getting a mortgage was, and if they got into trouble they'd work with that person. That came out of the equation so you had mortgage brokers and all kinds of intermediaries really pushing mortgages. Fannie and Freddie were buying these mortgages and the local banks became mere service agents without any risk exposure to these mortgages.

Now, Greenspan was before congress yesterday to try and justify low interest rates for an extended period of time, which obviously made getting mortgages much easier. But several things were going on at the same time. This was a moving target. There was euphoria in the country, the belief that things would just grow to the sky, that there would be no fall-out, that there was nothing that was

going to happen that was going to change things.

Investment bankers got leverage of thirty-five times their capital. That was unheard of before. The Securities and Exchange Commission (SEC) didn't pay too much attention to that. That led to the development of other products. While that was going on, the rating agencies were very optimistic about some of the new products that were being developed by the investment banks, by packaging mortgages from the east, west, north and south of the United States into one product and asserting that they were triple A. On many occasions, due diligence wasn't done and these were peddled as triple A products.

Bob Rubin, who was Secretary of Treasury when credit default swaps began to be used more extensively, thought they should not be regulated. A credit default swap is nothing but an insurance policy. And he said no, we don't want to regulate them. Now, credit default swaps were introduced originally so that a buyer who held a bond that he wanted to be paid could be sure he was going to get paid on maturity of that instrument.

In 2005, in December -- I could be off by a year, it could have

been in 2006 -- an organization called ISDA, which is an industry group to which most of the bankers in the derivative field belong, changed the rules for credit default swaps. Initially, they were only paid off at the termination of the duration of that instrument. But then they decided they were going to mark them to market so that if a collateralized debt obligation was downgraded for whatever reason, you had to put up more collateral. That was a very important change.

Another change was that if the company who was issuing the credit default swap was downgraded by the ratings agencies they too had to put up more collateral. Those two changes were devastating to the companies that were issuing credit default swaps.

Now remember, there was no so-called price discovery on these CDOs, these collateralized debt obligations. There was no exchange where you traded them. There was an index for a small period of time, but there was no exchange, so the dealers in these instruments were marking them to what they thought it should be, and they were all over the lot. My friends at Goldman Sachs had the lowest marks of any firm on the street. Right or wrong, that's what they did, and so more and more collateral was required by those who were issuing these credit defaults swaps. That was a lead-up to what happened.

Those that were putting together these collateralized debt obligations were putting more and more junk into these instruments and they were getting away from making them into triple A. When the ratings agencies pull these ratings -- which they did about a year or two later -- they obviously went way the hell down, and by going way down more and more collateral was required. And then you had a run on the banks, banks being those who were issuing the credit default swaps. That step never should have happened.

You have to ask, why did it happen? Where were the regulators? It's not that there were no regulations. We had regulations that were not being enforced. The SEC approved the leverage of the investment banks to outlandish levels. Nobody said anything about that. And you can go on and on.

AIG Financial Products, for example, had a regulator who was a thrift administrator who reported through treasury. They were in AIG Financial Products almost continuously. Where were they? The New York Insurance Department, under New York insurance law, has a holding company and there's a holding company law. Why didn't the insurance superintendant ever show up there? As far as I know, he

never did.

I left the company in 2005 in March, and AIG Financial Products wrote more credit default swaps in the following nine months than we had written in the previous seven years. This was obviously pretty stupid. And so that is what led to the problems at AIG Financial Products. And what happened affected many other institutions. It wasn't that there was a capital shortage. There was a liquidity crisis in many institutions in the United States.

What could have been done? If you go down to the Defense Department, they have a war plans division. They have plans for every contingency that might occur. If there's a break-out or a conflict any place in the world I assure you there's a plan for dealing with it. There was no plan in Treasury or at the Fed to deal with any kind of a financial crisis that might occur.

I wouldn't expect that they would think of everything that could lead to a financial crisis. But some of the signs were so evident that you would have thought that the two biggest institutions overseeing the field -- the Fed and the Treasury -- would have had some people working on contingency plans.

So when this thing broke out there was an ad hoc approach to it. It was a day to day reaction. If you haven't got a plan, then an ad hoc approach is all that is left to you. You can only react in an improvisational way. And some of the actions would change within 24 hours. That led to a loss of confidence throughout the system. If you don't have confidence it's very difficult to bring about change and stability.

Bear Stearns was the first in line and they were sold -- it was a forced sale. Lehman Brothers was next, and in my judgment it was a mistake to let Lehman go down. Lehman didn't get a bank holding company license which would have given them access to the Fed window, just as Goldman Sachs got a bank holding company license. And if Morgan Stanley hadn't got a bank holding company license they might have been in trouble as well, because the system was unwinding.

But letting Lehman go was a major loss of confidence surrounding the structures. It was a very old firm and while they did dumb things, obviously, they weren't the only ones who did dumb things and so letting them go was, I think, a big mistake.

That's what led to this uncertainty in the United States. So where are we going from here? Well, there are all kinds of congressional investigations. We still don't have all the facts as to what really took place and as to who did what. There are those who allege that some of the investment banks that were creating these collateralized debt obligations knew very well that the housing market was going to collapse, but nevertheless put together these instruments and sold them widely around the world. There's also an allegation that they had been shorting those instruments or shorting the firms who had issued credit default swaps to drive the price of their stock down.

So there is a lot of information that has not yet been discerned. Congress is holding hearings and the Towns Committee and the Dodd Committee in the Senate will be holding hearings and the Franks Committee will be holding hearings. And they have subpoena power. You can get telephone records and emails and find out who was talking to whom. A lot was going on that doesn't smell right to those of us who were in the midst of the problem.

That will all come out. If it doesn't come out in those hearings, investigative reporters are working on this. There's practically a book a week on this. It's not all out there yet because investigative reporters

will get a bit here and a bit there. I can tell you, though, that there are some people digging pretty hard and they will get to the bottom one way or the other.

Finally, if that doesn't bring it all out, there will be litigation where you can get discovery and depositions. That's a longer haul and costly to do, but we've got to get to the bottom of what happened and who was responsible for the different things that shouldn't have happened but happened nonetheless. Risk management was out the window. Common sense was not there. There was this greed which brings me to the issue of compensation.

I think that compensation on Wall Street got out of hand. I can only tell you that, 1) in the company that I chaired for many, many years, nobody in AIG had a contract. I refused one. No one had a contract. And 2) I would not accept a salary of more than a million dollars a year if that's all you got a tax deduction for. And 3) the highest bonus that was ever paid -- and which was related to performance -- was between about 5 and 7 million dollars.

Of course, we were a different company in many ways, because AIG was an outgrowth of a private company called C. V. Starr &

Company, which I chair today. And when it put AIG together by putting our assets into AIG, we got AIG stock in return. The market value then was only \$300 million, as Hal Jackman pointed out. But we put a plan together in a private company, to reward those in AIG, a public company, based on the performance of AIG.

If AIG performed well, then managers were picked who could participate in a plan, not being charged to the public shareholders at all, rather being charged to the shareholders of the private company. They couldn't get those shares until they retired and if they left the company they left the shares behind. It created a lot of loyalty, because they did very well. So the plan was unique -- much different than anything that existed on Wall Street. Of course, we used stock options as well. So you have got to have the incentives, not for short-term gains which defeat risk management, but for long-term gains. You have to have incentives that are long-term, that encourage management to think about the long term for the firm.

Looking ahead, what is going to happen? The Dodd Committee and Volcker and all those pundits are all coming up with newly-composed laws and regulations. We've even got Volcker saying that companies shouldn't get too big. I don't agree with that. I don't think

that we should try to make American financial institutions medium-sized. How are they going to succeed in a very competitive world? I think that's a mistake. That doesn't mean you shouldn't have all the right things to make it great, and to keep it great.

Coming out of this crisis, I think that at least for a while there will be more attention to the things that should keep it great and strong. We can't go overboard. The wrong thing to do is to propose legislation during a crisis. Look at what they did with the Sarbanes-Oxley Act. It was the wrong time, the wrong way, the wrong fix. You have to wait until you have a clear understanding of what really happened and of what should be fixed. Reacting emotionally is the wrong thing to do.

I testified before the Towns Committee and recommended they have a blue ribbon panel. I was asked what changes ought to be made and I said I would not make any changes at all till first of all we know what the hell happened, in detail, not just superficially. And then I would put together a blue ribbon panel of not a bunch of professors, but of people from the business world. I would mix them with some others and really examine what happened in detail. I would encourage public hearings so you get all the facts. Then if we need a change,

well, with any luck we can make the right changes.

As I said earlier, it wasn't the lack of regulation. It was the regulators who didn't do their job. There were all the regulations in the world that were available but nobody paid attention to them, including the regulators themselves. I don't mean to pick on the New York Fed, but Citigroup is in New York City. The New York Fed is in New York City. They had bank examiners all over the place. What were they doing? Clearly, you can't say that they didn't know that Citigroup was doing what they were doing. I mean, if they say that then you've got a more serious problem.

So, you know, I wouldn't jump the gun. I would first make sure that we get all the facts. And we have got to pay regulators enough money to get better regulators. You can't just get the lowest common denominator and say, I got the job filled with a warm body. That is not going to do it. There are some countries in the world where there is some damn good regulation. AIG did business in 130 countries. Go to Singapore. Singapore has very good regulation and very good regulators. They could get a job at any investment bank in the world. They're top flight. Now, yes, it is a small country. It is a city-state. But that doesn't mean that we can't shoot higher and get better people

than we've had so far.

Let me move to another topic for a moment -- the U. S. economy. I was asked to say a few words about that. Obviously, the economy is better than it was six months ago. But we have got some very serious problems ahead. I am not going to try and guess what the stock market is going to do or not do. The tape speaks for itself. But we're going to have to fight several things up front. We are going to have higher taxes, we have got a debt that's sky high and probably going higher and we're going to be fighting inflation. It's only a matter of when.

In the long term I think we have got other serious issues to deal with. In the short term, the economy is getting somewhat better. Main Street is still having trouble borrowing money, unemployment is still 9.7 percent and it will be a long time before it goes down to more reasonable levels. There are issues ahead and I think the administration got a lift out of the healthcare plan, which is going to be a disaster as far as costs are concerned. You probably know something about that in Canada.

We have -- historically -- been a market economy. It's hard to

call us that today. The trend is something less than that. Obviously, to those in business who believe in a market economy, there are concerns about what we currently have. I don't think the American people want, in the long term, to give up a market economy. I don't think it's in our national interest or in the interest of the people of the United States. Even the middle income group in our country would not, I believe, support a socialist government for any length of time. Maybe I don't want to believe it but I don't think so.

The third thing I would like to mention briefly is the geo-political situation. I think some of you know I go to China very often. I've been going since 1975 and I'm there about every six weeks. And the changes in China are just so startling. I never would have believed in a 1000 years that the China of 1975 would be the China of 2010. What they've accomplished in that period of time, well, nothing like that has ever been done in the history of this planet.

Do they have problems? You bet they do. There are lots of problems. They've got environmental problems, healthcare problems, they've got a billion and 300 million people that need to be fed, clothed and sheltered and only 300 million of those people have been lifted out of poverty. But that number, 300 million, is the population of

the United States. Think about that. Think about the job of that.

Clearly, China must have social stability to make the progress that they want. Their system is the only system that will work in China. This does not mean that they haven't liberalized life in China. They have. When I first went to China a husband might be working in Shanghai and the wife might be up in Dalian. They'd meet once a year. Today they can travel freely, do whatever they want. So there has been tremendous change in the country and change will continue.

Now we do have a problem with China, if you want to call it that, on trade. I was in China about two and half weeks ago and we subsequently met with the premier for about two hours. We're badgering China on the renminbi, their currency. We think it's undervalued and it should be significantly higher than what it is. One has to remember that China appreciated the currency by about 23% in the last three years. That is not an insignificant amount and Geithner is on his way there, if not there now, and probably China will do something about it but not at the beckoning of the United States.

They will not lose face and admit that we made them do this. That's the wrong approach and we should not be doing this publicly

anyway. You do not negotiate with China on something like that publicly. Saving face is very important in China and that's a dumb thing to do. But even if China were to revalue their currency by 40 % over a period of a couple of years, what would happen?

The products which they sell to the United States are mostly low-cost products in the United States. People buy them at either wholesale places, or retail, but always at low cost. Well, we would simply move that trade to Vietnam or somewhere else. It wouldn't change the trade deficit at all. It would just move to another country. And it might cause a little instability in China but it's not going to change anything dramatically.

The real problem in China in our trade is not that. The real problem with China and in their trade with us is that they subsidize virtually everything that's exported to the United States whether it's fuel, whether it's wages, whether it's oil or gas. Most of the products are subsidized because trade is very important to them. China, until it becomes more of a consumer market, is going to have to rely on trade for many, many years to come.

Now, they are beginning to develop a consumer market. There's

a huge urbanization program going on where they are going to move millions of people to designated cities in the country. That will create service jobs and these people will then spend more and you'll have a consumer market growing. They know that, we know that. But it is not going to happen overnight. It's going to take some time to achieve.

China is important to us for a lot of other reasons. Right now we have -- the world, really -- has a problem with Iran. Is Iran going to go nuclear? Are they building nukes for power or for weapons? China has been the only nation so far who did not want to sign on for sanctions. I had a long talk with some high-ranking Chinese officials on this trip and I told them how wrong that was. I explained that they would be as exposed, ultimately, as anybody else would because they sell these weapons and China has a Muslim population that is not very happy. And so to at least abstain from a negative vote at the United Nations would be in both our national interests.

We'll see what happens. The fact that Hu Jintao is coming to a meeting on nuclear programs in Washington is a good sign. We have not named China as a currency manipulator -- which, as I've said, would be a dumb thing to do -- and so being assured of that I'm sure he feels that he can come without being embarrassed. And it's the

right thing for him to do.

So yes, China is important to us. And North Korea is a nuclear power. China holds more sway over North Korea than anybody else. I was there actually about three months ago with an ex-four-star general and two other businessmen and our mission was to try and explain to the North Koreans that if they gave up their nuclear program they would get foreign investment. We didn't get very far. It was a failed mission.

But I must tell you, it's like going through the looking glass, going to North Korea. I've never witnessed or seen anything like it. It's like a bunch of zombies. Everybody is worshipping Kim, the great and dear leader. You can't believe human beings would be that brainwashed. But it is the case.

So we have geopolitical problems, we have economic problems, we have an economy that is far from healed and we have risk problems. I think we know more about the latter but we don't have all the facts yet. There are some people who did some things that really deserve to be punished. That will all come out in due course. I think I'll stop here and take questions.

