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AMERICAN INTERNATIONAL GROUP: EXAMINING WHAT WENT WRONG, GOVERNMENT INTERVENTION, AND IMPLICATIONS FOR FUTURE REGULATION

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

AN EXAMINATION OF WHAT WENT WRONG WITH AMERICAN INTERNATIONAL GROUP, WHERE GOVERNMENT INTERVENTION IS HEADED, AND THE IMPLICATIONS FOR FUTURE REGULATION

MARCH 5, 2009

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C O N T E N T S

THURSDAY, MARCH 5, 2009

WITNESSES

AMERICAN INTERNATIONAL GROUP: EXAMINING WHAT WENT WRONG, GOVERNMENT INTERVENTION, AND IMPLICATIONS FOR FUTURE REGULATION

THURSDAY, MARCH 5, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:06 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. Senator Shelby will be along in a minute or so, and we will just get underway because I know people have busy schedules for the day.

How we will proceed is I will make some opening comments, and when Senator Shelby comes on in, obviously he will have some opening comments to make. And then given the number of people here this morning, I am going to go right to our witnesses and then ask my colleagues' indulgence to use their time for opening statements on the matter as well as getting to the questioning; otherwise, we might be here an hour and a half before we got to questioning. So depending on—Richard, how are you?

Senator SHELBY. Good morning.

Chairman DODD. Good morning. I was just saying both of us will make opening statements, then get right to our witnesses, if that is all right with you.

Senator SHELBY. Sure.

Chairman DODD. And then we will proceed along the lines, and, again, we will try and keep the questioning somewhat limited in time so we can get to everyone here this morning.

Well, this morning the Committee comes together to examine what went wrong with American International Group, what lessons can be drawn from this situation, and where the Government overseers are headed. We have before us representatives from the State and Federal regulators of this insurance giant, as well as the Federal Reserve that decided to launch the Government rescue of AIG last September.

I want the Committee to be aware that we invited the Treasury Department to send a witness to testify here this morning, but they are unable to send anyone to the Committee this morning. And given the Treasury's increasing responsibilities, effectively the owner and overseer of AIG—although that issue is one we will discuss this morning as to actually where that ownership lies—I regret the Treasury did not have someone here this morning.

In fairness to them, they are in a transitional period and obviously putting a team together, and so I think there is some respect for whether or not they have the personnel on hand to be here. But, nonetheless, I would be remiss if I did not say that I am not pleased by the fact that we do not have someone here from Treasury to do some explaining as to what their role in this is and what role there will be in the coming weeks and months in all of that.

Obviously, again, my colleagues are as aware of these statistics as anyone. We have 10,000 foreclosures a day in the country—these numbers get repeated all the time—20,000 layoffs each and every day happening all across our country. I think all of us wish we were here today instead talking about how to help those struggling to get by through no fault of their own, not an institution indebted to sophisticated investors who should have known better and in many cases did know better. Instead we are here in the wake of the fourth plan to rescue AIG, once again committing tens of billions of dollars to a massive, failed institution, because, as reported recently last week, it effectively "has the world financial system by the throat." And that we find ourselves in this situation at all is, in my mind, and the minds of many of my constituents, quite frankly, sickening.

How did we come to this? That is the question this Committee seeks to answer today. Certainly there are an awful lot of reasons. If the financial meltdown was a man-made disaster due in part to bad mortgages, then AIG's collapse was predicated in part on the company's decision to essentially ensure securities backed by those mortgages and sell those derivatives to speculators, thus encouraging more and more risky investments.

When the credit markets seized up last September, AIG found itself on the verge of bankruptcy. In the wake of the decision by then-Secretary Paulson and Fed Chairman Bernanke to allow Lehman Brothers to declare bankruptcy, the Federal Reserve decided to exercise its authority as lender of last resort by lending AIG up to $85 billion.

In exchange, the Government took approximately 80-percent ownership of AIG, effectively taking over the company. At the time, the Fed, in their report required by Congress, told this Committee that they did not believe this deal with result in any "net cost to the taxpayers." With that rosy projection, AIG went on to have the single worst quarter of any corporation in American history, losing over $60 billion. That effectively means that during the final 3 months of last year, after the Government had effectively taken it over, AIG lost more than $450,000 per minute, every minute of every day. And while the Federal Reserve and then-Secretary Paulson continued to provide additional Government funds to the company, the AIG ordeal has now required the taxpayers to put up upwards of $150 billion to keep the company from bankruptcy.

Indeed, the Fed has provided another almost $40 billion to AIG through two separate Fed-owned and operated special purpose vehicles: Maiden Lane II and Maiden Lane III. Maiden Lane II was designed to absorb the problems associated with AIG's secured lending facility, which State insurance commissioners allowed to be heavily leveraged to mortgage-backed securities, the value of which, of course, disintegrated. Maiden Lane III was designed to absorb the losses AIG incurred through writing credit default protection against mortgage-backed securities in AIG's Financial Products office, which was not directly regulated. It was through that facility that the Fed has paid out at par the holders of credit default swaps and corresponding securities, and it is reasonable to ask why holders who would have received only pennies on the dollar for their credit default swaps, absent any Government intervention, would expect or deserve payments from what essentially is a bankrupt company.

It is not clear who we are rescuing, whatever remains of AIG or its trading partners. This Committee would like to know, and the taxpayers certainly have a right to know who they are effectively funding and how much they have already been given. Again, AIG's trading partners were not innocent victims here. They were sophisticated investors who took enormous irresponsible risk with the blessing of AIG's AAA rating.

The lack of transparency and accountability through this process has been rather stunning. Throughout the entire fourth quarter last year, it was, frankly, never clear who owned AIG or who was in charge. It is well documented that AIG management was allowed to pay extravagant bonuses. Their employees went on some trips all over the world. Little wonder it took almost 5 months for the Fed to select a single trustee to manage the Government's interest in AIG, and during that time it seems clear the foxes were truly guarding the henhouse.

So to say we have questions would be an understatement, to put it mildly. What were the State insurance commissioners doing while AIG was building up this large exposure in the secured lending program which was under their watch? Where was the Office of Thrift Supervision as AIG's holding company regulator throughout all of this? What coordination occurred between the Fed, the OTS, and the State insurance regulators? Was there any coordination at all, in fact? And, finally, who has been in charge of AIG these last few months, and who will be going forward? Who is in charge, in effect?

Unwinding AIG's assets will be extraordinarily difficult, to put it mildly, and it is certainly not going to happen overnight, regretfully. And for months the Fed and Secretary Paulson of Treasury were, it seemed to me, pointing fingers at each other. It is time someone assumed responsibility for the Government's ownership of AIG.

I have many questions—and I know my colleagues do—for Treasury, and, again, I regret they are not here this morning. I encourage Members to submit questions directed to them for the record, as I will be doing, and submit them for answers.

One question that already has a clear answer is why we need a vibrant insurance industry, and I would add that many in the industry, including many of those in my home State, are as aghast at AIG's behavior as all of us are. If credit is the lifeblood of our economy and a healthy banking system is the heart that pumps credit to our economy, then our insurance industry are the lungs that provide the oxygen we need to make sure that credit flows. For businesses to function and create jobs, they need access to insurance to protect those investments. That requires a robust insurance industry capable of providing insurance on fair and sound terms, to allow construction projects to be built, businesses to employ workers, and families to ensure against unexpected events.

As such, we are here today not just to better protect the taxpayer funds that have been put at risk to prop up AIG, but also to draw upon this experience and examine what our future regulatory structure must look like so that insurance will be readily available, consumers and policy holders would be adequately protected, and our Nation's economy can be rebuilt.

With that, I turn to my colleague from Alabama, Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

The collapse of the American International Group is the largest corporate failure in American history. Once a premier global insurance and financial services company, with more than $1 trillion in assets, AIG lost nearly $100 billion last year. Over the past 5 months, it has been the recipient of four bailouts. To date, the Federal Government has committed to provide approximately $170 billion in loans and equity. Given the taxpayers' dollars at stake and the impact on our financial system, this Committee has an obligation to thoroughly examine the reasons for AIG's collapse and how Federal regulators have responded.

I also hope that today's hearing will shed new light on the origins of our financial crisis as well as inform our upcoming discussions on financial regulatory reform. In reviewing our witnesses' testimony here today and AIG's public filings, it appears that the origins of AIG's demise were twofold: First, as has been widely reported, AIG suffered huge losses on credit default swaps written by its Financial Products subsidiary on collateralized debt obligations.

AIG's problems, however, were not isolated to its credit default swap business. Significant losses in AIG's State-regulated life insurance companies also contributed to the company's collapse. Approximately a dozen of AIG's life insurance subsidiaries operated a securities lending program whereby they loaned out securities for short periods in exchange for cash collateral. Typically, an insurance company or bank will lend securities and reinvest the cash collateral in very safe short-term instruments. AIG's insurance companies, however, invested their collateral in riskier long-term mortgage-backed securities. And although they were highly rated at the time, approximately half of them were backed by subprime and Alternate-A mortgage loans.

When the prices for mortgage-backed securities declined sharply last year, the value of AIG's collateral plummeted. The company was rapidly becoming unable to meet the demands of borrowers returning securities to AIG. By September, it became clear that AIG's life insurance companies would not be able to repay collateral to their borrowers. Market participants quickly discovered these problems and rushed to return borrowed securities and get back their collateral.

Because AIG was unable to cover its obligations to both its securities lending and derivatives operations, it ultimately had to seek Federal assistance. In total, AIG's life insurance companies suffered approximately $21 billion in losses related to securities lending in 2008. More than $17 billion in Federal assistance has been used to recapitalize the State-regulated insurance companies to ensure that they are able to pay their policy holders' claims. In addition, the Federal Reserve had to establish a special facility to help unwind AIG's securities lending program.

The causes of AIG's collapse raise profound questions about the adequacy of our existing State and Federal financial regulatory regimes. With respect to AIG's derivatives operations, the Office of Thrift Supervision was AIG's holding company regulator. It appears, however, that the OTS was not adequately aware of the risks presented by the companies credit default swap positions. Since AIG's Financial Products subsidiary had operations in London and Hong Kong, as well as in the U.S., it is unclear whether the OTS even had the authority to oversee all of AIG's operations. It is also unclear whether OTS had the expertise necessary to properly supervise what was primarily an insurance company.

Additionally, did AIG life insurance companies obtain the approval of their State regulators before they participated in securities lending? If so, why did the State insurance regulators allow AIG to invest such a high percentage of the collateral from its securities lending program in longer-term mortgage-backed securities? Also, did the insurance regulators coordinate their oversight of AIG's securities lending since it involved life insurance regulated by at least five different States?

While I hope we can get some answers to these and many other questions today, I believe we are just beginning to scratch the surface of what is an incredibly complex and, on many levels, a very disturbing story of malfeasance, incompetence, and greed.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Shelby. And as I mentioned earlier, we will go right to our witnesses, and then we will get to the question period.

Our first witness is Donald Kohn, Vice Chairman of the Board of Governors of the Federal Reserve, who has been before this Committee many times, and we thank you for being with us this morning. As many people know, before becoming a member of the Board, he served on its staff in various positions, including Secretary of the Federal Open Market Committee, Director of the Division of Monetary Affairs, and Deputy Staff Director for Monetary and Financial Policy.

Next we have Mr. Scott Polakoff. He is the Acting Director and the Senior Deputy Director and Chief Operating Officer of the Office of Thrift Supervision. Prior to his work at OTS, Mr. Polakoff assumed a variety of positions at the FDIC, including Deputy Regional Director.

And, finally, we will hear from Superintendent Eric Dinallo, who is the Superintendent of the New York State Insurance Department. Prior to this appointment, Mr. Dinallo was general counsel for Willis Group Holdings, the world's third largest insurance broker. We welcome him to the Committee. Thank you for being with us this morning.

Mr. Kohn, we will begin with you.

STATEMENT OF DONALD KOHN, VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. KOHN. Thank you, Mr. Chairman.

Chairman Dodd, Ranking Member Shelby, other Members of the Committee, I appreciate having this opportunity to discuss the role of the Federal Reserve in American International Group. My written testimony provides full detail about the support the Federal Reserve, working alongside the Treasury, has given AIG and the reasons for each of our actions. In my oral statement this morning, I would like to touch on the broader themes and provide the context that underlay the actions.

Over the past year-and-a-half, this Committee, the Congress, the Treasury, and financial regulators have all been dealing with the ongoing disruptions and pressures engendered by an extraordinary financial crisis. The weaknesses at financial institutions, resulting constraints on credit, declines in asset prices, and erosion of household and business confidence have in turn led to a sharp weakening in the U.S. economy. In addition to the extraordinary assistance provided by the Congress in approving the Emergency Economic Stabilization Act last fall and implemented by the Treasury, the Federal Reserve has employed all the tools at our disposal to break this spiral and help address the many challenges of the crisis and its effects on the economy.

One of the most important tools of the Federal Reserve is our authority under section 13(3) of the Federal Reserve Act to lend on a secured basis under "unusual and exigent" circumstances to companies that are not depository institutions. And since last fall, in order to foster the stability of the financial system and mitigate the effects of ongoing financial stresses on the economy, we have used that authority to help to stabilize the financial condition of AIG. My full written statement provides a detailed chronology of our actions. I want to put these actions and the reasons for them in context.

AIG is the largest insurance company in the United States, controlling both the largest life and health insurer and the second largest property and casualty insurer. It is also one of the largest insurance companies in the world, conducting insurance and finance operations in more than 130 countries, with more than 74 million customers and 116,000 employees globally, including 30 million customers and 50,000 employees in the U.S. As of September 30, 2008, it reported consolidated total assets of slightly more than $1 trillion; it is also the major provider of guaranteed investment contracts and products that protect participants in 401(k) retirement plans.

In addition, AIG is the leading commercial insurer in the U.S., insuring operations on more than 180,000 entities. Thus, millions of individual small businesses, municipalities, and corporate customers in the United States rely on AIG for insurance protection on their lives, homes, vehicles, business operations, pensions, investments, and other insurance risks.

But AIG is more than just a large insurance company. AIG has been a major participant in many derivatives markets through its Financial Products business unit. Unlike its regulated insurance company affiliates, Financial Products and its activities are not regulated. Financial Products is the counterparty on over-the-counter derivatives to a broad range of hundreds of customers, including many major national and international financial institutions, U.S. pension plans, stable value funds, and municipalities. Financial Products also provided credit protection through credit default swaps it has written on billions of dollars of multi-sector collateralized debt obligations.

While Financial Products has been winding down and exiting many of its trades, it continues to have a very large notional amount of derivatives contracts outstanding with numerous counterparties. And it is against this background that the Federal Reserve and the Treasury Department have taken a series of unusual actions to stabilize the company and prevent its disorderly collapse from infecting the broader financial system. These actions have entailed very difficult and uncomfortable decisions for a central bank, as well as the Treasury, because they involved addressing systemic problems created largely by poor decisionmaking by the company itself. Moreover, many of these decisions involved an unregulated business entity that exploited the strength, and threatened the viability, of affiliates that were large, regulated entities in good standing.

However, we believe we had no choice if we are to pursue our responsibility for protecting financial stability. Our judgment has been and continues to be that, in this time of severe market and economic stress, the failure of AIG would impose unnecessary and burdensome losses on many individuals, households, and businesses, disrupt financial markets, and greatly increase fear and uncertainty about the viability of our financial institutions. Thus, such a failure would deepen and extend market disruptions and asset price declines, further constrict the flow of credit to households and businesses in the United States and in many of our trading partners, and materially worsen the recession our economy is enduring.

To mitigate these risks, the Treasury felt compelled to provide equity capital to AIG and the Federal Reserve to provide liquidity support backed by the assets of AIG. We have restructured our assistance in response to changing economic conditions and, as needed, to mitigate potential risks. These restructurings reflect our continued belief that the disorderly failure of AIG during this period of severe economic stress would harm numerous consumers, municipalities, small businesses, and others who depend on AIG protection, and it would deepen the current economic recession. Taking these actions, we are also committed to protecting the interests of the U.S. Government and the taxpayer.

Thank you very much. I would be pleased to take your questions.

Chairman DODD. Thank you very much.

Mr. Polakoff.

STATEMENT OF SCOTT M. POLAKOFF, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. POLAKOFF. Good morning, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. Thank you for inviting me to testify about the oversight of AIG by the Office of Thrift Supervision.

The scope of the Government intervention on behalf of AIG has generated enormous public interest and acute attention by policymakers. I welcome the opportunity to present facts available to OTS and answer the important questions surrounding AIG.

The OTS granted a Federal savings bank charter to AIG in 1999, and the bank opened for business in 2000. The OTS is the primary Federal regulator for this $1 billion FDIC-insured depository institution and the consolidated regulator for the savings and loan holding company. In January 2007, the OTS was informed that its holding company supervision was deemed equivalent to that required by the coordinator under the European Union's Financial Conglomerates Directive.

My written testimony goes into detail about OTS' oversight of AIG, including our annual examinations of the company; targeted reviews of its subsidiaries, including the AIG Financial Products operating business; our reports on the findings of those supervisory activities; and follow-up communications with AIG's management and board of directors to address OTS concerns.

In my statement today, I would like to highlight just a few points.

The rapid decline of AIG stemmed from liquidity problems in two AIG business lines:

One, credit default swaps. A credit default swap is derivative instrument that provides insurance-like protection to investors against credit losses from the underlying obligations which were typically mortgage loans.

And, two, securities lending, a business strategy implemented by a handful of AIG State insurance subsidiaries.

It is important to note that AIG stopped originating credit default swaps that were linked to subprime borrowers in late 2005. By that time, however, the company already had $50 billion worth of such instruments on its books. AIG halted these activities while the housing market was still going strong, but the company's model forecasted trouble ahead.

Another important point is that AIG's credit default swaps were protecting against credit losses on the highest rates, super-senior, AAA-rated tranche of collateralized debt obligations. This segment of the securitization poses the least credit risk. In fact, as of September 30 of 2008, there have been no actual realized credit losses from the underlying CDOs.

AIG's crisis resulted from the enormous sums of liquidity required to meet collateral calls triggered by one of the following events: a rating agency downgrade of the company, a rating agency downgrade of the underlying CDO, a reduction in the market value of the underlying CDO.

AIG's securities lending program, which began prior to 2000, lent securities from the State insurance companies to third parties who provided cash collateral in return. As a general theme, the cash collateral was reinvested in residential mortgage-backed securities. With the turmoil in the housing and mortgage markets over the past 2 years, these mortgage-backed securities experienced sharp declines in value. When the trades expired or were unwound, the cash collateral had to be returned to the counterparty. This created unprecedented liquidity pressure for the company. The cash requirements of the program significantly contributed to AIG's crisis.

I think these are the keys to understand how we got to where we are today. As to where we go, I see two lessons.

Number one, the credit default swaps at the center of AIG's problems continue to be unregulated products. New regulations governing these complex derivative products are essential. The announcement of the President's Working Group on Financial Markets in November of last year to implement a central counterparty service for the CDS is a good beginning.

The AIG story makes a compelling argument for establishing a systemic risk regulator with the authority to examine the sources to address temporary liquidity crises and the legal authority to perform receivership activities if failure is unavoidable.

Thank you, Mr. Chairman, for inviting me to testify this morning. I look forward to responding to your questions.

Chairman DODD. Thank you very much.

Mr. Dinallo, welcome to the Committee.

STATEMENT OF ERIC DINALLO, SUPERINTENDENT, NEW YORK STATE INSURANCE DEPARTMENT

Mr. DINALLO. Thank you, Chairman Dodd, Ranking Member Shelby, and other Senators.

I think that to some extent, AIG is a microcosm of our regulatory regime, love it or hate it, and I want to try to explain what I think were the roles of at least the State insurance regulators here and try to clear up any confusion about responsibility that I know existed a couple of days ago, although it sounds like a lot of that has been clarified.

I think the State regulators did a very good job on what their main assignment is, which is solvency and policy holder protection. I think that the operating companies of AIG, particularly the property companies, are in excellent condition. The life insurance companies are experiencing a lot of the same stresses that other life insurance companies are experiencing across the country and the world.

I think that it is important to put some of these numbers in context, because I disagree with the concept that the securities lending program had much of anything to do with the problems at AIG. We calculate that without the Federal intervention, the life insurance companies are approximately $10 billion solvent, so they were solvent prior to the intervention.

The amount that was written, on Senator Shelby's numbers, the amount that was written and put into the securities lending pool wasn't a leveraging, it was a direct undertaking, would be, say, I think $40 billion was invested in RMBS. That would be against $400 billion of assets in the life insurance company. So there was 10 percent invested in AAA-rated RMBS. The loss, as you say, we will adopt the number of $17 billion. So that is less than 5 percent of the losses of the assets at the life insurance companies could be laid at the door of securities lending investing in RMBS, which I submit $17 billion is a big number, but as a percentage basis, I think it is not an overwhelming number. I would say that the securities lending business was used to expose itself to RMBS businesses. But if you look at the entirety of the assets as invested by life insurance companies, it was a modest percentage.

I think the Financial Products division had a huge causation on this. I think that Chairman Bernanke was correct a couple days ago when he described that causation. And the amounts of money are staggering. The securities lending business, as I said, you would put somewhere in the $75 billion range. The Financial Products division had notional exposure through CDSs and derivatives of $2.7 trillion. That is larger than the gross national debt of Germany, Great Britain, or Italy.

I do agree with both of your statements that what they essentially did was they wrote a form of insurance without anywhere near the capitalization that you would have for such an activity if you were in a regulated insurance company. They are the ones that created the systemic risk, and that systemic risk rolled through the operating companies, including causing the run that you described, Senator, on the securities lending business.

The securities lending business, which is something that I am happy to discuss with you, although New York only had about 8 percent exposure to it, is not the purpose or the reason for the Federal bailout. If there had been no Financial Products division involvement, I don't think there would have been any bailout of AIG's operating companies, certainly not the securities lending business.

I think it was caused by, A, the run on the bank, and also, of course, the Federal Government had to detangle it in order to sell the operating companies. So they essentially removed the remaining securities from the operating companies in the securities lending business in order to sell the assets. Those assets are the ones that are going to go to pay off the loan. So it is the solvency in the operating companies that are going to go to pay off the Federal loan that is necessary because of what Chairman Bernanke described as essentially a bolted-on hedge fund of Financial Products division.

When we came into the department, we did begin to take seriously some of the issues around securities lending, and I can detail that during question and answer. But we began to work it down starting in the beginning of 2007 by 25 percent. We got the holding company to guarantee $5 billion of the losses. And in July, we sent a circular letter to all of our companies saying this is something that you need to start to examine. It does have exposure to the mortgage underwritings and securitization.

And indeed, I will just tell you that we have subsequently sent out 25 letters to our regulated entities to look into securities lending businesses. Frankly, they have actually performed pretty well across the board. AIG is the lone securities lending business that has had this kind of problem of the 25 that we looked at, and I would hypothesize that it is because of the run on it and the run on it came directly because of the need for massive collateral and the run on Financial Products division.

I think that there are some lessons that we can discuss. I certainly think that one of them is a revisitation of Gramm-Leach-Bliley. We did not completely abrogate Glass-Steagall, thank God, or you would have the operating dollars of policy holders being used for the hedge fund activities. But we have, I think, seen for the first time that the creation of financial supermarkets can have a, what I would almost call a knock-on effect on the operating companies to which they are related.

The portions of the company that involves itself in leverage, which securities lending did not do any leverage, has the potential to commit itself so heavily that when there is a financial downturn and there is a need for liquidity which they simply didn't have, the operating companies are looked to as an opportunity for that liquidity, but because they are regulated, fortunately, against that, they can't put up the liquidity and you have a downgrade. You have people asking for collateral which doesn't exist at the holding company level, which the State regulators do not regulate. And you have the systemic effects of basically some of these companies' future being questioned, whereas actually the underlying solvency of them and the quality of them as operating companies, as Chairman Bernanke said 2 days ago, I think are actually—should be unquestioned.

Thank you.

Chairman DODD. Thank you very much, and again, we welcome the presence of all of you here this morning.

Let me begin. I have basically four questions that I would like to address. The first is who owns AIG? Second, who did the Fed rescue, in a sense? Who regulates AIG? And what has been the legal authority for the Fed activities?

So let me begin with you, Vice Chairman Kohn. Does the Federal Reserve Bank, do you own AIG?

Mr. KOHN. No, sir. The U.S. Treasury has the equity interest in AIG.

Chairman DODD. So the Treasury owns AIG?

Mr. KOHN. Owns 79.9, up to 79.9 percent.

Chairman DODD. The Fed required AIG to give 80 percent ownership to the government as part of receiving a loan from the Fed in September. It took almost 4 months, until January, for the New York Fed to select trustees—it is the Fed's responsibility to select the trustees—to represent the interest of the government. Between September and January, AIG went on record with the largest quarterly loss in corporate history in the United States. I might point out, it also set aside $1 billion in lavish payments to employees.

During the fourth quarter of 2008, who represented the government's 80 percent ownership of AIG?

Mr. KOHN. The Federal Reserve was deeply involved in interacting with AIG through this period. The Federal Reserve Bank of New York put a number of people onsite at AIG, and people at the Federal Reserve Bank of New York, in close consultation with the Treasury, were interacting with AIG as they were putting together their plans for selling off parts of the company in order to repay the loan.

So it is true that the trustees were not named until January, but on September 16, the government in the form of the Federal Reserve, working with the Treasury, became very deeply involved in the overall strategy of the company.

Chairman DODD. Why did it take so long to name the trustees? Explain that to us here. This is really a massive amount of money being involved and——

Mr. KOHN. I don't know. I don't know what was the delay in naming the trustees, but I know that the fact that the trustees weren't named until January is not indicative of any absence of concern by the Federal Reserve and the Treasury or absence of oversight by them.

Chairman DODD. I mentioned in my opening statement that the Federal Reserve made a decision to pay off at par value sophisticated investors who owned credit derivative swaps underwritten by AIG and who could also give to the Fed the security that those CDSs covered.

Mr. KOHN. Right.

Chairman DODD. The Fed created Maiden Lane II to conduct this operation. In most cases, those securities were trading well above par, sometimes—excuse me, well below par, sometimes 50 cents or lower on the dollar. And in bankruptcy, the CDS holders could have only expected pennies on the dollar, given AIG's financial situation.

Specifically, who were the largest counterparties that Maiden Lane III bought securities from, and will you provide, that is the Fed to the Committee, a full list of all those companies that sold securities to Maiden III, including the price at which those assets were sold?

Now, I know the question will be, we were providing loans here. This was loans, and providing loans is a different matter than owning them. But it seems to me that these were—these transactions by an SPB that is wholly owned and controlled by the Fed, there is no stigma for those who sold to this entity. Therefore, the objection, it seems to me, would be obviated or gone that historically has been given in matters like this. And I know in the past that the Fed, in responding to other Congressional committees, has indicated they would provide those names. What is the response of the Fed this morning to that inquiry?

Mr. KOHN. Mr. Chairman, I agree that the Federal Reserve needs to think very carefully about what it is revealing, the transparency of its operations across a broad range of our operations today. We are in a new world and new types of transparency are required. In fact, Chairman Bernanke has put me in charge of a committee to look at how we can be more transparent about a variety of our operations.

With regard to these particular operations, there are a lot of counterparties benefiting from the efforts of the government and the Federal Reserve to stabilize AIG, not just a few, but many of the pension funds, households, businesses, and people with insurance policies, 401(k)s, *et cetera,* and a whole variety of counterparties here. These counterparties, I think, entered into their transactions with AIG as normal commercial transactions, expecting confidentiality, as you would in a normal commercial transaction.

In fact, AIG and the Federal Reserve went to these counterparties to tear up the credit default swap arrangements because they were draining liquidity from the company, and we thought that canceling those arrangements, buying the CDOs, would protect the taxpayers and stabilize the company as best we could under those circumstances.

So they didn't approach us and say, we want to tear up these contracts. We approached them because we were trying to help the company and help the U.S. taxpayer and take some of the downside risk off AIG's balance sheet.

I would be very concerned that if we started revealing lists of names who did transactions with companies who later came under government protection, got capital, that sort of thing, that people just wouldn't want to do transactions with companies. We need AIG to be a vital part of our credit markets. As you said, Mr. Chairman, insurance companies are absolutely essential to keeping credit flowing.

We need AIG to be stable and to continue in a stable condition, and I would be very concerned that if we started giving out the name of counterparties here, people wouldn't want to do business with AIG. We need people to do——

Chairman DODD. I understand that——

Mr. KOHN. ——business with AIG, and I would be concerned that other people, fearing that some other entity that they were doing business with who now was getting TARP capital, might in the future get TARP capital, that the same demands would be made on them. They would draw back from doing business with those folks.

So I think not being transparent about those counterparties, not revealing the names of those counterparties——

Chairman DODD. But these are counterparties to Maiden——

Mr. KOHN. Maiden Lane III, that is right.

Chairman DODD. ——not AIG.

Mr. KOHN. But they started as counterparties to AIG——

Chairman DODD. It is very——

Mr. KOHN. ——and they became counterparties to Maiden Lane III as part of the government's effort to stabilize AIG.

Chairman DODD. I understand the rationale, but to make the case here that we can't reveal these, now we have got a lot of taxpayer money tied up in this. They were being paid at par at the time we clearly knew these securities were worth a lot less than par.

Mr. KOHN. We paid them market value for the securities, but they had already collected more from AIG in margin payments.

Chairman DODD. All the more reason that we ought to know who they are. So the answer from the Fed is, despite earlier testimony, we will not get the names of these counterparties?

Mr. KOHN. My judgment would be that giving the names would undermine the stability of the company and could have serious knock-on effects to the rest of the financial markets and the government's efforts to stabilize them.

Suppose you were doing business with another large systemically important financial institution that already has government support or might later get government support and you didn't know what form that would take. It could take the form of another Maiden Lane——

Chairman DODD. I understand that. Just understand, as well, that public confidence in what we are doing is at stake and that right now, the public is deeply, deeply troubled by all of this, and it is their money that is being poured into these operations. And they, frankly, don't understand, nor do we, understand the legal arguments you are giving. But at a time we need to engender public trust and confidence in these very difficult steps, that kind of an answer undermines that effort very significantly.

And so I would urge you here—and others may have a different point of view—that you go back and review the answer you have just given with the Chairman and other Members to determine whether or not there is a better answer to this question, because again, in the absence of it, it is going to be extremely difficult, in my view, for the coming requests I am sure will be made of us and this body to be supportive of the efforts to provide the resources, to provide some hope that we will get out of this mess.

But we are going to have an awfully difficult time doing that, it seems to me, an awfully difficult time anticipating Congressional support here to provide that kind of financial backing if, in fact, we can't get answers to this, why someone was being paid at par, in a sense, when the value was far less and we now can't find out who they were and the answer to who was actually being rescued.

Now, I have additional questions and my colleagues do, as well, but that is not a satisfactory answer, I would say to you, Mr. Vice Chairman, and I would urge you to review that answer and see if there can't be a better one. I know that in the other committee in the other body, a more favorable response was given, but no answers have been provided, and I am sure for the very reasons you have outlined, and I appreciate your answer, but I don't consider that an adequate one, to put it mildly.

I have additional questions here, but I have already taken up a lot of time on this point alone and so I will turn to my colleagues, but we will have a second round. Clearly, we will have that.

Senator Shelby.

Senator SHELBY. Governor Kohn, I just want to pick up on what Senator Dodd is talking about. If the American taxpayers' money is at stake, and it is, big time, I believe the American taxpayers and people in this Committee, we need to know who benefited, where this money went. There is no transparency here. And we are going to find out. The Fed and Treasury can be secretive for a while, but not forever. I think your answer here today is very disturbing.

As Senator Dodd has already alluded to, you are going to be coming back for more money and more money and more money, and the people want to know what you have done with this money, but more than that, like Senator Dodd just brought up, who benefited from this, because a lot of the people don't believe that the American people have benefited. At least they haven't felt it. So your answer might be the Fed answer, but it is not going to be the answer we are going to accept, and the American people aren't going to accept.

I want to now pose some questions to the Superintendent. Superintendent Dinallo, do you agree with all of the following statements. First, the New York Insurance Department reviewed and monitored AIG's securities lending program. Second, AIG's securities lending program heavily invested in long-term mortgage-backed securities. Three, AIG Life Insurance suffered approximately $20 billion in losses related to their securities lending operations last year. And fourth, the Federal Reserve has provided approximately $17 billion to recapitalize AIG Life Insurance Companies?

Mr. DINALLO. I think those are fair statements. The only one——

Senator SHELBY. What is your answer?

Mr. DINALLO. Well, yes, but on the very first one, I would say that when we—prior to 2007, I don't think it was monitored as well as it should have been, so I am actually agreeing—what you want to get from me, I will agree with you. I don't think it was as coordinated and as monitored, given it was a group activity, as you pointed out, as it could have been——

Senator SHELBY. So my question was, did the New York Insurance Department, which you headed, reviewed and monitored AIG's securities lending program, and you say not adequately, is that right?

Mr. DINALLO. Well, for the—no. For the 10 percent—our companies had 8 percent exposure to it. For that 8 percent, we did monitor it, yes. So we were not responsible for the whole securities lending program, sir. I just—I am just telling you what we did was about 8 percent. As I said, we have about 10 percent of the life insurance companies we regulate in the AIG holding empire and we monitored that 8 percent exposure.

Senator SHELBY. Your testimony, I believe, is ambiguous as to whether you believe AIG's securities lending facilities were activities of its insurance companies or of a non-insurance subsidiary. I think it is clear that they were activities of the insurance companies. Do you agree with that or disagree?

Mr. DINALLO. I, in part, disagree.

Senator SHELBY. And how do you disagree?

Mr. DINALLO. Well, because it was coordinated—it was orchestrated and coordinated by the holding company, by the holding company management, by the management of the holding company. They essentially set up a securities lending pool. You could not do it without holding company support. In fact, our agreements with the holding company under the "make whole" clauses that we established for $5 billion were with the holding company. So it is not—again, I am not trying to be evasive. It is not that clear. It is true that we were responsible for our exposures——

Senator SHELBY. Are you trying to evade your responsibility?

Mr. DINALLO. Oh, no. I am fully—I take as an agency full responsibility for the, I think percentage-wise, small losses in securities lending that our insurance companies—well, it is by a percentage, Senator, you are talking on your own telling, it is about $17 billion out of a 400——

Senator SHELBY. You call that small, $17 billion?

Mr. DINALLO. Seventeen-billion out of a 400–500 billion dollar portfolio of assets is about less than 5 percent, and I think that although it is unfortunate they invested in any RMBS, those are very small percentages compared to other institutions that have been completely blown out and decimated literally by RMBS. So I think I am just telling you the honest percentages.

Senator SHELBY. OK.

Mr. DINALLO. It is true that the RMBS exposure for the securities lending business was about 60 percent, but that still is a very small piece. That $40 billion was only 10 percent, or actually about 8 percent of the total life insurance assets.

Senator SHELBY. So if you are not taking the responsibility or accepting all of it, aren't you, in a sense, saying you are handing over the assets to a non-insurance entity? AIG insurers got the upside. The taxpayers got the downside. And you can claim here today that you have little responsibility, if any, for all of these problems.

Mr. DINALLO. No, I don't agree with that—I am sorry, Senator. I do not agree with that——

Senator SHELBY. Are you accepting responsibility——

Mr. DINALLO. The insurance companies maintained ownership and control of the assets. We monitored the amounts. We monitored the amounts for the New York State domestics. Do we take responsibility? I would first say that management should take responsibility for the losses, but we were the regulator. There is no dispute about that. But the losses are not a very large percentage of the operating companies' total assets, and I think that is an important fact. You had an amount that is about $40 billion as opposed to the notional exposure of Financial Products division, which is $2.7 trillion. You are dealing with a peanut across a trillion-dollar asset balance sheet.

Senator SHELBY. Would you like to comment on that, Scott?

Mr. POLAKOFF. Yes, Senator. When you look through the weeds, it is clear that the various insurance subsidiaries that participate in the security lending business, the insurance commissioners had responsibility for understanding and approving any agreements between the insurance companies and the entity that was formed for the security lending business and any of the losses that were recorded were recorded on the insurance company's books. The Insurance Commissioner's staff would have known that when they looked at the books and records.

Senator SHELBY. Were these securities lending losses greater than the statutory cap? For example, in 2008, it is my understanding that American International Life's statutory cap was 662 and the losses were 771.

Mr. DINALLO. No. As I said in my opening statements, our calculations are that even after taking into account the losses for the securities lending, the U.S. life insurers were $11 billion to the solvent side. They were not insolvent. And that would be going to statutory accounting, yes.

Senator SHELBY. Governor Kohn stated in his testimony that, quote, "A substantial contributor to AIG's massive fourth quarter losses were the losses on AIG's investment portfolios that are primarily, primarily attributable to its insurance subsidiary's holdings." In light of those facts, do you care to modify your prior testimony that AIG's problems did not come from its insurance operations? This is your testimony——

Mr. DINALLO. I fundamentally——

Senator SHELBY. ——Governor——

Mr. DINALLO. I fundamentally believe that the problems at AIG had absolutely nothing to do—the problems for which we are on a national stage here had nothing to do with the operating companies. There are—by the way, there are problems with State insurance regulation. I have been a proponent of us revisiting it. I think it is clunky. I think it has issues. But the solvency, the capital requirements of these insurance companies were done well and I am proud of how the regulators maintained themselves. I don't understand—I am not of any other opinion that the operating companies' ex-Financial Products division would have been just fine. In fact, arguably, AIG would be flourishing in this environment.

Senator SHELBY. Sir, AIG's most recent annual report states that, quote, "The two principal causes for its unprecedented strain on liquidity during the second half of 2008," and these are their words, "were a demand for the return of cash collateral under the U.S. securities lending program and collateral calls on credit default swaps issued by the Financial Products subsidiary."

Mr. DINALLO. And I agree with that. I am sorry.

Senator SHELBY. ——with the firm's analysis of its own problems?

Mr. DINALLO. No, I don't actually disagree with that. I agree with it. The only difference is causation. As I said, the 25 other domestic life insurance companies that we have examined have not had a problem with their securities lending. The causation of AIG's problem with its securities lending business was essentially the run on the entire company caused by its exposure from Financial Products division.

Senator SHELBY. Could you briefly walk us through the balance sheets for the life insurance companies under your jurisdiction? What was their capital at the start of 2008 and what were their losses in securities lending in that year? If you would take just a second. I know my time is up, but I think that is important.

Mr. DINALLO. The capital surplus at the end—capital and surplus at the end of December 31, 2007, was $1.7 billion. And, Senator, sorry, what did you want me to—and what else do you want to know? I apologize.

Senator SHELBY. I thought you could walk—I know that our time is very important here. If you could walk through the balance sheets of the life insurance companies under your jurisdiction, what was their capital at the start of 2008 and what were their losses——

Mr. DINALLO. $1.7 billion.

Senator SHELBY. That is all of them? And the losses were what?

Mr. DINALLO. Yes, and then you had a loss of $1.8 billion for that year. You had a contribution of 0.7. You had a net surplus of 0.5. So you ended up with—yes, right, I am sorry. So the net surplus at the end, including the contribution, is $500 million. So there was a net surplus of $500 million.

Senator SHELBY. Was that before or after the Fed put their money in?

Mr. DINALLO. After.

Senator SHELBY. After the Fed——

Mr. DINALLO. No, I am sorry. I am sorry. It was before, and then the capital contribution was—yes, and then the Fed put in 1.9 afterward. So it was a $500 million surplus, and then on top of that the Fed put in 1.9 to basically buy and unwind the securities.

As I said, there was—I believe our calculations across all the life insurers, there was an $11 billion surplus. And for the New York insurance companies, of which it is 8 percent of the total, 8 percent of the total was $500 million surplus, and the Fed then bought off the books, basically, the securities, the remaining securities.

So as I have said, I am not ungrateful for what the Fed did because it permitted us to untangle this. But there would have been solvency with or without the Fed action. That is all that I am pointing out.

Senator SHELBY. Have you untangled it, or are you in the process of untangling it?

Mr. DINALLO. It is completely severed now. So the concept of continued systemic risk from securities lending, to the extent anyone thought there was—and I would not agree that there was—it is a completely severed situation, because in order to sell the operating companies to various buyers to pay off the loan that you authorized them to give, you had to untangle the operating companies from the securities lending pool, and that required the Fed to buy $20 billion at face value of the securities. Those may actually perform well. They may not. But they were bought at the market price so we could unwind securities lending pool so we could sell the operating companies that have huge value.

Senator SHELBY. Thank you.

Chairman DODD. Thank you.

Senator Johnson.

Senator JOHNSON. Mr. Kohn, on Tuesday, Chairman Bernanke testified before the Senate Budget Committee and said that AIG exploited a huge gap in the regulatory system. Can you expand on Chairman Bernanke's statement about regulatory gaps?

Mr. KOHN. Yes, I can, Senator. I think the problem here—and it has been a little bit illustrated by the back-and-forth we have heard this morning about who was responsible for what—is that no one was responsible for the whole company. There was no umbrella regulator over the whole company, and there was a piece of the company, Financial Products, that really was not being supervised and regulated by anybody. And that piece of the company was able to exploit the AAA rating which arose from the insurance entities to get what looked like a very profitable business for a while in writing this credit protection, these CDSs. But they did not take appropriate account of the risk. They did not protect themselves against a very unlikely event, which was a massive weakening in the housing market and the economy. That unlikely event has come to pass, and those losses have come back to the whole company, weakening the entire company.

There are a number of things that contribute to this, as the previous dialog suggested, but this unregulated piece of the company certainly was a major contributor to the weakening. So I think the gap is that that piece was not regulated. It was part of a systemically important financial institution, the largest insurance company in the United States, one of the largest in the world, and no one was minding the whole company and looking at how things interacted and whether the whole company would under some circumstances put the financial system at risk. So I think——

Mr. POLAKOFF. Senator, may I make a comment?

Senator JOHNSON. Yes, please.

Mr. POLAKOFF. There may be a slight difference of opinion, and it is time for OTS to raise their hand and say we have some responsibility and accountability here. This entity was deemed a savings and loan holding company. We were deemed an accepted regulator for both U.S. domestic and international operations. The segment, this AIG Financial Products, was an unregulated, as that term is defined, subsidiary of AIG, but part of the overall consolidated regulator responsibilities of OTS.

Senator JOHNSON. Mr. Kohn, on Monday, the Federal Government announced revised terms of its assistance to AIG in order to strengthen the company's restructuring efforts and to further protect taxpayers from future losses and reduce the risk of further destabilizing the broader economy. How will the new terms protect taxpayers and help stabilize the economy?

Mr. KOHN. I think a major effort in the new terms, first of all, the Treasury put some contingent capital in. They made capital available to help protect the company and stabilize the company, which the company will draw on over time as it needs it.

Second, the Federal Reserve restructured its debt to really facilitate this process of breaking apart pieces of the company and taking them public or finding buyers—getting them in a condition that they might be more attractive to outside sources of capital to others who might be interested in buying these pieces of AIG, which would then help to repay the debt and earn a return for the taxpayers.

So we did that in part by transferring some of our debt to a preferred interest in two major insurance companies operating outside the U.S., to a trust that owns those. We did that in part by taking security for some of our debt as to the cash-flows on life insurance policies, securitization of life insurance policies, gradually helping the company prepare itself for getting down to its core businesses, selling the other businesses so it could return the cash.

Senator JOHNSON. As Congress considers regulatory modernization, is there a need for Federal insurance regulation?

Mr. KOHN. I think that is something that should be considered, but I do not have a strong view. I think that is something that should be considered as part of the overall look at regulation. I think my first priority would be to get some overall regulator for every systemically important institution, wherever that might be. But the Federal charter is an option you should be looking at, I think.

Senator JOHNSON. I yield back.

Chairman DODD. Thank you very much, Senator.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Dr. Kohn, we are miscommunicating. You are not communicating with the Committee, and the Committee must not—you must not be hearing what we are saying. We have put in approximately $170 to $180 billion into one corporation, and you are telling us that the counterparties—the counterparties that got par for their bonds or for whatever should not be—the American taxpayer should not know who they are. And then you may come back to us and ask for more money for more banks and more corporations. You will get the biggest "No" you ever got. I will hold the bill. I will do anything possible to stop you from wasting the taxpayers' money on a lost cause. And that is what AIG is. It is a lost cause.

The other day in the Budget Committee someone said, "What is the bottom line on AIG?" Is it $1 trillion? Is it $2 trillion? Where is the bottom line as far as the American taxpayer is concerned? Do you have an answer for that?

Mr. KOHN. I cannot give you a number, Senator Bunning. We have done with the Treasury what we can to stabilize the company. I think the exit strategy here is clear: stabilize the company, have it sell off non-core businesses, use that money to repay the taxpayer. As our press release said, I cannot guarantee you that——

Senator BUNNING. I am not interested in a press release. I am interested in facts. We all give out press releases. Factual numbers and factual data in the press release are not necessarily what the real facts are.

Can any of you give us an estimate of potential future losses at AIG? In other words, how much more public money is going to be needed to keep it afloat?

Mr. KOHN. I think I already responded——

Senator BUNNING. I just asked could anybody.

Mr. KOHN. No, sir.

Mr. DINALLO. Senator, the only facts I could give you on this that might be helpful are twofold: The securities lending issue is over, and it cost about $17 billion. And the second fact is that, to the extent the American public are ever repaid on this, it will be from the proceeds of selling the insurance operating companies, and——

Senator BUNNING. That is why the stock is at 50 cents?

Mr. DINALLO. Yes, the stock—well, that is a very good point, because, I will tell you, the markets—that reflects a belief by the markets that at the end of all these transactions, there will be little equity value. But that does not—but first you pay off the Federal Government before you would see equity. So that is actually—the fact that the markets even think there is 50 cents at this point is actually——

Senator BUNNING. That is only because $170 to $180 billion has been put into the company by the Federal Government.

Have any of you seen a document titled "AIG: Is the Risk Systemic?" It was supposedly written by AIG to justify Federal support. Have any of you seen that document?

Mr. POLAKOFF. I have not.

Senator BUNNING. You have?

Mr. DINALLO. I have seen it, Senator, yes.

Senator BUNNING. Would you please furnish a copy of that document to this Committee?

Mr. DINALLO. Should I give it to you right now?

Senator BUNNING. Well, the Committee.

Mr. DINALLO. I have it.

Senator BUNNING. OK, we would like to have a copy of that. Thank you very much.

Senator BUNNING. I heard from Dr. Kohn that he thought somebody should be given super-regulatory powers over entities like AIG that were in more than one jurisdiction, New York regulation of their insurance company, the chairman in England that was in the credit default swap business, and all these other things. Who do you think that should be?

Mr. KOHN. I do not know, Senator. I think that is something that you and the regulators need to talk about and think about. I have no firm view on who that should be. I think the most important thing is that for systemically important organizations that there be one.

Senator BUNNING. Thank you very much. My time has expired.

Chairman DODD. Thank you very much, Senator Bunning.

Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Governor Kohn, after listening to Mr. Polakoff describe his responsibilities, do you still stand by the statement that Financial Products is an unregulated entity that exploited a gap?

Mr. KOHN. I think—Mr. Polakoff can answer this better than I can—but I think that the focus of the regulation that existed under Gramm-Leach-Bliley was focused very sharply on the depository institution, and the theory was that if we protect the depository institutions, then we have protected the taxpayer so we do not have a repeat of 1991 in FDICIA and the taxpayer coming in. And the depository institutions are key to protecting the stability of the financial system. And I think what we have learned over the last 18 months is that the focus of the systemic regulator, the umbrella regulation authority, needs to be very wide. They need to be looking at all kinds of interactions that are not necessarily related to the depository institutions.

I think there was some oversight by OTS, but it really was not focused where we needed to focus.

Senator REED. Well, I am alarmed, because if the Fed has that position, it seems to contradict exactly what Mr. Polakoff said he did. In fact, OTS was recognized as an equivalent regulator for the purposes of AIG consolidated supervision—not regulating the Federal savings bank, consolidated supervision by EU; that, in fact, in 2005 OTS conducted several targeted risk-focused reviews of various lines of business, including AIG Financial Products; made numerous recommendations to AIG.

In your view, Mr. Polakoff, were you simply responsible for the depository institution and everything else was sort of free game?

Mr. POLAKOFF. I do not think the Governor and I are differentiating too much, but we were clearly responsible as the consolidated regulator for FP. We in 2004 should have taken an entirely different approach than what we wound up taking regarding the credit default swaps, but, nonetheless, we should have taken a different approach.

Senator REED. You were also engaged in terms of as an international regulator, at least participating, as you point out in your testimony, you would have conferences with other regulators, including the FSA. One of the operations was in London. Can you describe the insight you had into the London operation?

Mr. POLAKOFF. We had regular contact with the FSA. We would send examiners over there to look at operations. The FSA would reciprocate and send examiners here. We had annual supervisors conferences where all the foreign regulators, the State insurance commissioners came, at least once a year. We had regular contact throughout the year, certainly as things deteriorated with all of the regulators and PricewaterhouseCoopers, the external auditors.

Senator REED. So the perception that this London operation was some rogue sort of group that were unsupervised, that you had no access to, that your regulatory authority did not reach there, is not accurate?

Mr. POLAKOFF. Correct. That would be a false statement.

Senator REED. You say that the biggest fault of OTS was not recognizing the magnitude of the situation developing with respect to credit default swaps. In which way were you prevented by your regulatory structure or by your resources from recognizing the magnitude? Which I think Mr. Dinallo estimates about $2.7 trillion.

Mr. POLAKOFF. It was neither, and I think it is important for us to remember that the issue with the credit default swaps is $80 billion worth of credit default swaps that were written on CDOs that were multi-section CDOs. Really what we are talking about is $80 billion worth of credit default swaps.

These were written on AAA, super-senior tranches of the CDOs. The company stopped writing these in 2005. The holders of the CDOs still have not sustained an actual loss. All the losses that we are talking about, all of the collateral calls, represent market value deterioration. If these instruments are held to maturity, these instruments could pay out at par. It is a market value issue as we speak today.

Senator REED. Let me raise a question with Mr. Dinallo.

As Mr. Polakoff pointed out, in 2005 AIG Financial Products made the decision—I think there was—at your suggestion or independently?

Mr. POLAKOFF. Independently. I give the company credit for that.

Senator REED. To stop investing in mortgage-backed securities. But at that very time, in the securities lending program, the individual running that program decided to aggressively get into mortgage-backed and asset-backed securities. You have already indicated that your stewardship before 2007 was—you would like to have seen it a bit better, to be polite, but did you have any knowledge that one part of AIG had made a determination that these investments were too risky and another part of AIG that you had access to decided to aggressively get involved?

Mr. DINALLO. Well, I was not aware of those decisions of the Financial Products Division. Starting in 2007, we did begin to wind down—the New York Insurance Department led the group that began to wind down this securities lending. We brought it down by 25 percent. We began coordination that I would say probably did not exist before, as the Senators have pointed out before.

But there is a difference, I think, there is a difference between managing down an investment and having already committed to default protection across—I think it was about $460 billion in credit default swaps.

Senator REED. Let me pose just one quick question to you, Mr. Polakoff. This goes to kind of the management of the company. There was a conscious decision made by Financial Products that it is too risky to stay engaged in these asset-backed CD—mortgage-backed securities and this type of credit default swap. But another division plows into it with great gusto. Were you aware of that? Did you try to communicate to other regulators or do you find that alarming, that within the company there was a conscious decision independently made to stop doing this, and at the same time they allowed others to do it?

Mr. POLAKOFF. Well, I think our respective staffs certainly at the annual conferences that we held communicated the various risks within this complex company. There is a difference between, as you know, underwriting credit default swaps and actually investing in residential mortgage-backed securities. Nonetheless, Senator, as you described, the theme should have been consistent in both parties. And certainly, in listening to the testimony today, I think it is worthy for us to go back and chat with our staffs as to what was communicated.

Clearly, we know in the supervisors' college in 2007 we discussed the risks of the credit default swaps in FP, and I suspect that the various State insurance commissioners had ample opportunities to discuss in the supervisory colleges the risks that they were identifying.

Senator REED. Thank you very much.

Mr. Chairman, thank you.

Chairman DODD. Thank you.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman.

Mr. Polakoff, I am a little confused by the testimony. You keep referring to the fact that there have been no losses whatsoever in the super-senior AAAs, but there were credit default swap losses in the other segment, the second loss segment. Is that correct?

Mr. POLAKOFF. Yes, sir. It is a complicated subject. If I could offer——

Senator CORKER. I do not want—my point—I do not want to go down that path, really, but so when you keep saying that, it is, I think, somewhat confusing because there were credit default swap losses on a portion, a large portion of what they were selling. Is that correct? Just not the AAA, super-senior.

Mr. POLAKOFF. There was credit default swap exposure based on the market value depreciation, not on the credit losses in the CDOs.

Senator CORKER. On none of them?

Mr. POLAKOFF. Correct.

Senator CORKER. There have been no losses—this is kind of interesting. So you are saying that there have been no losses whatsoever on any of those obligations as far as the debt actually not being repaid to these particular individuals.

Mr. POLAKOFF. As of September 30, on the super-senior, AAA-plus tranches, I am saying that there was no credit loss.

Senator CORKER. OK. So let me move over to the Fed then. So, in essence, all of our losses, all the money the Federal Government has put—I think that is a real key point. It has all been about us—

these—I mean, AIG was the only entity in the world, I think, that sold these as insurance products where they would have to—and that were not—that were naked. In other words, they did not hedge off their risk. So, in essence, they had to keep—we have to keep on their behalf putting up collateral because of the way these products were written so that they would get a high rating. But yet the holders of this actually have not had any losses, credit losses yet. Is that correct?

Mr. KOHN. I believe that is correct, but let me clarify one point. The Federal Reserve—the taxpayers through the Federal Reserve—now own these CDOs against which the credit default swaps are written.

Senator CORKER. Right.

Mr. KOHN. So if, in fact, there are no credit losses on them and they pay off at par in the end, the taxpayer will realize the gain on that, because we paid market price for them when we bought them from the counterparties, who already had margins. So if they go up in value, five-sixths of that increase will belong to the taxpayers.

Senator CORKER. I have a hard time understanding the systemic risk issue then. The company was bankrupt. It could not meet its obligations. So, in our wisdom, we decided to fund all of this—this insurance product was drawn up so they had to put up collateral every time the value went down. If we had not funded that, there still was no systemic risk that I understand. If we would have had long on insurance, like most of Buffett's companies and others are, if we were long on insurance instead of this crazy mechanism that AIG had come up with, there still were no losses. So if we had just said we are not going to fund these, we will stand behind these as the Federal Government, but we are not going to fund the collateral in the interim, what would have been the systemic risk?

Mr. KOHN. If AIG had been unable to meet its obligations, it had an obligation to put up money not only for the CDS but for the RMBS that the securities lending was invested in——

Senator CORKER. I want to——

Mr. KOHN. ——and on Monday, September 15, it could not access the credit markets to get the funds that it needed, and Tuesday, September 16. If it had been unable to do that, if we had not extended the credit at that time, it would have had to go into bankruptcy court, and there would have been millions of counterparties to the insurance, the pension funds, all those folks would have been—as well as the counterparties on the——

Senator CORKER. But couldn't you have just——

Mr. KOHN. ——small part of it.

Senator CORKER. But couldn't you have just said this product was written up in an inane way, it is a ridiculous concept to have created an insurance product like this, we are not going to put up the collateral, I am sorry, the company is bankrupt. But what we will do as the Fed is we will stand behind the obligation so that in the event there is ever a credit issue, we will stand behind it. Wouldn't that have been a more intelligent thing to do?

Mr. KOHN. Our authority under the Federal Reserve Act is to make loans. We thought it was a short-term liquidity situation—in mid-September, this is what we thought—and that if we could bridge this situation with liquidity, then the company could make the adjustments to keep itself a going concern.

It turned out that the problems were deeper, the financial markets became a lot worse, and the whole situation deteriorated badly. I do not think we had the authority simply——

Senator CORKER. Well, it may not—I think this whole issue of authority is pretty incredible, and I think all of us realize that the Fed nor anyone else has the authority not only to deal with AIG but Citigroup or Bank—there is nobody. I mean, I think that is an amazing thing that for some reason only hits my alarm bell, nobody else's. But there is no entity in our country that has the ability to deal with an AIG, a Citigroup, a Bank of America, anybody. I find that pretty incredible. OK?

But I want to go back to this still. So the holders of these policies—most of us call it "credit default swaps," but these policies—have had no losses.

Mr. KOHN. That is right.

Senator CORKER. But in our wisdom, we decided on that fateful day, instead of just standing behind those, that we would fully fund those. And so that is also—I mean, we all thought—I guess AIG's whole thinking about this was the blunder of most major proportions in modern history, and I hate to say this because I like working with you and Chairman Bernanke. But it also sounds like that on that day, representatives of the U.S. Government made an equally large blunder of modern—largest in modern history. I mean, is that a fair assessment? Because if you had just stood behind it, we would not have any money out.

Mr. KOHN. Well, I do not agree with that assessment, Senator. This was before you had passed the EES Act, so the Treasury did not have the authority to go in and help with the credit risk the way it has under TARP. All we had was our lending authority under the Federal Reserve Act. Things have changed since September 16.

I agree with everybody that Financial Products was a major contributor to the problems of the company, but I think as people got in there, they saw that there were other contributors. So I do not think just taking that one piece—having the taxpayers take the risk for that one piece and made people whole at that time—would have been enough to stanch the bleeding. I think that was a serious situation. The financial markets were in very dire straits and becoming worse all the time. I think the problems were deeper and broader than just that one thing.

Senator CORKER. Mr. Chairman, I look forward to the second round. I think the line of questioning that you had on the front end regarding the payment of full value, when we all know these folks had hedges themselves—OK, I mean, they mostly were far more intelligent in thinking than AIG was, they all had hedges—and I think that line of questioning needs to be pursued further and I thank you for going that path.

Chairman DODD. Thank you very much.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

This is an area that I share Chairman Bernanke's comments about being angry. I am angrier than hell at what AIG has been able to get away with, and I am angry that regulators who, in my mind, should have seen the regulatory arbitrage that was taking place didn't bring it to the Congress's attention and say, hey, this is a gap that should be closed. The reason we have regulators is for them to be on the beat, not to be asleep at the switch.

We keep hearing that AIG has systemic risk. Well, even systemic risk has to be quantifiable. So my question is, after having given them another $30 billion to supposedly stop them from collapse, the fourth bailout that they have had, there are those who are asking when is the fifth and how much. So you must all, I assume, if we are doing our jobs here, thinking about best and worst case scenarios, and so what is the quantifiable risk here, particularly in your minds, in the worst case scenario, what are AIG's assets really worth, or do you even know?

Mr. KOHN. I don't have a calculation of a severe stress kind of scenario, what AIG's assets would be worth in those situations. I think what AIG is worth depends very, very importantly on the course of the economy and the financial markets from here on out.

Senator MENENDEZ. But shouldn't we be putting AIG through the same stress test that we are talking about in terms of financial institutions?

Mr. KOHN. We should be seeing what the——

Senator MENENDEZ. But I get a sense we are not.

Mr. KOHN. Well, I think we have done some of that, Senator, not to the same——

Senator MENENDEZ. Some of it? I mean, how can you keep coming back and asking for monies in which you cannot quantify for us the systemic risk and the assets here? You are asking for an open-ended check, and gentlemen, you are not going to get that, even from those of us who have supported this overall effort, forgetting about AIG for the moment. You are not going to get that.

You have got to quantify this risk. You have to tell us what is the level of the systemic risk. You have to give us a stress test analysis, as best as can be created, for us to quantify and figure out where we are going from here. But that doesn't seem to be the case right now.

I am also concerned—you can't give me what they are asking for. I am also concerned of what is happening in the property casualty insurance market here as a result of the government actions that we are taking with AIG. What steps—and I know that there is a GAO report underway, an inquiry underway to assess the impact of all of the aspects of the financial rescue package for AIG and the United States insurance marketplace, and it seems to me that because we are giving them all this money, they keep pricing their products in ways that would not be sustainable for any other insurance company in the marketplace and therefore becomes anti-competitive with the rest of the industry.

What steps are being taken to ensure that AIG's property casualty business is not being weakened, because at the end of the day, we may be the owners of it, and shouldn't there be an independent actuarial evaluation of their reserving and pricing practices here? Does anybody want to step up to the plate and answer that question?

Mr. DINALLO. I can answer some of that, Senator, if you would like me to. As far as the second part, we have received some of the competitors' allegations that you entail. We have been responsive to GAO. We are looking at them. In the property and casualty area, a lot of the rates are subject to prior approval, which means they can only actually come down—it is as dangerous, as you point out, to underprice as it is for consumers to overprice, because you could have an insolvency, so we are as mindful that companies aren't permitted to go down in pricing as much as we also worry about them pricing too high. And so I think we are being responsive to that.

Senator MENENDEZ. Is there any doubt in your mind that AIG is underpricing compared to——

Mr. DINALLO. I am not——

Senator MENENDEZ. ——marketplace?

Mr. DINALLO. I think that is subject to some debate and we are looking at it. I am not disagreeing that there have been allegations. I am sure you have heard from the same companies, Senator, and we are looking at it.

Senator MENENDEZ. Well, it seems to me that there is a real risk here that we are, by Federal money, providing AIG with the wherewithal to unfairly compete in this marketplace, and at the same time inheriting the risk of underfunding those liabilities.

So if you tell me you can't quantify the systemic risk, if you tell me you haven't done a full stress test analysis of what AIG is actually worth, if you tell me that you are not quite sure yet where they are in terms of this whole property and casualty markets, that is a recipe for disaster. It is just a recipe of throwing more money in a process in which we don't have a quantifiable baseline to determine where we should be going.

And gentlemen, if that doesn't happen yesterday, then I think we are in a set of circumstances in which you can't see any greater assistance here coming from the Congress. It is just not acceptable, and I think I will leave it at that, Mr. Chairman.

Chairman DODD. Senator Martinez.

Senator MARTINEZ. Thank you, sir.

Director Polakoff, I wanted to ask you, I was struck by your acknowledgement that perhaps you are the regulator that we have been looking for. I think that we had assumed that there wasn't one for the whole book of business. I want to delve into that and have you, as a follow-up to your statement, whether you can explain to the Committee what role you thought OTS has had in this company and whether you had the ability to look at the broadness of the whole entity and the multiple lines of business, particularly the one that seems to be the one that got them in trouble. So if you could please enlighten us and deepen a little bit on that comment.

Mr. POLAKOFF. Sure, Senator. I will give it——

Senator MARTINEZ. ——by the way, to say, me, I am the one.

Mr. POLAKOFF. I am the one, sir. This complex company is a savings and loan holding company, so at the very top——

Senator MARTINEZ. Define that a little more for me. What is a savings and loan holding company? Is it a company that—well, go ahead, if you would.

Mr. POLAKOFF. Any company that owns a Federal savings bank, *i.e.* an OTS-regulated entity, is by definition a savings and loan holding company.

Senator MARTINEZ. OK.

Mr. POLAKOFF. So in 1999, when OTS granted the Federal Savings Bank Charter, and when the institution opened in 2000, this entity became a savings and loan holding company, and that requires an application. We start obviously making sure that we understand the operations of this $1 billion Federal savings bank, because it is an insured institution. Then at the consolidated holding company level we look to the functional regulated entities to understand, supervise, and communicate the risk products to us.

For example, AIG, as a consolidated entity, is 85 percent represented by the insurance companies. We would look to the various State insurance commissioners to define the risk and then to communicate with us periodically throughout the year or at the supervisory college that we hold once a year, but throughout the year, what the risk is and what is being done. The issue becomes what is OTS doing for what we will call the entities that are not functionally regulated, and FP would be one——

Senator MARTINEZ. The non-insurance business?

Mr. POLAKOFF. Correct. Correct. The FP is the one that is under the most intense scrutiny today. I go back and I look at what we did over the years as we examined this company on a consolidated basis. We had throughout the years, many times, recommendations for action either at the consolidated level or at the FP level for better risk management practices within FP.

I stand on my prior statement, sir, that in 2004, we should have done a better job in identifying what the liquidity risk was associated with these credit default swaps and insisted on a plan to mitigate that risk. When the business stopped in 2005, what we had post-2005 was how do we handle this risk that is now on the books.

I would also—I have to remind myself and others that in 2004, this was a AAA-rated company and we were in an entirely different financial environment than we are now. Many of our models, many of our analyses, many of our discussions were driven by the economy that we were operating in in 2004 and 2005. It is easy to look back now in 2009 with some, we should have done X, Y, and Z, and we should have. A post-mortem is absolutely appropriate in this case.

Senator MARTINEZ. I think that is fair, and I think Monday morning quarterbacking is always a much easier thing to do. I think that also applies to Governor Kohn and some of the things that we have been discussing about what did or didn't take place in September of 2008. I understand that.

Now, tell me the relationship between the S&L holding company and the FMP part of the business. Was there a connection between the two, other than the fact that they were both part of the same holding company?

Mr. POLAKOFF. AIG FP was a subsidiary of the holding company, so——

Senator MARTINEZ. Of the S&L holding company?

Mr. POLAKOFF. No, no, of AIG Inc., the big holding company.

Senator MARTINEZ. Right.

Mr. POLAKOFF. FP was one of the subsidiaries.

Senator MARTINEZ. And the S&L?

Mr. POLAKOFF. Correct.

Senator MARTINEZ. Was another?

Mr. POLAKOFF. Correct. It is a very complex organization, so——

Senator MARTINEZ. Right, but they were parallel entities, but you felt you had the regulatory authority to look beyond the S&L business to the FMP business because it impacted the S&L?

Mr. POLAKOFF. By statute and by regulation, we have absolute authority to operate as a consolidated regulator to work with the other functional regulators in assessing risk.

Senator MARTINEZ. So when we say that the financial products part of the AIG business was unregulated, we would be wrong to say that?

Mr. POLAKOFF. That would be correct.

Senator MARTINEZ. I mean, it might not have been regulated as it should have been or as we look over the situation, maybe the regulator was not as prudent as maybe we should have been with hindsight, but there was a regulation in place, a regulator in place, maybe not in the way we would want to go into it in the future, but there was—you were the regulator——

Mr. POLAKOFF. Yes, sir.

Senator MARTINEZ. ——for that part of the business?

Mr. POLAKOFF. Yes, sir.

Senator MARTINEZ. Mr. Dinallo, I wanted to ask you about—well, I guess my time is up. May I just take another moment? OK. The unregulated derivatives have been identified as a significant factor in the turmoil that AIG had and I am really leading to the area of derivatives investment model regulation that was developed by the National Association of Insurance Commissioners, I presume you are aware of that, back in 1996. Are you aware of that?

Mr. DINALLO. No, I am not exactly aware of that. I think we may be talking about the ability for insurance companies to use derivatives to hedge, but I am not certain. I apologize.

Senator MARTINEZ. Well, apparently there was a derivatives investment model regulation developed and adopted by the National Association of Insurance Commissioners, which I presume you are a member of.

Mr. DINALLO. I am, sir.

Senator MARTINEZ. And as part of that—that was back in 1996—apparently the State of Illinois was the only State that actually adopted that regulation. I guess my question was going to be, but if you don't know of the existence of it, whether more States having adopted that, and particularly New York, whether that would have been of help in——

Mr. DINALLO. I don't think—Senator, honestly, I don't think that would have been the issue here. Most States have some rules around how much derivatives an insurance company can use to hedge. They are generally prohibited from investing directly in derivatives.

What I think I would just modestly—what I would focus on a little bit in history here is two things. You have a situation, and as you go forth and work on this—I know that the Committee wants to get this right—the concept that AIG could pick its regulator, essentially, that the holding company could essentially obtain an S&L and then choose the OTS is something that I think is something that really—I do agree that there is something that has to be looked at transcendentally about companies this size, who should regulate them, especially from a systemic risk aspect.

And second, although I think it is pretty impressive that the OTS is coming here and saying, we were ultimately regulating over the FP, let us be clear, though. Most of the products in FP were by the country's decision unregulated derivatives. We chose to make them unregulated. And what that essentially means, it is not about finger pointing. It means that we decided that there was going to be extremely little capital requirements behind those, as Senator Corker said, insurance—what they really are are financial guaranty obligations that act like insurance without any of the solvency requirements.

So through the CFMA, we made some radical decisions about how to—what to regulate and what not to regulate, but almost most importantly, how to capitalize those regulatory decisions and the products that go with them. I think that is really important historically here.

Senator MARTINEZ. I think I agree with you, and I think it translates also to thinly capitalized entities like Fannie Mae and Freddie Mac, as well, who were so thinly capitalized that they really would not have ever been able to operate as a bank would operate.

Thank you.

Chairman DODD. Thank you, Senator.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman.

I would like to come back to the line that Senator Corker and you, Mr. Chairman, and the Ranking Member were addressing. Mr. Kohn, I think you are hearing enormous frustration, obviously, and I guess I want to just put this in a little context. I mean, it wasn't like—even before the meltdown, it wasn't like there was huge amounts of surprise from the financial markets. AIG was a high-flying company. You have described, or I think some of the panel has described it as an insurance company with a hedge fund bolted onto it.

Mr. KOHN. Exactly.

Senator WARNER. And that AIG's practices, whether it would be in effect a mortgage securities lending business that went from $1 billion of exposure to about $100 billion of exposure between 1999 and 2007, it was a huge rise.

Mr. KOHN. Right.

Senator WARNER. And it basically, as Senator Corker pointed out, did something that the rest of the market would have viewed as kind of crazy, on these credit default swaps where they would, in effect, sell this quasi-insurance product and not even have the good sense to hedge on the downside the risk.

Mr. KOHN. Right.

Senator WARNER. So I guess where our frustration is, at least my frustration comes in two parts. One is that all of the counterparties that took advantage of this high-flying entity, in effect buying or renting their AAA rating to take their perhaps equally bad or worse products to elevate how those products would be viewed. Now these counterparties, who have done pretty well, one, not only do we not know who those counterparties are and how we, the Federal Government and the taxpayers, are bailing them out, but two, I believe you are also saying that these counterparties are being paid in full. Did they not have some obligation to do some level of due diligence themselves?

So would it not be fair—now, I understand at that moment of crisis in September when you had to act. We could agree or disagree. But even if we grant you that you had to act at that point, AIG still racked up subsequent to that, wasn't it north of $64 billion in losses? So why are we continuing in honoring these obligations at close to par, or as you say, market price, but it is not really market price because these counterparties are already able to keep whatever collateral has been issued to them.

Mr. KOHN. That is correct.

Senator WARNER. So they are getting a better deal. Why has there not been a more focused effort on making sure that some of these counterparties—you are not even going to tell us who they are—at least take a haircut?

Mr. KOHN. I share your frustration and the frustration of everybody else on this Committee. This has been a most unpleasant and difficult situation, to be dealing with this company that, as you say, people knew was kind of a high-flyer, was taking some risks. They still had until very shortly before their fell their AAA rating, which they were exploiting for this.

I wish with every fiber in my body that we didn't have to come in and do what we did. Our judgment was that if we had inflicted losses on counterparties, not only on September 16 but subsequently, that it would undermine confidence not only in AIG, but in other critical U.S. financial institutions. So we have——

Senator WARNER. So the vast majority of these counterparties are U.S., not foreign?

Mr. KOHN. I wasn't worried so much about the counterparties. I am worried more about other U.S. institutions operating in the financial market. So we are in the middle of a very severe crisis with confidence in a lot of important U.S. institutions eroded significantly, as reflected in the equity markets and elsewhere.

And our concern was that if we imposed losses on the counterparts for AIG, not so much worried about those particular counterparties. I actually don't know what the list is, but my guess is many of them can handle it themselves. I am worried about the knock-on effects in the financial markets. So now would other people be willing to do business with other U.S. financial institutions? Forget AIG. Forget the counterparties. Think about the systemic risk here if they thought that in a crisis like this, they might have to take some losses.

There is a huge moral hazard here. We have made those credit counterparties whole in ways that will reduce their incentive to be careful in the future——

Senator WARNER. So we have, sir, if I can just—what I think you are saying is we, the American taxpayer, have taken a high-flying company that was doing what most of us would believe in a normal market circumstance was high risk-—

Mr. KOHN. Right.

Senator WARNER. ——counterparties that should have recognized that high risk of what they were buying, this insurance product they were buying——

Mr. KOHN. They were relying on——

Senator WARNER. and we have to step up and make those counterparties whole because—the counterparties again that you won't share who they are—we have to make them whole because, again, the kind of amorphous need that there might be lack of confidence going forward. And there is no sense, and I think you are hearing great concern from this Committee and I can assure you there is going to be even more from non-committee members, that if there are additional counterparty obligations out there that maybe a little tighter and tougher negotiation with those going forward rather than paying out at par or close to par, I really would hope you would also not only consider sharing that information, but reconsider some of your negotiating strategy.

Mr. KOHN. I think I will do that and certainly take this message back and the request for additional information, as Chairman Dodd said, back to the Federal Reserve Board and we will consider it.

I think if you step back just a second, the real problem here is we have this systemically important institution that was allowed to get large. Mr. Polakoff admits that they weren't exercising really sufficient oversight over this institution. That cannot be allowed to repeat itself and we need to change our laws——

Senator WARNER. But I think what you are also saying—I know my time is up, I apologize, Mr. Chairman—but you are telling us, Congress, go fix this, and I believe there will clearly be under the Chairman and the Ranking Member's leadership a good fix prospectively, but until that time, you can't share with us how much more we are on the hook for this too-big-to-fail institution. You can't share with us who we are paying off. And you can't share with us that we are going to renegotiate at anything other than par for risky, what should have been at least viewed in the marketplace as risky bets made by these counterparties buying up AIG's AAA rating.

Mr. KOHN. I think we need to do our best to realize the best returns, minimize any losses to the taxpayer, through any avenue we can do. I do think another issue that is highlighted by this whole situation is the lack of a resolution regime for anything but banks. So we have, for systemically important banks, through the FDIC, we have a way of resolving banks. We have an exception to the least-cost resolution for systemically important banks. Another thing on the to-do list for the administration, the Federal Reserve, and the Congress is a regime where whoever is designated—it doesn't matter who—could come in and figure out how to stabilize the system, impose some losses on some of the creditors. That regime, those authorities don't exist right now without——

Senator WARNER. And my last—my time is up, but if in just maybe a straight yes or no on whether I am hearing you correctly. What we must do prospectively in terms of fixing that, I fully understand. But until that time, and with the case of AIG, we have no option other than what appears to be a bottomless pit with no knowledge of who we are helping out and that we are going to continue to pay off 100 cents on the dollar.

Mr. KOHN. I will re-raise all those issues back at the Federal Reserve and with the Treasury. I think we are working very, very hard to limit any losses to the taxpayers. That is how we and why we did the restructuring we did, in order to facilitate the sale, the shrinkage of this organization——

Senator WARNER. Obviously, I think some on the Committee question that——

Mr. KOHN. I understand.

Senator WARNER. I wanted to come back at some point, Mr. Chairman, and ask, 79 percent, and we have just put in additional funds, why aren't we actually bumping up much higher than that 79 percent, but thank you.

Chairman DODD. And again, looking at the statement by Mr. Dinallo, and they argue this, we all accept, I think you have heard it said, the primary source of the problem was the FP, AIG's Financial Products, which had written credit default swaps, derivatives, and futures with a notional amount of about $2.7 trillion, including $440 billion of credit default swaps. That is equal to the gross national product of France. And the question is, are we going to pay par for that and for all of this. In the absence of some response, that is a staggering proposal.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair.

It has been mentioned in several cases that holes in the regulatory system were exploited, leading us to the situation we are in now. I had an interesting conversation the other day with a senior member of the New York Stock Exchange. I was asking the question why these are called swaps rather than credit default insurance, and his response was very simple. The term "swap" was used because if the term "insurance" was used, the New York Insurance Agency would be engaged and would have exercised some regulatory oversight.

I am not sure this point has really been addressed and I just want to ask the question, had they called these things, these insurance contracts insurance, would they have been regulated by your agency, Mr. Dinallo?

Mr. DINALLO. Yes. There has been discussion about whether you could have categorized credit default swaps as insurance. I have always felt that there is a view that when you have a covered, as opposed to the naked variety the Senator described, you have arguably an insurance product. But the CFMA made it clear that they wanted these to be essentially exempted, and the only question that we were ever asked was about a naked credit default swap, which clearly is a form of speculation. You could even call it gambling, by the way, because there were laws that prohibited that kind of activity, that speculation on securities without actually owning the security, which is essentially what a naked credit default swap is. Those were preempted by the CFMA. They were called the Bucket Shop laws of the various States.

So yes, there is—you could, and I think that there has been discussion. But then what happens to them is that they become very expensive to use as a hedging instrument because you have to capitalize them like an insurance product. Therefore, the belief was from, I think, the Federal regulators and the CFMA that they would be too expensive to use as a hedging instrument if they were regulated as insurance products.

Senator MERKLEY. Were there folks within your agency who asserted that the agency should, in fact, exercise some regulation of——

Mr. DINALLO. Well, I was not——

Senator MERKLEY. ——insurance compacts?

Mr. DINALLO. I was not there in 2000. I don't think any insurance regulator was—I don't think our opinions were solicited when the CFMA was passed, frankly. I don't think anyone thought about the possibility that this was essentially the kind of insurance that financial guaranty firms write. But it had been moved over to an entirely unregulated area on Congressional decision.

Senator MERKLEY. Does anyone else want to comment on this question?

Mr. POLAKOFF. Senator, I believe the Chair of the CFTC brought forward to Congress a number of years ago the idea and the recommendation to indeed regulate credit default swaps. These instruments need to be regulated. They are too individualized. There is not a central clearing. There is not a secondary market. I think that most regulators, whether Federal or State, would say that credit default swaps need to be regulated as a product.

Senator MERKLEY. I will say it is kind of a sad commentary on our regulatory system if all it takes is changing the name from insurance to swap in order to bypass regulation.

One of the things I am concerned about is the role that these insurance contracts had in essentially putting lipstick on a pig. That is, CDOs and CDO-Squared that were then insured, and by insuring them you were able to say to pension funds and other financial entities that were buying these contracts, or buying these products, that, look, don't worry, they are insured. And yet the insurance was unregulated. That sounds like a house of cards. I am speaking really in kind of simple terms here to try to characterize this.

Is that kind of a fair way to portray it, that we had in some cases CDO-Squared that had 100 pieces of bonds offering from the lower tranches and then each of those might hold other, in some cases, 20,000, 25,000 pieces of low-quality bonds piled together, but then you put this insurance on them and say to investors, look, these are safe. Did this play a major role in creating this house of cards?

Mr. POLAKOFF. Senator, I do not believe so. These CDOs absolutely were complex, but the credit default swap portion was written on the super-senior AAA-plus tranche of it. And these ratings were assigned to these super-senior tranches before the credit default swaps were written.

Mr. DINALLO. Senator, I have testified before the Senate and in Congress on credit default swaps specifically, and I have called them the "great enablers" of this financial catastrophe, because many people thought that they had essentially an insurance policy when, in fact, they did not have near the solvency behind it. There are two ways that you could write—essentially, there are some companies that engage in bond insurance. They do financially guarantee default on the bonds, and there are certain solvency requirements that go there. AIG in a sense, by writing credit default swaps, was guaranteeing the default on these CDOs. And I believe that to the extent you and Senator Warner are correct, they were essentially loaning their AAA over, that happened. And the question is: Well, why did anyone let this happen? Because I think what was going on was there was an assumption that the AAA came from an ability to reach into that $1 trillion balance sheet you heard about to be able to pay for any liquidity problems. But the money was in these regulated entities that, of course, thankfully just do not let the capital flow out because that is policy holder premium.

So I think actually the world kind of understood in a way that was never very clear that when the operating companies are actually depository institutions or insurance companies, you do not really have access to it for liquidity the way you would in a normal widget-producing company.

Senator MERKLEY. Mr. Dinallo, can you repeat that phrase, "great enabler"?

Mr. DINALLO. Yes. I think that when you look at what happened historically, I think you see the worst form of moral hazard and the lack of any kind of retention of exposure in the underwriting process, which would be kind of a short story for the mortgage meltdown. But at the end, when people finally bought those securitized instruments, they went into the marketplace and thought that they were essentially safe because they had credit default insurance on those——

Senator MERKLEY. I just wanted to make sure I captured your comment correctly, that the credit default swaps were the great enabler of the major financial meltdown we are experiencing.

Mr. DINALLO. Absolutely, because every asset manager who was holding those CDOs essentially turned to his risk manager and said, "I have insurance on these. I have the downside covered." But there was not near the capital behind them.

Senator MERKLEY. So just to follow up on this, Mr. Polakoff, I think you disagree with that point of view.

Mr. POLAKOFF. Yes, sir. I would once again offer that there were no realized credit losses on the CDOs, at least as of September 30 of 2008. These were AAA-rated, super-senior tranches, and while the market value may have moved, the underlying value from cash stream of the borrowers remained strong.

Mr. DINALLO. We do not disagree——

Senator MERKLEY. If I could ask one more——

Mr. DINALLO. Senator, I just want to point out, we actually do not disagree. I do not disagree with that. There have been no realized losses, but in order to keep those positions, you needed a certain amount of capital or liquidity, which they simply did not have at the holding company or in FP. That is the only distinction.

Senator MERKLEY. So several people have spoken to the role of the AAA rating as being borrowed or used, if you will. We have an inherent conflict of interest in which rating agencies are paid by the firms that they are rating. We are all trying to learn lessons from this on how we are going to go forward and do this far, far better to restore a financial system with integrity.

How are we going to resolve this issue of the inherent conflict of interest in the rating agencies and the use of AAA ratings in apparently inappropriate circumstances?

Mr. DINALLO. Well, this week I had an op-ed published in the *Wall Street Journal* about our proposal to create a buy-side rating agency so that the interests are aligned between the purchasers of the securities or the bonds and the rating agencies.

Right now you have this inherent conflict because essentially the issuers of the products pay for the ratings. And our proposal is that the insurance industry is large enough and a big enough user, as are the regulators, of both the ratings and municipal bonds and other structured instruments—in fact, I think it is about $3 trillion—that a very modest amount paid by the insurance industry could fund such a rating agency, and the problem of free riding would be taken away because the regulators would essentially require it and require it as part of the capital calculation of the insurance company's assets.

And then you could expand that to all financial services. You could essentially have all financial services paying in a very modest amount to fund buy-side ratings and make it required by the regulator, used by the regulator, so you take out the free-riding problem.

Senator MERKLEY. Do you all share that strategy, Mr. Kohn and Mr. Polakoff?

Mr. KOHN. I think it is a strategy worth pursuing. The SEC has proposed a series of changes in the regulation of the credit rating agencies to make them more transparent, to have them publish the history of what they have rated so people can judge, to make it so that if somebody starts shopping around from credit rating agency to credit rating agency, they have to publish that amount.

So I think meanwhile there is a lot we can do to make the credit rating agencies better.

Senator MERKLEY. Thank you.

Chairman DODD. Thank you, Senator.

Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman. I know we are short on time, and I will have some questions I will submit in writing. But I think as I sit through these hearings, Mr. Chairman, what is so frustrating is that you get a very strong sense that there was nothing inevitable about any of this stuff; that people understood in the case of AIG and the market how reckless their behavior was; that somehow we did not realize this, I think, in sufficient detail so that, come September, we spent 2 days trying to get the market or somebody in the private sector to figure out how to fix this. They cannot. We make a decision that to the American—it may have been the right decision. I am not saying that it is not. But the American public saw it as a very hasty decision. I think they still do not understand it. I think commitments were made that they do not feel are being honored. And that is the difficulty that you are facing here and the frustration that you are hearing here.

To think that these guys, even the reckless people that were writing these credit default swaps, finally in 2005 said, you know what, maybe we should stop writing this stuff because our model is starting to show that there may be a deterioration in the housing market, and we have no capacity, the regulators seemed to not have a capacity to detect that they are going to—that they have stopped writing the paper themselves—and I will make that into a question—just is terribly worrisome. Because I do not think this really is, you know, Monday morning quarterbacking, because what we are trying to figure out is how to do the regulation a way that makes sense. If we are not going to figure it out prospectively, there is no point in having regulators at all.

So I guess one question I would ask here—and I have got another one, so I do not want to take too much time with it. Is there a way to detect when people are doing things like stopping writing a bunch of credit default swaps which ought to set off alarm bells about what is happening in the market?

Mr. KOHN. I think there are ways of trying to do that. One can look at the spreads, look at the activity, see that unusual things are going on. Think of the leverage in the U.S. financial system that was growing exponentially.

Senator BENNET. Another great example.

Mr. KOHN. The maturity mismatches that were going on. So I think there are a variety of early warning signs that we should have perhaps looked at a little harder, that there perhaps should have been a systemic risk regulator, as some of the Senators have talked about, who had the authority and opportunity to call out the problem, take some actions to do that.

But I also think that there is never going to be a fail-safe system.

Senator BENNET. And I agree with that. I think that one would have hoped—it obviously did not happen in this case maybe until it was too late—that the boards of directors of these companies would have exercised the fiduciary duty on behalf of everybody and said, you know what, we are getting 30 times the leverage, maybe that is too much, 25 times the leverage, maybe that is too much. But I for one—and I am sure other people up here—will be interested to know how the regulator can create its own set of stoplights to be able to say, you know, we feel like we are moving directionally in the wrong place—or maybe in the right place—prospectively, so that our only answer to the American people is not, Sorry, we missed this and now we have to respond in a way that may or may not work, where we could maybe not predict, for example, what the underlying assets are worth here. So I for one look forward to working with you on that.

Let me go to a second question here before my time is expired. Mr. Kohn, this is for you. I was not here in September, but I gather there was testimony in September from the Fed that the credit facility would result in no loss, no net loss to the taxpayer. And I am wondering whether there is a change in the testimony today when what I think you are saying is that we are trying to mitigate whatever loss there may be. Is that a shift in the position of the Fed? Or are we still telling the taxpayers there is not going to be any net loss after all this is——

Mr. KOHN. I think the credit facility per se, the credit that the Federal Reserve has given, is fully securitized, and we do not expect a net loss from that.

I think the open question is how much of the equity that the Treasury has put in, part of which went to pay off the Federal Reserve in November, will come back to the taxpayers.

Senator BENNET. So the Fed may be OK, but the Treasury may be——

Mr. KOHN. Well, and the way to look at it—you are absolutely right, Senator—is for the taxpayers as a whole. And I think that depends on how this company is handled from here on out. That is what I mean when I say we are trying to do our best to make it so that any losses to the taxpayer are minimized. That along with financial stability of the system and jobs for Americans are the motivators behind our actions here.

Senator BENNET. The last thing, Mr. Chairman—and I will submit it in writing with my other colleagues—I really am interested in hearing some testimony at some point on how these workouts are actually happening. In other words, who really is figuring out what residual value there is in these operating units in AIG but, for that matter, some of the other things we may be looking at. Whose eyes are getting cast on that both in the Government and in the private sector to be able to assure that when the time comes, the taxpayers really are getting the best return we can get on these sales?

I will not wait for an answer on that, but I will say I am very interested in it. Mr. Chairman, thank you very much for——

Chairman DODD. Well, thank you very much. We have got a vote that has come on. I know Senator Corker has additional questions he would like to ask. We will try to figure out how to do this. It will not go on much longer.

I had one quick question, and then I will turn to Senator Corker and see if we cannot get both of them in here before we wrap up and submit questions.

Vice Chairman Kohn, the Fed is under the authority legally, as I understand it, to only provide resources to creditworthy companies. Is that traditionally true? Am I missing some point before I——

Mr. KOHN. We lend on a secured basis.

Chairman DODD. To creditworthy companies?

Mr. KOHN. Generally to creditworthy companies. We have, I would say, pushed the boundaries in dealing with this crisis.

Chairman DODD. Well, that is the question I was going to ask, because if we are an 80-percent shareholder, in effect, of AIG, and you have got to securitize the additional loans, I am just mystified as to how we could do that. I understand if their numbers were lower somehow, but it seems to me that it is awfully difficult to achieve that result. How do you believe these loans that have been made by the Fed during the fourth quarter of 2008 were adequately secured given that AIG was losing about $450,000 a minute?

Mr. KOHN. I think there are more than enough assets, even at these distressed market values, to repay the Federal Reserve's loans. We have tried to structure them that way. Senator Shelby does not believe me. As I answered Senator Bennet, we have several outside advisers looking at this. We have outside advisers managing Maiden Lanes II and III that have these CDOs. We have outside advisers advising us on the restructuring, and the company itself has several sets of outside advisers. There are many, many pairs of eyes on this, and our outside advisers believe that we will be repaid out of the assets of AIG and the assets of Maiden Lane I and Maiden Lane II. This is not just an assertion that we are making.

But I also recognize that how much of the $40 billion that the Treasury has advanced and potentially another $30 billion, how much that return to the taxpayers will depend critically on how this company winds itself down.

Chairman DODD. Well, I would like to pursue that, maybe in a written question, but trying to get this completed here before we go. A quick question from Senator Shelby, then Senator Corker.

Senator SHELBY. I will be fast. Governor Kohn, are you telling us and the American people that you believe that the Government, the taxpayers is going to recoup their money they have invested or they have loaned or given or whatever to AIG, billions and billions of dollars? Are you saying that money is safe?

Mr. KOHN. We are working very hard to make it safe, Senator.

Senator SHELBY. Well, I hope you are right, but I believe you are totally wrong.

Thank you.

Chairman DODD. Senator Corker.

Senator CORKER. Thank you. I just want to get back to the systemic risk issue, and I know that you mentioned that you did not have some facilities in place in September. I do want just for the record—you all have taken numbers of actions since that time that were not made in haste and continue down the same path.

Mr. KOHN. That is right, but one of the distinguishing characteristics of the actions since that time is bringing in the TARP money.

Senator CORKER. Right. And I was in the country of Ukraine when that happened and got the call. The fact was that TARP money never was ever supposed to be used for something that was not buying something of value. So that was a huge departure, a huge departure, but I know that is out of your bailiwick. That is in the Treasury's area.

I still do not understand what the systemic risk would have been if you all would have said that on an actual call on the CDS will make it good. I do not understand what systemic risk possibly could have been in place there.

Mr. KOHN. First of all, as I understand it, there is no legal mechanism to impose losses outside of bankruptcy, and bankruptcy, we believe, would have been a major systemic event for the U.S. financial system.

Senator CORKER. Even though you could have said Chapter 11 will stand behind any real——

Mr. KOHN. There are literally millions of counterparties to AIG. AIG is a global company. I think we experienced some things over with the Lehman Brothers bankruptcy that suggested that it would have been a disorderly thing. I think it would—I really——

Senator CORKER. How much of your actions, then—because we keep coming back to the fact that there is no entity, there is no way to actually deal with an entity—how much of your actions have been because of the fact that there is no Federal entity to actually orderly unwind an organization like this?

Mr. KOHN. I think particularly early on, that was a major part of our actions, but let me be clear again. Our actions were not aimed at AIG and its counterparties. Our actions were aimed at the U.S. financial system and the knock-on effects of imposing losses on counterparties. Would those counterparties or others be willing to do business with other U.S.—systemically important U.S. institutions that might someday end up in the Government's hands? I think it would have accelerated what was a very, very bad situation, caused more of a withdrawal from taking risk, a shift of business toward a very few financial institutions that were clearly going to survive the maelstrom.

Senator CORKER. We have ended up buying stock, and instead of having our money be backing up this collateral that went to these counterparties that really have made out like bandits, and I can see why—they really have made out like bandits in this particular atmosphere.

Mr. KOHN. They have realized the value that they would realize over time if AIG was a surviving firm.

Senator CORKER. Which they are not, and so I would guess that these CDOs were selling, let us say 6 months leading up to this, at a great discount then. So they have actually made out like bandits twice. OK? They have gotten—because of our involvement, the face value of these has risen to probably 100 cents on the dollar, and this crazy collateral that we have had to put up, which was part of the contract, has been there, too. But the fact is our Federal investment has now been made in stock, OK?

It seems to me that that is another step that we have made that has greatly put taxpayer monies at risk, and I just wonder why we would have done that.

Mr. KOHN. We thought we needed to do that to stabilize the company; to prevent a flight of creditors from the company, they needed some protection underneath them in the capital structure. And if we had not provided the protection in the capital structure to creditors, they would not have advanced credit to AIG, AIG would have had a disorderly failure, and there would have been severe consequences. The U.S. Government is on record saying that it will not countenance, it will not allow a disorderly failure of a systemically important institution. I think that is absolutely critical at this time.

Chairman DODD. Well, listen, this could be a week-long hearing rather than a few hours.

Mr. KOHN. It could be. It feels like a week, Mr. Chairman, but it has only been 2 hours.

Chairman DODD. I am sure. We will have you back here because, obviously, the question is what we do as we learn about what happened, but clearly what steps we need to take to see to it, and we did not get to as many questions as I wanted to raise with OTS because obviously here, by your own admission, this was a major gap in all of this. So there will be additional written questions, I am sure. We will be back at this issue again as we look forward to writing the modernization of regulations here that Senator Shelby and I will be deeply involved in.

We thank you for being here today, but a very troubling hearing, I must say. Very troubling hearing in terms of where we are, and some steps need to be taken, maybe more quickly, in light of the fact we are looking at the potential exposure here. And if we are going to be paying at par, these numbers here, they are just not sustainable under any set of circumstances. And so we need some corrections, whether it takes legislation to do it or by regulation or by the existing powers you have, but the current course of action is unsustainable and must change. And so we need to hear from the Fed very quickly whether or not you need our authority to change; and if you do not, what are the steps you intend to take, because the present path here is just unacceptable.

I do not think those are my own views. I think these are views probably shared by all of us. So we need a very quick response from the Fed on this.

The Committee would stand adjourned.

[Whereupon, at 12:24 p.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record follow:]

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Thank you, Mr. Chairman.

The collapse of the American International Group is the greatest corporate failure in American history. Once a premiere global insurance and financial services company with more than one trillion dollars in assets, AIG lost nearly $100 billion last year. Over the past 5 months it has been the recipient of four bailouts. To date, the Federal Government has committed to provide approximately $170 billion in loans and equity to AIG. Given the taxpayer dollars at stake and impact on our financial system, this Committee has an obligation to throughly examine the reasons for AIG's collapse and how Federal regulators have responded.

I also hope that today's hearing will shed new light on the origins of our financial crisis, as well as inform our upcoming discussions on financial regulatory reform. In reviewing our witnesses' testimony and AIG's public filings, it appears that the origins of AIG's demise were two-fold. First, as has been widely reported, AIG suffered huge losses on credit default swaps written by its Financial Products subsidiary on collateralized debt obligations.

AIG's problems, however, were not isolated to its credit default swap business. Significant losses at AIG's State-regulated life insurance companies also contributed to the company's collapse. Approximately a dozen of AIG's life insurance subsidiaries operated a securities lending program, whereby they loaned out securities in exchange for cash collateral. Typically, an insurance company or bank will lend securities and reinvest the cash collateral in very safe, short-term instruments. AIG's insurance companies, however, invested their collateral in riskier long-term mortgage-backed securities. Although they were highly rated securities, approximately half of them were backed by subprime and alt-a mortgage loans.

When the prices for mortgage-backed securities declined sharply last year, the value of AIG's collateral plummeted. The company was rapidly becoming unable to meet the demands of borrowers returning securities to AIG. By September, it became clear that AIG's life insurance companies would not be able to repay collateral to their borrowers. Market participants quickly discovered these problems and rushed to return borrowed securities and get back their collateral.

Because AIG was unable to cover its obligations to both its securities lending and derivatives operations, it ultimately had to seek Federal assistance. In total, AIG's life insurance companies suffered approximately $21 billion in losses related to securities lending in 2008. More than $20 billion dollars in Federal assistance has been used to recapitalize the State-regulated insurance companies to ensure that they are able to pay their policyholders' claims. In addition, the Federal Reserve had to establish a special facility to help unwind AIG's securities lending program. I am submitting for the record a document from AIG that shows the losses from securities lending suffered by each AIG subsidiary that participated in AIG's securities lending program and the impact those losses had on its statutory capital. (See *Exhibit A,* below.)

The causes of AIG's collapse raise profound questions about the adequacy of our existing State and Federal financial regulatory regimes. With respect to AIG's derivatives operations, the Office of Thrift Supervision was AIG's holding company regulator. It appears, however, that the OTS was not adequately aware of the risks presented by the company's credit default swap positions. Since AIG's Financial Products subsidiary had operations in London and Hong Kong, as well as in the U.S., it is unclear whether the OTS even had the authority to oversee all of AIG's operations. It is also unclear whether OTS had the expertise necessary to properly supervise what was primarily an insurance company.

According to the National Association of Insurance Commissioners, a life insurance company may participate in securities lending only after it obtains the approval of its State insurance regulator. If so, why did State insurance regulators allow AIG to invest such a high percentage of the collateral from its securities lending program in longer-term mortgage-backed securities? Also, how did insurance regulators coordinate their oversight of AIG's securities lending since it involved life insurers regulated by at least five different States?

While I hope we can get answers to these and many other questions today, I believe we are just beginning to scratch the surface of what is an incredibly complex and, on many levels, a very disturbing story of malfeasance, incompetence, and greed.

Thank you, Mr. Chairman.

Exhibit A

Participants in AIG's U.S. Securities Lending Program
2008 Securities Lending Realized Losses and Capital Contributions Received
By Company and State of Domicile

($ in millions)

	Statutory Legal Entity	12/31/07 Statutory Total Adjusted Capital	Total 2008 Securities Lending Realized Losses	2008 Capital Contributions, pre FRBNY	2008 Capital Contributions, post FRBNY	Total 2008 Capital Contributions	12/31/08 Statutory Total Adjusted Capital
AZ	AIG SunAmerica Life Assurance Co	$ 1,222	$ (425)	$ 6	$ 280	$ 285	$ 1,317
	SunAmerica Life Insurance Co	5,976	(2,281)	925	1,725	2,650	4,805
	State total	7,198	(2,706)	931	2,004	2,935	6,122
DE	AIG Life Insurance Co	538	(870)	235	679	915	465
	American Life Insurance Co (ALICO)	5,307	(470)	15	967	982	4,332
	State total	5,845	(1,340)	250	1,647	1,897	4,797
NY	American International Life Assurance Co of NY	662	(771)	151	801	952	458
	First SunAmerica Life Insurance Co	509	(654)	568	644	1,212	550
	The United States Life Ins Co in the City of NY	511	(395)	3	456	459	305
	State total	1,682	(1,820)	722	1,901	2,623	1,314
TN	American General Life and Accident Insurance Co	620	(977)	28	765	793	594
TX	AIG Annuity Insurance Co	4,878	(7,109)	1,596	6,047	7,643	3,242
	American General Life Insurance Co	3,223	(3,790)	905	3,084	3,989	2,844
	The Variable Annuity Life Insurance Co (VALIC)	3,632	(3,563)	955	3,620	4,576	2,940
	State total	11,733	(14,462)	3,456	12,752	16,208	9,027
	Subtotal	27,077	(21,304)	5,387	19,069	24,456	21,853
	Companies that exited prior to 9/30/08	13,037	(101)	2	915	917	11,277
	AIG Corp	n/a	(100)	1	9	10	n/a
	Total Participants	$ 40,114	$ (21,505)	$ 5,390	$ 19,994	$ 25,384	$ 33,130

- Statutory total adjusted capital (TAC) includes capital and surplus plus the asset valuation reserve, shown on a standalone basis (i.e., excluding TAC of life insurance subsidiaries, if any).
- Securities lending realized losses reflect losses, primarily other-than-temporary impairment charges, recorded by the participants resulting from declines in value and sales of investments made with securities lending collateral.
- Post FRBNY capital contributions reflect contributions made subsequent to the involvement of the Federal Reserve Bank of New York (FRBNY).
- Companies that exited prior to 9/30/08 include American Home Assurance Co, Lexington Insurance Co, New Hampshire Insurance Co, American General Assurance Co, Delaware American Life Insurance Co, and Merit Life Insurance Co.

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Thank you, Mr. Chairman and Ranking Member Shelby for holding this hearing today. I was concerned last fall when the American International Group, a non-federally regulated insurance company, received an $85 billion bailout from the Federal Reserve. Now, we have seen four bailouts in 6 months totaling $160 billion dollars. This is a breathtaking amount of taxpayer money, and AIG's announcement this week of the largest corporate quarterly loss for any company ever is even more stunning. I hope we will find out more from today's witnesses about how we got to this point.

Americans are angry about taxpayer money going to financial institutions and other companies like AIG, with what appears to be little improvement in our economic situation. This anger is warranted—the largest bailout to date has gone to a business run in such an irresponsible manner, not only in the risks it took with its products, but the actions of its CEOs after it received taxpayer money, that if it were a Main Street small business it would have been forced to close its doors long ago.

I hope to hear from the witnesses about the steps the Government has taken to keep AIG afloat, particularly the newest actions announced earlier this week. I do not think it would be an exaggeration to say that the "bailout" of AIG remains the least transparent of all the bailouts we have witnessed in the past 6 months.

I also look forward to working with my colleagues on this Committee on regulatory modernization and ask that insurance regulation is not left out of our efforts. For many years I have advocated for a modernized system of Federal insurance regulation; I am even more convinced after the past 6 months that our current, outdated, State-by-State regulatory system is ill-equipped to deal with a 21st century insurance company. We cannot afford another situation like AIG and we must ensure that our regulators can assess the risks across all financial services including insurance.

PREPARED STATEMENT OF DONALD KOHN

VICE CHAIRMAN,

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MARCH 5, 2009

Chairman Dodd, Ranking Member Shelby, and other Members of the Committee, I appreciate having this opportunity to discuss the role of the Federal Reserve in stabilizing American International Group, Inc. (AIG). In my testimony, I will detail the support the Federal Reserve, working alongside the Treasury, has given AIG and the reasons for each of our actions. Before I go into the extended narrative, however, I think it would be useful to briefly put our decisions in their broader context.

Over the past year and a half, we have all been dealing with the ongoing disruptions and pressures engendered by an extraordinary financial crisis. The weaknesses at financial institutions and resulting constraints on credit, declines in asset prices, and erosion of household and business confidence have in turn led to a sharp weakening in the economy. The Federal Reserve has employed all the tools at its disposal to break this spiral and help address the many challenges of the crisis and its effects on the economy. One of the most important of these tools is the Federal Reserve's authority under section 13(3) of the Federal Reserve Act to lend on a secured basis under "unusual and exigent" circumstances to companies that are not depository institutions. Since last fall, in order to foster the stability of the financial system and mitigate the effects of ongoing financial stresses on the economy, we have used that authority to help to stabilize the financial condition of AIG.

AIG is a widely diversified financial services company that, as of September 30, 2008, which is the reporting date closest to the date we first provided it assistance, reported consolidated total assets of more than $1 trillion. AIG was at that time, and continues to be, one of the largest insurance companies in the world and, in terms of net premiums underwritten, is both the largest life and health insurer in the United States and the second largest property and casualty insurer in the United States. It conducts insurance and finance operations in more than 130 countries and jurisdictions and has more than 74 million individual and corporate customers and 116,000 employees globally. In the United States, it has approximately 30 million customers and 50,000 employees. AIG is the leading commercial insurer in the United States, providing insurance to approximately 180,000 small businesses and other corporate entities, which employ approximately 106 million people in the United States. It is also a major provider of 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.

AIG has also been a major participant in many derivatives markets through its Financial Products business unit (Financial Products). Financial Products is an unregulated entity that exploited a gap in the supervisory framework for insurance companies and was able to take on substantial risk using the credit rating that AIG received as a consequence of its strong regulated insurance subsidiaries. Financial Products became the counterparty on hundreds of over-the-counter derivatives to a broad range of customers, including many major national and international financial institutions, U.S. pension plans, stable value funds, and municipalities. Financial Products also provided credit protection through credit default swaps it has written on billions of dollars of multi-sector collateralized debt obligations (CDOs). Financial Products did not adequately protect itself against the effects of a declining economy or the loss of the highest ratings from the credit rating agencies, and thereby was a source of weakness to AIG. While Financial Products has been winding down and exiting many of its trades, it continues to have a very large notional amount of derivatives contracts outstanding with numerous counterparties.

It is against this background that the Federal Reserve and the Treasury Department have taken a series of unusual actions to stabilize the company. These have entailed very difficult and uncomfortable decisions for a central bank. These decisions were particularly difficult and discomforting because they involved addressing systemic problems created largely by poor decision-making by the company itself. Moreover, many of these decisions involved an unregulated business entity that exploited the strength, and threatened the viability, of affiliates that were large, regulated entities in good standing. However, uncomfortable as this was, we believe we had no choice if we are to pursue our responsibility for protecting financial stability.

Our judgment has been and continues to be that, in this time of severe market and economic stress, the failure of AIG would impose unnecessary and burdensome losses on many individuals, households, and businesses; disrupt financial markets; and greatly increase fear and uncertainty about the viability of our financial institutions. Thus, such a failure would deepen and extend market disruptions and asset price declines, further constrict the flow of credit to households and businesses in the United States and in many of our trading partners, and materially worsen the recession our economy is enduring. To mitigate these risks, the Treasury provided equity capital to AIG and the Federal Reserve provided liquidity support backed by the assets of AIG.

The Federal Reserve's involvement in AIG began in mid-September of 2008. AIG's financial condition had been deteriorating for some time. The financial and credit markets were experiencing severe stress due to various economic problems arising out of the broad-based decline in home prices, rise in delinquencies and foreclosures, and substantial drop in values of mortgages as well as mortgage-backed securities and other instruments based on such assets. In short-term funding markets, very high spreads between lending rates and the target Federal funds rate and very illiquid trading conditions in term money markets had come to prevail. AIG was exposed to these problems because of the protection Financial Products had written on mortgage-related securities, because of investments AIG had made in mortgage-related securities in connection with its securities lending program, and because its counterparties had begun to withdraw funding. These pressures mounted through September. The private sector worked through the weekend of September 13–14 to find a way for private firms to address AIG's mounting liquidity strains. But that effort was unsuccessful in a deteriorating economic and financial environment in which firms were not willing to expose themselves to risks—a risk aversion that greatly increased following the collapse of Lehman Brothers on September 15.

Under these circumstances, on September 16, 2008, acting with the full support of the Treasury, the Board authorized the Federal Reserve Bank of New York (New York Reserve Bank) pursuant to section 13(3) to lend up to $85 billion to AIG through a revolving credit facility (Revolving Credit Facility) in order to ease the liquidity strain on AIG. The liquidity pressures experienced by AIG during that time of fragile economic markets threatened its ability to continue to operate, and the prospect of AIG's disorderly failure posed considerable systemic risks in various ways as a consequence of its significant and wide-ranging operations. Such a failure would also have further undermined business and household confidence and contributed to higher borrowing costs, reduced wealth, and general additional weakening of the economy. Moreover, at the time the Board extended the Revolving Credit Facility, there was no Federal entity that could provide capital to AIG to help stabilize it. The Troubled Asset Relief Program (TARP) legislation was requested in part to fill that void and authorized by Congress on October 3, 2008.

The Revolving Credit Facility was established with the purpose of assisting AIG in meeting its obligations when due and facilitating a restructuring whereby AIG would sell certain businesses in an orderly manner, with minimal disruption to the overall economy. AIG would repay the Revolving Credit Facility over a period of two years as it sold assets. Importantly, the Revolving Credit Facility was (and remains) secured by a pledge of a substantial portion of the company's assets, including AIG's ownership interests in its domestic and foreign insurance subsidiaries. As additional compensation for the Revolving Credit Facility, AIG agreed to issue to a trust for the benefit of the Treasury, preferred stock convertible into 79 percent of AIG's outstanding common stock. With these protections, the Board believed that the authorization of the Revolving Credit Facility would not result in any net cost to taxpayers.

In connection with the extension of credit, AIG's CEO was replaced. In addition, the New York Reserve Bank established a team to review the financial condition of AIG, and monitor the implementation of AIG's plan to restructure itself and repay the Revolving Credit Facility. Furthermore, as an ongoing condition of the Revolving Credit Facility, the New York Reserve Bank staff established an on-site presence to monitor the company's use of cash flows and progress in pursuing its restructuring and divestiture plan. The Federal Reserve does not have statutory supervisory authority over AIG or its subsidiaries as we would over a bank holding company or State chartered bank that is a member of the Federal Reserve System. Rather, the rights of the Federal Reserve are those typical of a creditor and are governed by the credit agreement for the Revolving Credit Facility. Using these rights, the Federal Reserve works with management of AIG to develop and oversee the implementation of the company's business strategy, its strategy for restructuring, and its new compensation policies, monitors the financial condition of AIG, and must approve certain major decisions that might reduce its ability to repay its loan.

The Federal Reserve has a team of about 15 staff members, led by senior officials, who conduct oversight of the company pursuant to the credit agreement. The team has frequent on site contact at the company to make sure the Federal Reserve is adequately informed on funding, cash flows, liquidity, earnings, asset valuation, and progress in pursuing restructuring and divestiture. Federal Reserve staff is also assisted by qualified advisers in its monitoring and coordinates with officials of the Treasury.

We routinely make our views known on key issues, such as major incidents of corporate spending and executive compensation. For example, we pressed for the company to ensure that robust corporate governance surrounds all compensation actions and worked with AIG management on limits to executive compensation that restrict salary and bonuses for 2008 and 2009. The Treasury has also imposed standards governing executive compensation that are broader than the general restrictions under the TARP Capital Purchase Program. The Treasury has also required a comprehensive written policy on corporate expenses that may be materially amended only with the Treasury's prior consent.

Following the establishment of the Revolving Credit Facility, AIG accessed its funds to meet various liquidity needs and by October 1, 2008, the company had drawn down approximately $61 billion. In part these draws were used to settle transactions with counterparties returning securities they had borrowed from AIG entities under a securities lending program used by AIG insurance subsidiaries. The cash collateral received by AIG in these lending programs was used to purchase a portfolio of residential mortgage-backed securities (RMBS). As the value of RMBS declined, these transactions became a significant source of liquidity strain on AIG. When securities borrowing counterparties chose to terminate their securities borrowing transactions with AIG, AIG was unable to immediately dispose of the illiquid and price-depressed RMBS as a source of repayment to securities borrowers without realizing substantial losses. As a result, AIG had to supply cash from its own resources to repay the securities borrowing counterparties.

To reduce these liquidity pressures, the Board approved an additional credit facility (the Secured Borrowing Facility) that permitted the New York Reserve Bank to lend to certain AIG domestic insurance subsidiaries up to $37.8 billion in order to allow them to return the cash collateral they received from their securities borrowing counterparties. The Secured Borrowing Facility was designed to provide the company additional time to arrange and complete the orderly sales of RMBS and other assets in a manner that would minimize losses to AIG and disruption to the financial markets. AIG borrowed approximately $20 billion under the Securities Borrowing Facility by November of 2008. State insurance authorities of AIG's regulated insurance subsidiaries participating in the securities lending program supported the Board's action.

Additionally, toward the end of October, four AIG affiliates began participating in the Federal Reserve's Commercial Paper Funding Facility (CPFF) on the same terms and conditions as other participants. The CPFF is a generally available program that involves the purchase, through a special purpose vehicle with financing from the Federal Reserve, of 3-month unsecured and asset-backed commercial paper directly from eligible issuers. As of February 18, 2009, the AIG-affiliated CPFF participants had borrowed approximately $14 billion in the aggregate from the facility.

During the month of October, credit markets continued to be severely stressed and liquidity pressures on AIG did not abate even with access to government credit. The company was negatively affected by the decline in market value of many assets owned by AIG entities or to which AIG entities were exposed through derivatives. Losses on the RMBS portfolios in the securities borrowing program and credit default swap protection Financial Products had written on multi-sector CDOs together accounted for approximately $19 billion of the $24.5 billion in losses announced by the company for the third quarter of 2008. The losses experienced through the third quarter, and the consequent capital erosion placed in jeopardy the credit ratings of AIG. Had the credit ratings agencies downgraded AIG in November, AIG would have been required to find additional funds to meet collateral calls and termination events on the exposures held by Financial Products alone.

The Board and Treasury therefore took a series of actions, announced on November 10, 2008, to mitigate the effect of third quarter losses and liquidity drains on AIG and its subsidiaries, and provide for a more stable capital structure. These actions were designed to facilitate AIG's execution of its divestiture plan in an orderly manner, and thereby protect the interests of the taxpayers, both by preserving financial stability and by giving AIG more time to repay the Federal Reserve and return the Treasury's investment.

As part of the set of actions, Treasury invested $40 billion in newly issued Senior Preferred Stock of AIG under its recently granted TARP authority. In connection with that investment, the Federal Reserve modified the terms of the Revolving Credit Facility to be more sustainable: The maturity of loans extended under the facility was extended to 5 years (due 2013), the maximum amount available was reduced from $85 billion to $60 billion, and the interest rate and commitment fees were reduced. The facility remained secured by substantially all of AIG's assets, and the company continued to be required to apply proceeds of asset sales to permanently repay any outstanding balances under the facility.

At the same time, the Board approved the establishment of an additional lending facility that would provide a permanent solution to the AIG securities lending program's losses and liquidity drains, thus eliminating the need for the Securities Borrowing Facility. Under the new facility, the New York Reserve Bank extended approximately $19.5 billion in secured, non-recourse credit to a special purpose limited liability company in which AIG would hold a $1 billion first-loss position (Maiden Lane II). Maiden Lane II then purchased, at market prices, RMBS with a par value of $39.3 billion from certain AIG domestic insurance company subsidiaries. This facility allowed AIG to terminate its securities lending program and to repay fully all outstanding amounts under the Securities Borrowing Facility, which was then terminated.

The Federal Reserve also took steps to help address the drain of liquidity on AIG arising from potential collateral calls associated with credit default swap contracts written by Financial Products on multi-sector CDOs. The New York Reserve Bank made a secured, non-recourse loan in the amount of $24.3 billion to another special purpose limited liability company (Maiden Lane III). Maiden Lane III then purchased, at market prices, multi-sector collateralized debt obligations with a par value of approximately $62 billion from credit default swap counterparties of Financial Products in return for the agreement of the counterparties to terminate the credit default swaps. AIG provided $5 billion in equity to Maiden Lane III to absorb future losses on the CDOs held by Maiden Lane III.

The Federal Reserve loans to Maiden Lane II and III have a term of 6 years and are secured by the entire portfolio of each company. The Federal Reserve reports the amount of the loans to these facilities and the value of the supporting collateral regularly on its Web site. The investment manager to the New York Reserve Bank for these entities projects that, even under very stressed scenarios, the loans to Maiden Lane II and Maiden Lane III will be repaid over time with no loss to the taxpayer.

On Monday, March 2, 2009, AIG announced a loss of approximately $62 billion for the fourth quarter of 2008, ending a year in which AIG suffered approximately $99 billion in total net losses. As a consequence of increased economic weakness and market disruption, the insurance subsidiaries of AIG, like many other insurance companies, have recorded significant losses on investments in the fourth quarter of

2008. Commercial mortgage-backed securities and commercial mortgages have experienced especially severe impairment in market value, requiring a steep markdown on the companies' books, despite a lack of significant credit losses on these assets to date.

The loss of value in the company's investment portfolios, which totaled approximately $18.6 billion pre-tax, was primarily attributable to the insurance subsidiaries' holdings. This loss was a substantial contributor to AIG's fourth quarter loss. The remainder of the fourth quarter loss was significantly associated with the mark to market of assets transferred to Maiden Lane II and Maiden Lane III during the middle of that quarter, losses due to accounting on securities lending transactions that occurred during the fourth quarter, impairment of deferred tax assets and goodwill, and other market valuation losses. At the same time, general economic weaknesses, along with a tendency of the public to pull away from a company that it viewed as having an uncertain future, hurt AIG's ability to generate new business during the last half of 2008 and caused a noticeable increase in policy surrenders.

In addition, these extreme financial and economic conditions have greatly complicated the plans for divestiture of significant parts of the company in order to repay the U.S. Government for its previous support. Would-be buyers themselves are experiencing financial strains and lack access to financing that would make such purchases possible.

To address these weaknesses, the Federal Reserve and Treasury, in consultation with management of AIG and outside advisers retained by the Federal Reserve, announced on March 2, 2009, a plan designed to provide longer-term stability to AIG while at the same time facilitating divestiture of its assets and maximizing likelihood of repayment to the U.S. Government. The plan involves restructuring the current obligations of AIG to the Federal Reserve and Treasury, additional capital contributions by Treasury, and continued access to Federal Reserve credit on a limited basis for ongoing liquidity needs of AIG.

Under the plan, Treasury will create a new capital facility that would allow AIG to issue to the Treasury up to $30 billion over 5 years in new preferred shares under the TARP as liquidity and capital needs arise. This brings the total equity support of the Treasury to $70 billion.

Additionally, Treasury will restructure the $40 billion in preferred equity AIG issued to the Treasury in connection with the actions taken to aid the company in November. This restructuring, along with the injections of capital from the new preferred shares, will bolster AIG's capital position and reduce its leverage, bolstering confidence in the company.

Under the plan, the Federal Reserve also has agreed to reduce and restructure AIG's outstanding debt under the Revolving Credit Facility. Capacity under the Revolving Credit Facility will be reduced from $60 billion to $25 billion. The current outstanding debt of $39.5 billion will be restructured in several ways. First, up to about $26 billion will be satisfied by providing the Federal Reserve with preferred equity interests in AIG's two largest life insurance subsidiaries, American Life Insurance Company (ALICO) and American International Assurance Company (AIA). The actual amount will be a percentage of the fair market value of AIA and ALICO based on valuations acceptable to the Federal Reserve. This action would be a positive step toward preparing these two valuable AIG subsidiaries for sale to third parties or disposition through an initial public offering, the proceeds of which would return to the Federal Reserve through its preferred equity interest stake in these two companies.

Another component of the debt restructuring involves the use of an insurance industry tool to monetize cash flows on a specified block of life insurance policies already in existence. Under the plan, the Federal Reserve would extend up to $8.5 billion in credit to special purpose vehicles (SPV) that would repay the obligation from the net cash flows of identified blocks of life insurance policies previously issued by certain AIG domestic life insurance subsidiaries. The total amount of principal and interest due to the Federal Reserve on this credit would represent a fixed percentage of the estimated net cash flow from the underlying policies that would flow to the borrowing SPVs. This "buffer" between the amount of the credit and the net cash flow would provide the Federal Reserve with security and provide reasonable assurance of repayment.

Each of the decisions to provide assistance to AIG has been difficult and uncomfortable for us. However, the Federal Reserve and the Treasury agree that the risks and potential costs to consumers, municipalities, small businesses and others who depend on AIG for insurance protection in their lives, operations, pensions, and investments, as well as the risks to the wider economy, of not providing this assistance during the current economic environment are unacceptably large. The disorderly failure of systemically important financial institutions during this period of severe economic stress would only deepen the current economic recession. We have been and will continue to work alongside the Treasury and other Government agencies to avoid this outcome. At the same time, in exercising the tools at our disposal, we are also committed to acting only when and to the extent that our assistance is necessary and can be effective in addressing systemic risks and we are committed to protecting the interests of the U.S. Government and taxpayer.

PREPARED STATEMENT OF SCOTT M. POLAKOFF

ACTING DIRECTOR,
OFFICE OF THRIFT SUPERVISION

MARCH 5, 2009

Good morning, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. Thank you for inviting me to testify regarding the Office of Thrift Supervision's (OTS) examination and supervisory program and its oversight of American International Group, Inc. (AIG). I appreciate the opportunity to familiarize the Committee with the complex, international operations of AIG as well as the steps the OTS took to oversee the company.

At the Committee's request, in my testimony today, I will discuss the complicated set of circumstances that led to the government intervention in AIG. I will provide details on our role as the consolidated supervisor of AIG, the nature and extent of AIG's operations, the risk exposure that it accepted, and the excessive concentration by one of its companies in particularly intricate, new, and unregulated financial instruments. I will also outline the Agency's supervisory and enforcement activities.

I will describe some lessons learned from the rise and fall of AIG, and offer my opinion, in hindsight, on what we might have done differently. Finally, I will outline some needed changes that could prevent similar financial companies from repeating AIG's errors in managing its risk, as well as actions Congress might consider in the realm of regulatory reform.

History of AIG

AIG is a huge international conglomerate that operates in 130 countries worldwide. As of year-end 2007, the combined assets of the AIG group were $1 trillion. The AIG group's primary business is insurance. AIG's core business segments fall under four general categories (*e.g.,* General Insurance, Life Insurance and Retirement Services, Financial Services, and Asset Management). AIG's core business of insurance is functionally regulated by various U.S. State regulators, with the lead role assumed by the New York and Pennsylvania Departments of Insurance, and by foreign regulators throughout the 130 countries in which AIG operates.

My testimony will focus primarily on AIG, the holding company, and AIG Financial Products (AIGFP). Many of the initial problems in the AIG group were centered in AIGFP and AIG's Securities Lending Business.

It is critically important to note that AIG's crisis was caused by liquidity problems, not capital inadequacy. AIG's liquidity was impaired as a result of two of AIG's business lines: (1) AIGFP's "super senior" credit default swaps (CDS) associated with collateralized debt obligations (CDO), backed primarily by U.S. subprime mortgage securities and (2) AIG's securities lending commitments. While much of AIG's liquidity problems were the result of the collateral call requirements on the CDS transactions, the cash requirements of the company's securities lending program also were a significant factor.

AIG's securities lending activities began prior to 2000, Its securities lending portfolio is owned pro-rata by its participating, regulated insurance companies. At its highest point, the portfolio's $90 billion in assets comprised approximately 9 percent of the group's total assets. AIG Securities Lending Corp., a registered broker-dealer in the U.S., managed the much larger, domestic piece of the securities lending program as agent for the insurance companies in accordance with investment agreements approved by the insurance companies and their functional regulators.

The securities lending program was designed to provide the opportunity to earn an incremental yield on the securities housed in the investment portfolios of AIG's insurance entities. These entities loaned their securities to various third parties, in return for cash collateral, most of which AIG was obligated to repay or roll over every two weeks, on average. While a typical securities lending program reinvests its cash in short duration investments, such as treasuries and commercial paper, AIG's insurance entities invested much of their cash collateral in AAA-rated residential mortgage-backed securities with longer durations.

Similar to the declines in market value of AIGFP's credit default swaps, AIG's residential mortgage investments declined sharply with the turmoil in the housing and mortgage markets. Eventually, this created a tremendous shortfall in the program's assets relative to its liabilities. Requirements by the securities lending program's counterparties to meet margin requirements and return the cash AIG had received as collateral then placed tremendous stress on AIG's liquidity.

AIGFP had been in operation since the early 1990s and operated independently from AIG's regulated insurance entities and insured depository institution. AIGFP's $100 billion in assets comprises approximately 10 percent of the AIG group's total assets of $1 trillion.

AIGFP's CDS portfolio was largely originated in the 2003 to 2005 period and was facilitated by AIG's full and unconditional guarantee (extended to all AIGFP transactions since its creation), which enabled AIGFP to assume the AAA rating for market transactions and counterparty negotiations.

AIGFP's CDS provide credit protection to counterparties on designated portfolios of loans or debt securities. AIGFP provided such credit protection on a "second loss" basis, under which it repeatedly reported and disclosed that its payment obligations would arise only after credit losses in the designated portfolio exceeded a specified threshold amount or level of "first losses." Also known as "super senior," AIGFP provided protection on the layer of credit risk senior to the AAA risk layer. The AIGFP CDS were on the safest portion of the security from a credit perspective. In fact, even today, there have not been credit losses on the AAA risk layer.

AIGFP made an internal decision to stop origination of these derivatives in December 2005 based on their general observation that underwriting standards for mortgages backing securities were declining. At this time, however, AIGFP already had $80 billion of CDS commitments. The housing market began to unravel starting with subprime defaults in 2007, triggering a chain of events that eventually led to government intervention in AIG.

OTS's Supervisory Role and Actions

Supervisory Responsibilities

Mr. Chairman, I would like next to provide an overview of OTS' responsibilities in supervising a savings and loan holding company (SLHC). In doing so, I will describe many of the criticisms and corrective actions OTS directed to AIG management and its board of directors, especially after the most recent examinations conducted in 2005, 2006, and 2007.

As you will see, our actions reveal a progressive level of severity in our supervisory criticism of AIG's corporate governance. OTS criticisms addressed AIG's risk management, corporate oversight, and financial reporting, culminating in the Supervisory Letter issued by OTS in March 2008, which downgraded AIG's examination rating.

You will also see that where OTS fell short, as did others, was in the failure to recognize in time the extent of the liquidity risk to AIG of the "super senior" credit default swaps in AIGFP's portfolio. In hindsight, we focused too narrowly on the perceived creditworthiness of the underlying securities and did not sufficiently assess the susceptibility of highly illiquid, complex instruments (both CDS and CDOs) to downgrades in the ratings of the company or the underlying securities, and to declines in the market value of the securities. No one predicted, including OTS; the amount of funds that would be required to meet collateral calls and cash demands on the credit default swap transactions. In retrospect, if we had identified the absolute magnitude of AIGFP's CDS exposures as a liquidity risk, we could have requested that AIGFP reduce its exposure to this concentration.

OTS' interaction with AIG began in 1999 when the conglomerate applied to form a Federal Savings Bank (FSB). AIG received approval in 2000, and the AIG FSB commenced operations on May 15, 2000. OTS is the consolidated supervisor of AIG, which is a savings and loan holding company by virtue of its ownership of AIG Federal Savings Bank.

OTS supervises savings associations and their holding companies to maintain their safety, soundness, and compliance with consumer laws, and to encourage a competitive industry that meets America's financial services needs. As the primary Federal regulator of savings and loan holding companies, OTS has the authority to supervise and examine each holding company enterprise, but relies on the specific functional regulators for information and findings regarding the specific entity for which the functional regulator is responsible.

Once created, a holding company is subject to ongoing monitoring and examination. Managerial resources, financial resources and future prospects continue to be evaluated through the CORE holding company examination components (*i.e.,* Capital, Organizational Structure, Risk Management and Earnings). The OTS holding company examination assesses capital and earnings in relation to the unique organizational structure and risk profile of each holding company. During OTS's review of capital adequacy, OTS considers the risk inherent in an enterprise's activities and the ability of the enterprise's capital to absorb unanticipated losses, support the level and composition of the parent company's and subsidiaries' debt, and support business plans and strategies.

The focus of this authority is the consolidated health and stability of the holding company enterprise and its effect on the subsidiary savings association. OTS oversees the enterprise to identify systemic issues or weaknesses, as well as ensure compliance with regulations that govern permissible activities and transactions. The examination goal is consistent across all types of holding company enterprises; however, the level of review and amount of resources needed to assess a complex structure such as AIG's is vastly deeper and more resource-intensive than what would be required for a less complex holding company.

OTS Supervisory Actions

OTS's approach to holding company supervision has continually evolved to address new developments in the financial services industry and supervisory best practices. At the time AIG became a savings and loan holding company in 2000, OTS focused primarily on the impact of the holding company enterprise on the subsidiary savings association. With the passage of Gramm-Leach-Bliley, not long before AIG became a savings and loan holding company, OTS recognized that large corporate enterprises, made up of a number of different companies or legal entities, were changing the way such enterprises operated and would need to be supervised. These companies, commonly called conglomerates, began operating differently from traditional holding companies and in a more integrated fashion, requiring a more enterprise-wide review of their operations. In short, these companies shifted from managing along legal entity lines to managing along functional lines.

Consistent with changing business practices and how conglomerates then were managed, in late 2003 OTS embraced a more enterprise-wide approach to supervising conglomerates. This shift aligned well with core supervisory principles adopted by the Basel Committee and with requirements adopted by European Union (EU) regulators that took effect in 2005, which required supplemental regulatory supervision at the conglomerate level. OTS was recognized as an equivalent regulator for the purposes of AIG consolidated supervision within the EU, a process that was finalized with a determination of equivalence by the French regulator, Commission Bancaire.

Under OTS's approach of classifying holding companies by complexity, as well as the EU's definition of a financial conglomerate, AIG was supervised, and assessed, as a conglomerate. OTS exercises its supervisory responsibilities with respect to complex holding companies by communicating with other functional regulators and supervisors who share jurisdiction over portions of these entities and through our own set of specialized procedures. With respect to communication, OTS is committed to the framework of functional supervision Congress established in Gramm-Leach-Bliley. Under Gramm-Leach-Bliley, the consolidated supervisors are required to consult on an ongoing basis with other functional regulators to ensure those findings and competencies are appropriately integrated into our own assessment of the consolidated enterprise and, by extension, the insured depository institution we regulate.

Consistent with this commitment and as part of its comprehensive, consolidated supervisory program for AIG, OTS began in 2005 to convene annual supervisory college meetings. Key foreign supervisory agencies, as well as U.S. State insurance regulators, participated in these conferences. During the part of the meetings devoted to presentations from the company, supervisors have an opportunity to question the company about any supervisory or risk issues. Approximately 85 percent of AIG, as measured by allocated capital, is contained within entities regulated or licensed by other supervisors. Another part of the meeting includes a "supervisors-only" session, which provides a venue for participants to ask questions of each other and to discuss issues of common concern regarding AIG. OTS also uses the occasion of the college meetings to arrange one-on-one side meetings with foreign regulators to discuss in more depth significant risk in their home jurisdictions.

As OTS began its early supervision of AIG as a conglomerate, our first step was to better understand its organizational structure and to identify the interested regulators throughout the world. In this regard, AIG had a multitude of regulators in over 100 countries involved in supervising pieces of the AIG corporate family. OTS established relationships with these regulators, executed information sharing agreements where appropriate, and obtained these regulators' assessments and concerns for the segment of the organization regulated.

As OTS gained experience supervising AIG and other conglomerates, we recognized that a dedicated examination team and continuous onsite presence was essential to overseeing the dynamic and often fast-paced changes that occur in these complex structures. In 2006, OTS formally adopted a risk-focused continuous supervision program for the oversight of large and complex holding companies. This program combines on- and off-site planning, monitoring, communication, and analysis into an ongoing examination process. OTS's continuous supervision and examination program comprises development and maintenance of a comprehensive risk assessment, which consists of: an annual supervisory plan; risk-focused targeted reviews; coordination with other domestic and foreign regulators; an annual examination process and reporting framework; routine management meetings; and an annual board of directors meeting.

OTS conducted continuous consolidated supervision of the AIG group, including an onsite examination team at AIG headquarters in New York. Through frequent, ongoing dialogue with company management, OTS maintained a contemporaneous understanding of all material parts of the AIG group, including their domestic and cross-border operations.

OTS's primary point of contact with the holding company was through AIG departments that dealt with corporate control functions, such as Enterprise Risk Management (ERM), Internal Audit, Legal/Compliance, Comptroller, and Treasury. OTS held monthly meetings with AIG's Regulatory and Compliance Group, Internal Audit Director, and external auditors. In addition, OTS held quarterly meetings with the Chief Risk Officer, the Treasury Group, and senior management, and annually with the board of directors. OTS reviewed and monitored risk concentrations, intra-group transactions, and consolidated capital at AIG, and also directed corrective actions against AIG's Enterprise Risk Management. OTS also met regularly with Price Waterhouse Coopers (PwC), the company's independent auditor.

Key to the continuous supervision process is the risk assessment, resulting supervisory plan, and targeted areas of review for each year. OTS focused on the corporate governance, risk management, and internal control centers within the company and completed targeted reviews of non-functionally regulated affiliates within the holding company structure.

In 2005, OTS conducted several targeted, risk-focused reviews of various lines of business, including AIGFP, and made numerous recommendations to AIG senior management and the board with respect to risk management oversight, financial reporting transparency and corporate governance. The findings, recommendations, and corrective action points of the 2005 examination were communicated in a report to the AIG Board in March 2006.

With respect to AIGFP, OTS identified and reported to AIG's board weaknesses in AIGFP's documentation of complex structures transactions, in policies and procedures regarding accounting, in stress testing, in communication of risk tolerances, and in the company's outline of lines of authority, credit risk management and measurement.

Our report of examination also identified weaknesses related to American General Finance (AGF), another non-functionally regulated subsidiary in the AIG family that is a major provider of consumer finance products in the U.S. These weaknesses included deficiencies regarding accounting for repurchased loans, evaluation of the allowance for loan losses: Credit Strategy Policy Committee reporting, information system data fields, and failure to forward copies of State examination reports and management response to the Internal Audit Division.

The examination report also noted weaknesses in AIG's management and internal relationships, especially with the Corporate Legal Compliance Group and the Internal Audit Division, as well as its anti-money laundering program.

In 2006 OTS noted nominal progress on implementing corrective measures on the weaknesses noted in the prior examination; however, the Agency identified additional weaknesses requiring the board of directors to take corrective action. Most notably, OTS required the board to establish timely and accurate accounting and reconciliation processes, enhance and validate business line capital models, address compliance-related matters, adopt mortgage loan industry best practices, and assess the adequacy of its fraud detection and remediation processes.

During 2007, when there were signs of deterioration in the U.S. mortgage finance markets, OTS increased surveillance of AGF and AIGFP. OTS selected AGF for review because of its significant size and scope of consumer operations, and to follow up on the problems noted in prior examinations.

OTS also has supervisory responsibility for AIG Federal Savings Bank. OTS took action against AIG FSB in June, 2007, in the form of a Supervisory Agreement for its failure to manage and control in a safe and sound manner the loan origination services outsourced to its affiliate, Wilmington Finance, Inc. (WFI). The Agreement addressed loan origination activities and required AIG FSB to identify and provide timely assistance to borrowers who were at risk of losing their homes because of the thrift's loan origination and lending practices. OTS also required a $128 million reserve to be established to cover costs associated with providing affordable loans to borrowers.

Later, in light of AIG's growing liquidity needs to support its collateral obligations, OTS took action in September 2008 at the FSB level to ensure that depositors and the insurance fund were not placed at risk. OTS actions precluded the bank from engaging in transactions with affiliates without OTS knowledge and lack of objection; restricted capital distributions; required maintenance of minimum liquidity and borrowing capacity sensitive to the unfolding situation; and required retention of counsel to advise the board in matters involving corporate reorganization and attendant risks related thereto. AIG FSB continues to be well capitalized and maintains adequate levels of liquidity.

After a 2007 targeted review of AIGFP, OTS instructed the company to revisit its modeling assumptions in light of deteriorating subprime market conditions. In the summer of 2007, after continued market deterioration, OTS questioned AIG about the valuation of CDS backed by subprime mortgages. In the last quarter of 2007, OTS increased the frequency of meetings with AIG's risk managers and PwC. Due to the Agency's progressive concern with corporate oversight and risk management, in October 2007 we required AIG's Board to:

- Monitor remediation efforts with respect to certain material control weaknesses and deficiencies;
- Ensure implementation of a long-term approach to solving organizational weaknesses and increasing resources dedicated to solving identified deficiencies;
- Monitor the continued improvement of corporate control group ability to identify and monitor risk;
- Complete the holding company level risk assessment, risk metrics, and reporting initiatives and fully develop risk reporting;
- Increase involvement in the oversight of the firm's overall risk appetite and profile and be fully informed as to AIG Catastrophic Risk exposures, on a full-spectrum (credit, market, insurance, and operational) basis; and
- Ensure the prompt, thorough, and accountable development of the Global Compliance program, a critical risk control function where organizational structure impediments have delayed program enhancements.

OTS further emphasized to AIG management and the board that it should give the highest priority to the financial reporting process remediation and the related long-term solution to financial reporting weaknesses. In connection with the 2007 annual examination, the Organizational Structure component of the CORE rating was downgraded to reflect identified weakness in the company's control environment.

Shortly after OTS issued the 2007 report, AIG disclosed its third quarter 2007 financial results, which indicated for the first time a material problem in the Multi Sector CDS portfolio evidenced by a $352 million valuation charge to earnings and the disclosure that collateral was being posted with various counterparties to address further market value erosion in the CDS portfolio.

As PwC was about to issue the accounting opinions on the 2007 financial statements, the independent auditor concluded that a material control weakness existed in AIGFP's valuation processes and that a significant control deficiency existed with Enterprise Risk Management's access to AIGFP's valuation models and assumptions. Due to intense pressure from PwC, in February 2008, AIG filed an SEC Form 8K announcing the presence of the material weakness. AIG pledged to implement complete remediation efforts immediately.

OTS's subsequent supervisory review and discussions with PwC revealed that AIGFP was allowed to limit access of key risk control groups while material questions relating to the valuation of super senior CDS portfolio were mounting. As a result of this gap, corporate management did not obtain sufficient information to completely assess the valuation methodology. In response to these matters, AIG's Audit Committee commissioned an internal investigation headed by Special Counsel to the Audit Committee to review the facts and circumstances leading to the events disclosed in the SEC Form 8K. The Special Counsel worked with OTS to evaluate the breakdown in internal controls and financial reporting. Regulatory entities such as the Securities Exchange Commission and Department of Justice then also commenced inquiries.

The OTS met with AIG senior management on March 3, 2008, and communicated significant supervisory problems over the disclosures in the SEC Form 8K and the unsatisfactory handling of the Enterprise Risk Management relationship with AIGFP. OTS downgraded AIG's CORE ratings and communicated the OTS's view of the company's risk management failure in a letter to AIG's General Counsel on March 10, 2008.

As part of this remediation process and to bolster corporate liquidity and oversight, AIG successfully accessed the capital markets in May of 2008 and raised roughly $20 billion in a combination of common equity and equity hybrid securities. This action coupled with existing liquidity at the AIG parent, provided management with reasonable comfort that it could fund the forecasted collateral needs of AIGFP. AIG also added a Liquidity Manager to its corporate Enterprise Risk Management unit to provide senior management with more timely stress scenario reporting and formed a liquidity monitoring committee composed of risk managers, corporate treasury personnel, and business unit members to provide oversight.

On July 28, 2008, AIG submitted a final comprehensive remediation plan, which OTS reviewed and ultimately accepted on August 28, 2008. The AIG audit committee approved the company's remediation plan, which also was used by PwC to assess AIG's progress in resolving the material control weakness covering the valuation of the CDS portfolio and the significant control deficiency attributable to AIG's corporate risk oversight of AIGFP, AGF, and International Lease Finance Corporation (ILFC). OTS continues to monitor these remediation efforts to this day, notwithstanding AIG's September 2008 liquidity crisis.

As AIG's liquidity position became more precarious, OTS initiated heightened communications with domestic and international financial regulators. Through constant communication, OTS monitored breaking events in geographic areas where AIG operates, kept regulators in those jurisdictions informed of events in the U.S. and clarified the nature of AIG's stresses. OTS's identification of AIGFP as the focal point of AIG's problems added perspective that allowed foreign regulators to more accurately assess the impact on their regulated entities and to make informed supervisory decisions.

In September 2008 the Federal Reserve Bank of New York (FRB-NY) extended an $85 billion loan to AIG and the government took an 80 percent stake in AIG. On the closure of this transaction? Federal statute no longer defined AIG as a savings and loan holding company subject to regulation as such. This result would be true whether AIG had been a savings and loan holding or bank holding company subject to regulation by the Federal Reserve Board. Nonetheless, OTS has continued in the role of equivalent regulator for EU and international purposes. FRB-NY's intervention had no impact on OTS's continued regulation and supervision of AIG FSB.

Although OTS has scaled back some regulatory activities with regard to AIG, the Agency continues to meet regularly with key corporate control units and receive weekly reports on various exposures and committee activities. OTS closely monitors the activities at AIGFP to reduce risk, as well as the divesture efforts of the holding company. OTS will continue to focus on Residential Mortgage Backed Securities exposures and the ultimate performance of underlying mortgage assets. OTS is tracking AIG's remediation efforts. Finally, OTS continues to work with global functional regulators to keep them apprised of conditions at the holding company, as well as to learn of emerging issues in local jurisdictions.

Lessons Learned

Despite OTS's efforts to point out AIGFP's weaknesses to the company and to its Board of Directors, OTS did not foresee the extent of the risk concentration and the profound systemic impact CDS products caused within AIG. By the time AIGFP stopped originating these derivatives in December 2005, they already had $65 billion on their books. These toxic products posed significant liquidity risk to the holding company.

Companies that are successful have greater opportunities for growth. AIG was successful in many regards for many years, but it had issues and challenges. OTS identified many of these issues and attempted to initiate corrective actions, but these actions were not sufficient to avoid the September market collapse.

It is worth noting that AIGFP's role was not underwriting, securitizing, or investing in subprime mortgages. Instead; AIGFP simply provided insurance-like protection against declines in the values of underlying securities. Nevertheless, in hindsight, OTS should have directed the company to stop originating CDS products before December 2005. OTS should also have directed AIG to try to divest a portion of this portfolio. The pace of change and deterioration of the housing market outpaced our supervisory remediation measures for the company. By the time the extent of the CDS liquidity exposure was recognized, there was no orderly way to reduce or unwind these positions and the exposure was magnified due to the concentration level. The CDS market needs more consistent terms and conditions and greater depth in market participants to avoid future concentration risks similar to AIG.

I believe it is important for the Committee to understand the confluence of market factors that exposed the true risk of the CDS in AIGFP's portfolio. OTS saw breakdowns in market discipline, which was an important element of our supervisory assessment. Areas that we now know were flawed included: overreliance on financial models, rating agency influence on structured products, lack of due diligence in the packaging of asset-backed securities, underwriting weaknesses in originate-to-distribute models, and lack of controls over third party (brokers, conduits, wholesalers) loan originators.

Shortcomings in modeling CDS products camouflaged some of the risk. AIGFP underwrote its super senior CDS using proprietary modeling similar to that used by rating agencies for rating structured securities. AIGFP's procedures required modeling based on simulated periods of extended recessionary environments (*i.e.,* ratings downgrade, default, loss, recovery). Up until June 2007, the results of the AIGFP models indicated that the risk of loss was a remote possibility, even under worst-case scenarios. The model used mainstream assumptions that were generally acceptable to the rating agencies, PwC, and AIG.

Following a targeted review of AIGFP in early 2007, OTS recommended that the company revisit its modeling assumptions in light of deteriorating subprime market conditions. In hindsight, the banking industry, the rating agencies and prudential supervisors, including OTS, relied too heavily on stress parameters that were based on historical data. This led to an underestimation of the unprecedented economic shock and misjudgment of stress test parameters.

Approximately 6 months after OTS's March 2008 downgrade of AIG's examination rating, the credit rating agencies also downgraded AIG on September 15, 2008. That precipitated calls that required AIGFP to post huge amounts of collateral for which it had insufficient funds. The holding company capital was frozen and AIGFP could not meet the calls.

Recommendations

From the lessons learned during our involvement with supervising AIG, we would like you to consider two suggestions in your future exploration of regulatory reform.

Systemic Risk Regulator

First, OTS endorses the establishment of a systemic risk regulator with broad authority, including regular monitoring, over companies that if, due to the size or interconnected nature of their activities, their actions, or their failure would pose a risk to the financial stability of the country. Such a regulator should be able to access funds, which would present options to resolve problems at these institutions. The systemic risk regulator should have the ability and the responsibility for monitoring all data about markets and companies, including but not limited to companies involved in banking, securities, and insurance.

Regulation of Credit Default Swaps—Consistency and Transparency

CDS are financial products that are not regulated by any authority and impose serious challenges to the ability to supervise this risk proactively without any prudential derivatives regulator or standard market regulation. We are aware of and support the recent efforts by the Federal Reserve Bank of New York to develop a common global framework for cooperation. There is a need to fill the regulatory gaps the CDS market has exposed.

We have also learned there is a need for consistency and transparency in CDS contracts. The complexity of CDS contracts masked risks and weaknesses in the program that led to one type of CDS performing extremely poorly. The current regulatory means of measuring off-balance sheet risks do not fully capture the inherent risks of CDS. OTS believes standardization of CDS would provide more transparency to market participants and regulators.

In the case of AIG, there was heavy reliance on rating agencies and in-house models to assess the risks associated with these extremely complicated and unregulated products. I believe that Congress should consider legislation to bring CDS under regulatory oversight, considering the disruption these instruments caused in the marketplace. Prudential supervision is needed to promote a better understanding of the risks and best practices to manage these risks, enhance transparency, and standardization of contracts and settlements. More and better regulatory tools are needed to bring all potential instruments that could cause a recurrence of our present problems under appropriate oversight and legal authority.

A multiplicity of events led to the downfall of AIG. An understanding of the control weaknesses and events that transpired at AIG provides an opportunity to learn to identify weaknesses and strengthen regulatory oversight of complex financial products and companies. OTS has absorbed these lessons and has issued risk-focused guidance and policies to promote a more updated and responsive supervisory program.

Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee, for the opportunity to testify on behalf of the OTS on the collapse of AIG.

We look forward to working with the Committee to ensure that, in these challenging times, thrifts and consolidated holding companies operate in a safe and sound manner.

PREPARED STATEMENT OF ERIC DINALLO

SUPERINTENDENT,
NEW YORK STATE INSURANCE DEPARTMENT

MARCH 5, 2009

I would like to thank Chairman Christopher Dodd, Ranking Member Richard Shelby, and the Members of the Senate Committee on Banking, Housing, and Urban Affairs for inviting me to testify today at this hearing on "American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation."

My name is Eric Dinallo and I am Insurance Superintendent for New York State.

I very much appreciate the Committee holding this hearing so that we can discuss what has happened at AIG and how to improve financial services regulation in the future.

I would like to start by taking this opportunity to clear up some confusion. I have read a number of times statements that the New York State Insurance Department is the primary regulator of AIG.

The New York Insurance Department is not and never has been the primary regulator for AIG. AIG is a huge, global financial services holding company that does business in 130 countries. Besides its 71 U.S.-based insurance companies, AIG has 176 other financial services companies, including non-U.S. insurers.

State insurance departments have the power and authority to act as the primary regulator for those insurance companies domiciled in their State. So the New York Department is primary regulator for only those AIG insurance companies domiciled in New York.

Specifically, the New York Insurance Department is the primary regulator for 10 of AIG's 71 U.S. insurance companies: American Home Assurance Company, American International Insurance Company, AIU Insurance Company, AIG National Insurance Company, Commerce and Industry Insurance Company, Transatlantic Reinsurance Company, American International Life Assurance Company of New York, First SunAmerica Life Insurance Company, United States Life Insurance Company in the City of New York, and Putnam Reinsurance Company. AIG's New York life insurance companies are relatively small. The property insurance companies are much larger. Other States act as primary regulator for the other U.S. insurance companies.

State insurance regulators are not perfect. But one thing we do very well is focus on solvency, on the financial strength of our insurance companies. We require them to hold conservative reserves to ensure that they can pay policyholders. That is why insurance companies have performed relatively well in this storm. One clear lesson of the current crisis is the importance of having plenty of capital and not having too much leverage.

The crisis for AIG did not come from its State regulated insurance companies. The primary source of the problem was AIG Financial Products, which had written credit default swaps, derivatives and futures with a notional amount of about $2.7 trillion, including about $440 billion of credit default swaps. For context, that is equal to the gross national product of France. Losses on certain credit default swaps and collateral calls by global banks, broker dealers and hedge funds that are counterparties to these credit default swaps are the main source of AIG's problems.

Faced with ratings downgrades, AIG Financial Products and AIG holding company faced tens of billions of dollars of demands for cash collateral on the credit default swaps written by Financial Products and guaranteed by the holding company.

Federal Reserve Chairman Bernanke recently said, "AIG had a financial products division which was very lightly regulated and was a source of a great deal of systemic trouble." This week, Chairman Bernanke accurately called the Financial Products unit "a hedge fund basically that was attached to a large and stable insurance company, made huge numbers of irresponsible bets, took huge losses."

The main reason why the Federal Government decided to rescue AIG was not because of its insurance companies. Rather, it was because of the systemic risk created by Financial Products. There was systemic risk because of Financial Products relationships and transactions with virtually every major commercial and investment bank, not only in the U.S., but around the world. I would like to note that insurance companies were not the purchasers of AIG's toxic credit default swaps.

To quote Chairman Bernanke again, Financial Products "took all these large bets where they were effectively, quote, 'insuring' the credit positions of many, many banks and other financial institutions."

By purchasing a savings and loan in 1999, AIG was able to select as its primary regulator the Federal Office of Thrift Supervision, the Federal agency that is charged with overseeing savings and loan banks and thrift associations. The Office of Thrift Supervision is AIG's consolidated supervisor for purposes of Gramm-Leach-Bliley.

AIG Financial Products is not a licensed insurance company. It was not regulated by New York State or any other State.

We all agree that AIG Financial Products should have been subject to more and better regulation. A major driver of its problems stemmed from its unregulated use of credit default swaps, which were exempted from regulation by Federal legislation in the late nineties.

Some have tried to use AIG's problems as an argument for an optional Federal charter for insurance companies. I am open to a Federal role in regulating insurance and the non-insurance operations of large financial services groups such as AIG. I have said as much in prior testimony to other Congressional committees.

But an optional Federal charter is the wrong lesson to learn from AIG for two very clear reasons.

One, when you permit companies to pick their regulator, you create the opportunity for regulatory arbitrage. The whole purpose of financial services regulation is to appropriately control risk. But when you allow regulatory arbitrage, you increase risk. Because you create the opportunity for a financial institution to select its regulator based on who might be more lenient, who might have less strict rules, who might demand less capital.

This is not a theoretical contention. I refer the Committee to a January 22, 2009, article in the *Washington Post* titled "By Switching Their Charters, Banks Skirt Supervision." The article reports that since 2000 at least 30 banks switched from Federal to State supervision to escape regulatory action. The actual number is likely higher because the newspaper was only able to count public regulatory actions. They could not discover banks that acted to pre-empt action when they saw it coming. In total, 240 banks converted from Federal to State charters, while 90 converted from State to Federal charters. The newspaper was unable to discover if any of those formerly State banks were avoiding State action.

Two, what happened at AIG demonstrates the strength and effectiveness of State insurance regulation, not the opposite.

The only reason that the Federal rescue of AIG is possible is because there are strong operating insurance companies that provide the possibility that the Federal Government and taxpayers will be paid back. And the reason why those insurance companies are strong is because State regulation walled them off from non-related activities in the holding company and at Financial Products.

In most industries, the parent company can reach down and use the assets of its subsidiaries. With insurance, that is greatly restricted. State regulation requires that insurance companies maintain healthy reserves backed by investments that cannot be used for any other purpose. I've said that the insurance companies are the bars of gold in the mess that AIG has become.

There are activities that the States need to improve, such as licensing and bringing new products to market. But where we are strong has been in maintaining solvency.

I would note that at a time when financial services firms are in trouble because they do not have adequate capital and are too highly leveraged, at a time when commercial banks and investment banks have very serious problems, insurance companies remain relatively strong.

There is justified concern about AIG's securities lending program, which affects only AIG's life insurance operations. I would like to review for you some facts about that program and the actions the New York Department has taken in regards to that program.

It is important to understand that securities lending did not cause the crisis at AIG. AIG Financial Products did. If there had been no Financial Products unit and only the securities lending program as it was, we would not be here today. There would have been no Federal rescue of AIG. Financial Products' trillions of dollars of transactions created systemic risk. Securities lending did not.

If not for the crisis caused by Financial Products, AIG would be just like other insurance companies, dealing with the stresses caused by the current financial crisis, but because of its size and strength, most likely weathering them well.

Securities lending is an activity that has been going on for decades without serious problems. Many, if not most, large financial institutions, including commercial banks, investment banks and pension funds, participate in securities lending.

Securities lending involves financial institution A lending a stock or bond it owns to financial institution B. In return, B gives A cash worth generally about 102 percent of the value of the security it is borrowing. A then invests the cash. A still owns the security and will benefit from any growth in its value. And A invests the cash to gain a small additional amount.

Problems can occur if B decides it wants to return the security it borrowed from A. A is then required to sell its investment to obtain the cash it owes B. Generally, in a big securities lending program, A will have some assets it can easily sell. But if there is a run, if many of the borrowers return the securities and demand cash, A may not be able to quickly sell enough assets to obtain the cash it needs or may have to sell assets at a loss before they mature.

AIG securities lending was consolidated by the holding company at a special unit it set up and controlled. This special unit was not a licensed insurance company. As with some other holding company activities, it was pursued aggressively rather than prudently.

AIG maintained two securities lending pools, one for U.S. companies and one for non-U.S. companies. At its height, the U.S. pool had about $76 billion. The U.S. security lending program consisted of 12 life insurers, three of which were from New York. Those three New York companies contributed about 8 percent of the total assets in the securities lending pool.

The program was invested almost exclusively in the highest-rated securities. Even the few securities that were not top rated, not triple A, were either double A or single A. Today, with the perfect clarity of hindsight, we all know that those ratings were not aligned with the market value of many mortgage-backed securities, which made up 60 percent of the invested collateral pool.

The New York Department was aware of the potential stresses at the AIG securities lending program and was actively monitoring it and working with the company to deal with those issues. Those efforts were working, but were thwarted by the Financial Products crisis in September 2008.

As early as July 2006, we were engaged in discussions about the securities lending program with AIG. In 2007, we began working with the company to start winding down the program.

Unfortunately, the securities lending program could not be ended quickly because beginning in 2007 some of the residential mortgage securities could not be sold for their full value. At that time there were still few if any defaults, the securities were still paying off. But selling them would have involved taking a loss.

Still, we insisted that the program be wound down and that the holding company provide a guarantee to the life companies to make up for any losses that were incurred as that happened. In fact, the holding company provided a guarantee of first $500 million, then $1 billion and finally $5 billion.

In 2008, New York and other States began quarterly meetings with AIG to review the securities lending program. Meanwhile, the program was being wound down in an orderly manner to reduce losses. From its peak of about $76 billion it had declined by $18 billion, or about 24 percent, to about $58 billion by September 12, 2008.

At that point, the crisis caused by Financial Products caused the equivalent of a run on AIG securities lending. Borrowers that had reliably rolled over their positions from period to period for months began returning the borrowed securities and demanding their cash collateral. From September 12 to September 30, borrowers demanded the return of about $24 billion in cash.

The holding company unit that managed the program had invested the borrowers' cash collateral in mortgage-backed securities that had become hard to sell. To avoid massive losses from sudden forced sales, the Federal Government, as part of its rescue, provided liquidity the securities lending program. In the early weeks of the rescue, holding company rescue funds were used to meet the collateral needs of the program. Eventually the Federal Reserve Bank of New York created Maiden Lane II, a fund that purchased the life insurance companies' collateral at market value for cash.

There are two essential points about this. First, without the crisis caused by Financial Products, there is no reason to believe there would have been a run on the securities lending program. We would have continued to work with AIG to unwind its program and any losses would have been manageable. In fact, the New York Department has worked and continues to work with other insurance companies to unwind their securities lending programs with no serious problems.

Second, even if there had been a run on the securities lending program with no Federal rescue, our detailed analysis indicates that the AIG life insurance companies would not have been insolvent. Certainly, there would have been losses, with some companies hurt more than others. But we believe that there would have been sufficient assets in the companies and in the parent to maintain the solvency of all the companies. Indeed, before September 12, 2008, the parent company contributed slightly more than $5 billion to the reduction of the securities lending program.

But that is an academic analysis. Whatever the problems at securities lending, they would not have caused the crisis that brought down AIG. And without Financial Products and the systemic risk its transactions created, there would have been no reason for the Federal Government to get involved. State regulators would have worked with the company to deal with the problem and protect policyholders.

I would like to also review briefly what the New York Department has done generally about securities lending in the insurance industry.

Based on what we were seeing at AIG, but before the Financial Products crisis in September, we warned all licensed New York companies that we expect them to prudently manage the risks in securities lending programs. On July 21, 2008, New York issued Circular Letter 16 to all companies doing business in New York which indicates Department concerns about security lending programs. We cautioned them about the risks, reminded them of the requirements for additional disclosure and told them we would be carefully examining their programs.

On September 22, 2008, the Department sent what is known as a Section 308 letter to all life insurance companies licensed in New York requiring them to submit information relating to security lending programs, financing arrangements, security impairment issues and other liquidity issues. My staff then conducted a thorough investigation of the securities' lending programs at New York life insurance companies. The results were reassuring. Almost all of the companies had modest sized programs with highly conservative investments, even by today's standards. Companies with larger programs had ample liquidity to meet redemptions under stress. What became clear was that AIG, because of the Financial Products problems, was in a uniquely troubling situation.

In the succeeding months we have continued to analyze the securities lending programs at New York companies. We are currently drafting regulatory guidelines that will govern the size and scope of securities lending programs and will include best practices. We will also continue to enforce our legal authority to shut-down any programs that we believe endanger policyholders.

Also, as chair of the National Association of Insurance Commissioners Statutory Accounting Practices Working Group, we have successfully worked to have the NAIC adopt increased disclosure rules for securities lending programs.

Our primary principle throughout the effort to assist AIG has been to continue to protect insurance company policyholders and stabilize the insurance marketplace. And it is appropriate to recognize that all our partners in this effort, including officials from the Federal Reserve Bank of New York, the Federal Reserve Board, the U.S. Treasury, AIG executives and their financial advisors, investment and commercial bankers, private equity investors, other State regulators at all times understand and agree that nothing should or would be done to compromise the protection of insurance company policyholders. The dependable moat of State regulation that protects policyholders remains solid.

We will continue to evaluate any transactions involving AIG insurance companies on that basis.

Thank you and I would be happy to answer your questions.

RESPONSE TO WRITTEN QUESTIONS OF THE SENATE BANKING COMMITTEE FROM ERIC DINALLO

Q.1.a. State Rescue Plan: Superintendent Dinallo, it has been reported that last year you and the Pennsylvania Insurance Commissioner sought to save AIG by allowing AIG's property and casualty insurers to transfer $20 billion in liquid government securities to AIG's holding company in exchange for stock in AIG's domestic life insurers. On September 15, 2008, New York Governor David Paterson issued a press release stating that he had instructed you to permit AIG's parent company to access the $20 billion from its subsidiary property-casualty insurance companies.

Please provide the Committee with a complete description of this plan, including the documents you presented to Governor Paterson to obtain his approval for the plan.

A.1.a. The basic terms of the initial proposed plan provided for three distinct elements: (1) the parent company American International Group, Inc. (AIG) raising equity capital from commercial sources, (2) AIG quickly selling a significant business unit or units, and (3) AIG property casualty companies exchanging liquid assets for equally valuable, but less liquid, assets owned by the parent and the parent in turn converting those liquid assets to cash. The plan was discussed at length over the weekend of September 12–14, 2008, and into Monday, September 15, 2008, as described below, but was supplanted by other actions and not implemented.

This was not a formally developed "Plan" with lengthy development or long written analyses. The plan was a constantly evolving, working response developed during a rapidly changing crisis. We were aware of and engaged in discussions concerning all three parts of this plan. It was always our expectation and understanding that all three elements were required and that we would not implement the third element unless there was a comprehensive solution for the crisis. In addition, the third element was itself never finalized. One of the conditions for our final approval was the company providing assets that would be, in our estimation, of sufficient value to protect the property casualty companies and their policyholders.

Governor Paterson's direction was to ensure that policyholders inside and outside New York were protected. The Governor's press release on Monday, September 15, reflected an agreement in principle. It was clearly not a final approval.

As the weekend of September 12 to 14 progressed, AIG's projected cash needs grew substantially. By early Tuesday, it was clear that, even if possible to complete, this plan would not suffice and all parties focused on other actions.

For the first element of the plan, AIG discussed raising equity capital from a variety of commercial sources. If a capital raise resulted in another entity acquiring control, as defined in Article 15 of the New York Insurance Law (the "Insurance Law"), of New York licensed insurance companies, New York State Insurance Department (the "Department") approval would have been required. While we were not negotiating the terms of any prospective capital raises, we were periodically updated on the progress of those discussions.

For the second element of the plan, AIG was discussing possible imminent business unit sales. As noted above, another entity acquiring control, as defined in Article 15 of the Insurance Law, of New York licensed insurance companies would have required Department approval. As with AIG's capital raising efforts, while we were not negotiating the terms of any prospective sales, we were periodically updated on the progress of these discussions.

For the third element of the plan, AIG sought to have certain of its property casualty companies exchange municipal bonds they owned for stock in AIG Life Holdings (U.S.), Inc. and AIG Retirement Services, Inc. (the "Life Company Stock"), intermediate holding company subsidiaries of AIG which own substantial operating insurance companies, and for other assets including certain real estate interests and other investments. AIG would then seek to post these municipal bonds with the Federal Reserve Bank of New York in exchange for cash. That would allow AIG to use the cash to post cash collateral for its AIG Financial Products collateral calls.

Among the property casualty companies considered for this exchange (as providers of municipal bonds and receivers of life insurance company stock) were American Home Assurance Company (AHAC) and Commerce and Industry Insurance Company (C&I), each a New York domiciled property casualty company. Additionally, three Pennsylvania domiciled property casualty companies were also considered, National Union Fire Insurance Company of Pittsburgh, Pa., New Hampshire Insurance Company, and The Insurance Company of the State of Pennsylvania.

The stated goal of AIG for the proposed transactions in this third element of the plan was to provide $20 billion of liquidity to AIG. An aggregate purchase price for the Life Company Stock of approximately $15 billion dollars was proposed by AIG. The additional asset sales sought by AIG had a proposed aggregate purchase price of approximately $5 billion dollars. By Monday, September 15, as the plan evolved, the Department was considering only that the New York domiciled property casualty companies might purchase a portion of the Life Company Stock, and not any other assets.

The plan contemplated that if the exchange were completed, the Life Company Stock would then be sold to third party purchasers over a longer sale period, with the sale proceeds retained by the property casualty companies. The discussions contemplated that the groups of New York and of Pennsylvania property casualty companies would each purchase approximately 50 percent of the Life Company Stock.

Throughout Saturday and Sunday, September 13 and 14, my staff and I had many discussions with AIG and its advisors. We reviewed and discussed their various proposals and ideas for implementing the exchange. We did not at any time give final approval for the proposed exchange. Indeed, we were at all times clear that the proposal had to be part of a holistic solution and had to overprotect policyholders, or it would not be approved.

As my statement in Governor Paterson's press release, issued on the morning of September 15, noted, as of Monday morning we continued "working closely with AIG" on its proposal. As the Governor stated in that release on the morning of September 15, I was, at the Governor's direction, working with the Federal Reserve Bank of New York (FRBNY) in response to the rapidly changing crisis.

As my discussions with the FRBNY, the U.S. Treasury Department and numerous other parties continued through Monday afternoon and well into Monday night, other plans developed. The primary alternative considered was a commercial line of credit provided by commercial lenders. Through roughly midnight Monday or 1 a.m. on Tuesday, when I left AIG's offices, that appeared to be the most likely option. By the time of a meeting commencing at 7:30 a.m. Tuesday morning, that alternative appeared to have failed. Discussion then turned to possible Federal Reserve and Federal Government actions and consideration of the credit facility announced that night. The three part plan that is the subject of your question was not further pursued.

Q.1.b. Which other State and Federal regulatory agencies, private sector firms and banks were involved in preparing this plan?

A.1.b. Concerning our own advisors, in addition to Department resources, we retained the law firm of Fried, Frank, Harris, Shriver, and Jacobson as outside counsel. We later retained Centerview Partners as outside financial advisors, although such retention was not in effect during the period that your question covers.

We dealt with many parties between September 12 and September 16. To say that they were each "involved in preparing this plan" is an overstatement and a more formal characterization than would be accurate. Each of them, however, played a role in those 5 days and our own response and actions incorporated, at least indirectly, our dealings with a broad range of other firms and agencies.

Concerning commercial parties, these included AIG, JPMorgan Chase and Blackstone as advisors to AIG, Sullivan & Cromwell as counsel to AIG, Simpson Thacher & Bartlett as counsel to the AIG board of directors, J.C. Flowers & Co., Texas Pacific Group, Kohlberg Kravis & Roberts, and Berkshire Hathaway as prospective investors and/or purchasers. On September 15 and 16, these also included Goldman Sachs. I do not recall any other firms or banks as being involved, but only AIG and the other parties can say definitively whether they retained or engaged any other firms or banks.

Concerning other government agencies, we dealt with the Federal Reserve Bank of New York, the FRBNY's financial advisors Morgan Stanley, the FRBNY's legal counsel Davis Polk & Wardwell, the United States Treasury Department, the Pennsylvania Department of Insurance, the National Association of Insurance Commissioners (including the then-NAIC president Sandy Praeger, who is the Kansas Insurance Commissioner and the NAIC president-elect, and now president, Roger Sevigny, who is the New Hampshire Insurance Commissioner), and a number of other State insurance departments. I have subsequently learned that a staff member of the United States Office of Thrift Supervision contacted one of my staff late on Sunday, September 14. I was unaware of that contact at the time and I had no contact with the Office of Thrift Supervision during the period covered by your question.

Q.1.c. Did any State insurance regulators object to or express any concerns about this plan?

A.1.c. Accurately answering your question requires separating it into two parts, the first being whether any insurance regulators "object[ed] to" such plan and the second being whether any insurance regulators "express[ed] any concerns."

On the first part, I do not recall any State insurance regulator saying that they objected to the plan.

On the second part, all State insurance regulators I spoke with expressed concerns. Indeed, I had great concerns and worked virtually around the clock beginning Friday evening in response to those concerns. Our shared concerns were policyholder protection and the solvency of the licensed insurance companies. As Governor Paterson stated in his press release on the morning of September 15, protection of policyholders was a pre-condition for any approval and we focused intently on such protection. We worked to evaluate the possible asset exchange in detail, including whether the assets to be received by the property and casualty companies were of sufficient value, and continued doing so through late Monday, September 15.

Q.2.a. Securities Lending: Superintendent Dinallo, according to AIG corporate records, AIG's securities lending program invested more than 60 percent of its collateral in long-term mortgage-backed securities. More than 50 percent of its mortgage-backed securities were comprised of subprime and alt-a mortgages. Since AIG loaned out securities for typically less than 180 days, there was a significant asset-liability mis-match in AIG's securities lending program.

Why was AIG allowed to invest such a large percent of the collateral from its securities lending program in long-term assets?

When did you first become aware that AIG had invested such a high percentage of the collateral from its securities lending program in mortgage-backed securities? Did it raise any concerns at the time? If so, what specific steps did your Department take to address those concerns?

A.2.a. Based on what we were seeing at AIG, but before AIG Financial Products caused a crisis in September 2008, we warned all licensed New York companies that we expect them to prudently manage the risks in securities lending programs. On July 21, 2008, the New York Department issued Circular Letter 16 to all insurance companies doing business in New York, indicating Department concerns about securities lending programs. We cautioned them about the risks, reminded them of the requirements for additional disclosure and told them we would be carefully examining their programs. The Department does not issue many circular letters and they are understood by the industry to be important communications.

Immediately after the AIG crisis began, on September 22, 2008, the Department sent what is known as a Section 308 letter to all life insurance companies licensed in New York, requiring them to submit information relating to securities lending programs, financing arrangements, security impairment issues and other liquidity issues. My staff then conducted a thorough investigation of the securities lending programs at New York life insurance companies.

Besides gathering information from all companies, the Department met with 25 New York life insurance companies which have a securities lending program. The results were reassuring. Almost all of the companies had modest sized programs with highly conservative investments, even by today's standards. Companies with larger programs had ample liquidity to meet redemptions under stress. None of them had the same issues as the AIG program.

In the succeeding months we have continued to analyze the securities lending programs at New York companies. We are currently drafting regulatory guidelines that will govern the size and scope of securities lending programs and will include updated best practices. We will use our legal authority to shut down any programs that we believe endanger policyholders.

AIG's securities lending program was operated by a special unit created by the holding company, rather than by each individual AIG life insurance company. No other New York insurance company operates its securities lending at the holding company.

The New York Insurance Department began discussing securities lending with AIG in 2006 in the context of applying risk-based capital. Risk-based capital looks at the risk of a particular investment and requires the company to hold capital against that investment based on an analysis of the risk. For securities lending, the Department took the position that insurers with securities lending programs had counterparty risk and should take a risk-based capital charge on that basis. AIG in particular, and the industry in general, disagreed with our position. Taking a charge would have protected the company and its policyholders, but would also have reduced the amount earned from securities lending.

In early 2007, AIG gave the Department a presentation about its securities lending program. The intent of the presentation was to explain why there should be no risk-based capital charge. The company explained that they had reinvested the cash collateral largely in asset-backed and mortgage-backed securities. They explained to us that they maintained sufficient liquidity to meet "normal" collateral calls and that the reinvested assets were in AAA-rated, highly-liquid assets. At the time of the presentation, these assertions seemed valid and in fact the market value of the securities was sufficient to cover the liability, that is, the return of the cash collateral.

The issue of a risk-based capital charge for securities lending was settled to our satisfaction in 2007. The Department, as chair of the NAIC Capital Adequacy Task Force, spearheaded a subgroup to review the risk-based capital formula to ensure that the appropriate charge was taken by all companies for their securities lending programs. The subgroup completed its work in 2007, and recommended changes that were adopted and effective for the 12/31/08 annual statement filing.

The bad news about the residential mortgage-backed securities market began to become serious in the summer of 2007. Because of that, we conducted further discussions with AIG in September 2007. In those discussions, we focused on the percentage of the investments in mortgage-backed securities and their terms and maturity.

At that time, the AIG U.S. securities lending program reached its peak of $76 billion. AIG stated that the program was structured to ensure that sufficient liquidity was maintained to meet the cash calls of the program under "normal circumstances." At that time, AIG's securities lending program held 16 percent cash and cash equivalents, 33 percent securities with 2 years or less maturity, 34 percent securities with 3 to 5 years maturity, 15 percent securities with 5 to 10 years to maturity and only 2 percent securities with more than 10 years maturity.

It was then clear that the program should be reduced. The holding company promised at that time to pay the securities lending program for any losses on sales of securities up to $1 billion, which later was increased to $5 billion, to protect the life insurance companies. We began to work with the company on reducing the size of the program. [1]

In March 2008, New York and other States began quarterly meetings with AIG to review the securities lending program. Meanwhile, the program was being wound down in an orderly manner to reduce losses. Because of the size of the program and the bad market conditions, the company had to proceed slowly with sales of assets in order to reduce losses on those sales. Despite those problems, the company was able to make substantial progress. From its peak of about $76 billion in September 2007, the securities lending program had declined by $18 billion, or about 24 percent, to about $58 billion by September 12, 2008.

At that point, the crisis caused by Financial Products caused the equivalent of a run on the AIG securities lending program. Securities borrowers that had reliably rolled over their positions from period to period for months began returning the borrowed securities and demanding their cash collateral. From September 15 to September 30, borrowers demanded the return of about $24 billion in cash.

The holding company unit managing the program had invested the securities borrowers' cash collateral in mortgage-backed securities that had become hard to sell. To avoid massive losses from sudden forced sales, the Federal Government, as part of its rescue, provided liquidity to the securities lending program. In the early weeks of the rescue, holding company rescue funds were used to meet the collateral needs of the program. Eventually the FRBNY created Maiden Lane II, a special purpose vehicle which, according to AIG, purchased the life insurance companies' securities lending collateral at an average price of about 50 percent of par.

If not for the Financial Products crisis, we believe that AIG could have continued to manage the reduction of its securities lending program. It would have incurred some losses, but they would have been manageable. There is no doubt in my mind that the Federal Government would not have stepped in to rescue AIG if the company only had its securities lending problems.

[1] According to an unofficial transcript, in my oral statement to the Committee on March 5, which I did not read, but presented from brief notes, I stated that we began working with the company to reduce the securities lending program "starting in the beginning of 2007." Later in my testimony, I stated more precisely that "starting in 2007, we did begin to wind down" the program. While we were working with AIG on issues related to the securities lending program in early 2007, in fact, as noted, we began working with the company specifically on reducing the size of the program towards the end of 2007.

It is also important to note that despite the fact that New York life insurance companies are relatively small and made up only 8 percent of the AIG securities lending program, the New York Insurance Department was active from the start in dealing with the issues related to the program.

Q.2.b. How does the reinvestment strategy of AIG's securities lending program compare with those of other insurance companies? Are you aware of any other companies having a similarly risky reinvestment strategy?

A.2.b. In September and October 2008, the Department met with 25 New York life insurance companies which have a securities lending program. In addition, the Department sent out 134 letters (Section 308 requests) to New York insurance companies to obtain information on securities lending programs, as well as other liquidity issues. The review indicated that none of the New York companies had a similar reinvestment strategy.

Q.3. Holding Company Supervision: Superintendent Dinallo, what authority does New York insurance law give your office to examine the activities of insurance holding companies and their affiliates?

Did your office ever exercise this authority with respect to AIG?

A.3. Beginning nearly two generations ago, most if not all States in the Nation, New York included, enacted a "holding company act" to ensure that any authorized (*i.e.,* licensed) insurance company that is part of a holding company system is subject to scrutiny by insurance regulators. The purpose of these holding company acts is to ensure, first and foremost, that insurance companies can meet their obligations to policyholders, and are not exploited in ways that inure to policyholder detriment. Thus, under holding company acts, insurance regulators must review, among other things, the financial condition and trustworthiness of any person or entity that seeks to acquire control of an authorized insurer, as well as significant transactions within a holding company system.

New York's holding company act is codified at Article 15 of the New York Insurance Law. Section 1504(b) sets forth the Insurance Superintendent's authority to examine holding companies themselves: "Every holding company and every controlled person within a holding company system shall be subject to examination by order of the superintendent if he has cause to believe that the operations of such persons may materially affect the operations, management or financial condition of any controlled insurer within the system *and* that he is unable to obtain relevant information from such controlled insurer" (emphasis added). This power does not provide that such non-licensed holding companies or other affiliates are regulated by the Department. It is a far more narrow authority providing for an ability to examine such entities under the specified conditions.

In the case of AIG, the New York Insurance Department did not exercise its authority under section 1504(b) to examine the holding company. First, the AIG holding company and its Financial Products unit were regulated by the Federal Office of Thrift Supervision. AIG chose OTS as its primary regulator in 1999 based on the fact that the company owned a tiny savings and loan. It is worth noting that the courts have stopped other State agencies that tried to take action against federally regulated companies. Second, at no time did the Department request “relevant information” from an insurer in the AIG holding company system that we were “unable” to obtain from that insurer. To the contrary, the AIG insurance entities domesticated in New York have been responsive to requests for information from the New York Insurance Department. Further, insurers like American Home Assurance in AIG’s commercial insurance group have had such strong financial positions—with billions of dollars of policyholder surplus, and, until September 2008, top credit ratings from rating agencies—that the Superintendent had no “cause to believe that the operations” of AIG’s holding company might “materially affect the operations, management or financial condition of any controlled insurer within the system.”

Q.4. AIG Securities Lending Operations: Based on data provided by the company, it appears that several insurers suffered losses on their securities lending during 2008 that exceeded the amount of their total adjusted capital at the start of 2008. Due to the Fed’s loan, these companies have been recapitalized. If the Fed had not intervened, however, it appears several companies, including New York insurers, could have been close to insolvency.

Had the Fed not intervened to rescue AIG, was the New York State Guaranty Fund prepared to handle the insolvency of one or more AIG companies? Please provide data to support your answer.

A.4. The data provided below do not support the view that AIG’s life insurance companies would have been insolvent both before and after the Financial Products crisis without the intervention of the FRBNY. As of the end of 2007, the companies had adjusted capital and surplus (inclusive of asset valuation reserves) of $27 billion. Their aggregate securities lending losses in 2008 totaled $21 billion, leaving them with remaining adjusted capital and surplus as a group of about $5.8 billion. The AIG parent company contributed $5.3 billion apart from any action by the FRBNY. So without accounting for any action by the Federal Reserve, and without accounting for any ordinary course earnings during 2008, the life insurance companies had total adjusted capital and surplus of $11 billion. As a result of the Federal Reserve action, that total increased to $19 billion.

Adjusted Capital & Surplus for AIG Life Insurance Companies Participating in Securities Lending

($ in billions)

State	% of Pool	Total Adj. Capital 12-31-07 (includes asset valuation reserve)	Securities Lending Losses 2008	Gross Cap (C&S-losses)	Parent Capital Infusions pre-FRBNY	Net Surplus (Gap) Before FRBNY	12-31-08 After FRBNY Capital Infusions
3 NY Co's	8.4%	$1.682	($1.82)	($.138)	$.722	$.584	$1.901
All AIG	100%	$27.078	($21.305)	$5.773	$5.387	$11.16	$19.069

As noted, the New York domestic companies would not have been insolvent without Federal Reserve intervention. As to the New York State Life Insurance Guaranty Fund, under the Life Insurance Company Guaranty Corporation of New York, the basic answer is that the New York Department was and is prepared to deal with the potential insolvency of a life insurer. Generally, the first effort is to determine if the parent company has the ability to cure the insolvency. If that is not possible, the second step is usually to seek a buyer. This is often possible. The final step is to take a company into rehabilitation or liquidation. Since life insurance obligations extend over a long period, there is generally some time to determine the extent to which a company's assets are insufficient to meet its liabilities.

Had it been necessary to take the three AIG New York life insurance companies into rehabilitation and/or liquidation, the Department would have been ready for such action. It is important to note that two of the three New York domestic companies are licensed in all 50 States and would be subject to the guaranty funds of the 50 States, not just the New York Guaranty Fund. The third company is licensed in three States, so the guaranty funds of the three States would be involved. In New York, as well as the other 49 States, the guaranty funds are funded by assessments from its licensed companies. Even if a company is deemed insolvent, assessments may not be required immediately. Generally, assessments are only imposed as they are actually needed. The Department believes that the guaranty funds would have been ready to handle the insolvency of one or more AIG companies.