TESTIMONY

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HOUSE OF REPRESENTATIVES

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HEARING ON
"THE CAUSES AND EFFECTS OF THE AIG BAILOUT"

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I would like to thank Chairman Henry Waxman, Ranking Member Tom Davis and the members of the Committee on Oversight and Government Reform for inviting me to testify today at this hearing on the causes and effects of the AIG bailout.

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

I think it would be useful to begin by describing my department's oversight authority with respect to AIG and thus our role in the events we are discussing.

AIG is a huge, global financial services holding company with more than $1 trillion in assets. AIG does business in 130 countries. It has 116,000 employees and 74 million customers. It owns the largest commercial and industrial insurance company in the U.S. and one of our country's and the world's largest life insurance companies.

AIG owns 71 U.S-based insurance companies and 176 other financial services companies, including non-U.S. insurers. AIG the holding company by its own choice is regulated by the Office of Thrift Supervision, the federal agency that is charged with overseeing savings and loan associations. Only AIG's U.S. insurance subsidiaries are regulated by state insurance departments, including New York.

Several of AIG's largest and most important insurance companies are domiciled in New York. The New York Insurance Department is the primary regulator for: 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. Many other AIG insurance companies are domiciled, and thus primarily regulated, by other states, although most are licensed and do business in New York.

The parent holding company is headquartered in New York just a few blocks from my office and is a major employer and a major contributor to the city's status as the world financial capital. In New York State, AIG companies have 8,500 employees with an annual payroll of $897 million.

Before I go any further, I would like to make one critical point. It's important for everyone, and especially policyholders in AIG insurance companies, to understand that the insurance companies, which are regulated by New York and other states, are solvent and have the funds to pay any policyholder claims. AIG's problems came from its parent company and from its non-insurance operations, which are not regulated by New York or any other state.

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 New York Federal Reserve Bank, the U.S. Treasury, AIG executives and their financial advisors, investment and commercial bankers, private equity investors, other state regulators and everyone else at all times understood and agreed 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.

Some have tried to use AIG's problems as an argument for an optional federal charter for insurance companies. I am open to some 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 House committees. But what happened at AIG demonstrates the strength and effectiveness of state insurance regulation, not the opposite.

That brings us to the issue of what happened at AIG. That history has been well reported in the press. Using its non-insurance operations, AIG, just like many other financial services institutions, invested heavily in subprime mortgages. AIG's Financial Products unit, a non-insurance company, sold hundreds of billions of dollars of credit default swaps and other financial products. As with other financial services companies, AIG was forced to mark to market and post collateral against many of these positions not because of actual defaults on subprime mortgages, but because of fears of defaults and the drying up of a market to trade these securities, thus resulting in very depressed market prices. By marking its securities to market, AIG was forced to announce losses, which kept growing. As a result, investors became concerned about just how serious the company's problems would end up being and whether the company had a full grasp of and was taking necessary steps to deal with its problems. AIG's stock price fell sharply.

AIG responded in June by replacing its top manager. The new CEO was working on a restructuring plan, which the company planned to announce on September 25.

The immediate spark for the crisis was the sudden decision by the credit rating agencies to downgrade AIG without waiting to see the results of its restructuring only two weeks away. The company learned about this decision on or about Friday, September 12. The downgrade would require AIG to post additional collateral against its credit default swaps and against its guaranteed investment contracts. AIG's initial estimates were that it would need about $18 billion in cash to post collateral. While AIG had assets, including its insurance companies, worth many times this amount, the assets were not liquid and could not be used to solve the collateral problem. Thus it appeared initially that the company had a liquidity problem. That is, it was not short of capital, but it was short of cash because it could not turn most of its assets into cash quickly enough.

The New York Insurance Department has historically had a close regulatory relationship with AIG because of its proximity to the New York Insurance Department and because it is one of the largest writers of insurance for New York residents and businesses. We had increased our scrutiny of the company and had meetings and conversations with company about its exposure to credit default swaps starting in early February 2008. First and foremost we made sure that the insurance companies were not exposed to these holding company losses.

We were meeting with company officials on Friday, September 12 as part of that increased scrutiny. I received a call from AIG's general counsel and former chief financial officer informing me of the company's serious and immediate liquidity problem, and asking for assistance.

I immediately began to brief New York Governor David Paterson. Governor Paterson at once understood the importance of AIG to New York, the nation and the global economy. He dispatched Deputy Secretary Charlotte Hitchcock to join me in working on assessing what could be done to help the company get through the crisis.

I mobilized my key staff and, with Deputy Secretary Hitchcock, we had a conference call with AIG leaders Saturday morning and then went over to their office for the remainder of the weekend to provide assistance and be in a position to expedite any regulatory actions that needed to be taken to get through the crisis.

Working under the Governor's direction, the Department worked with AIG to develop solutions, vet proposals and find transactions that would stabilize AIG while protecting policyholders. As a result, we developed a proposal that the Governor announced on Monday, September 15. This plan would have allowed AIG to temporarily access about $20 billion of in excess surplus assets in its insurance companies while fully protecting policyholders. There has been considerable misinformation about this plan in the press, so I would like to take some time to describe it to you.

Gov. Paterson's proposal would not have reduced the amount of assets that available to pay policyholders at AIG insurance companies. In fact, it might have increased them. We were willing to consider allowing AIG to effectively sell some U.S. AIG life insurance companies to some of AIG's property insurance companies. In exchange for the stock of the life insurance companies, the property insurance companies would have transferred a lesser value of certain liquid assets, specifically municipal bonds, to the parent. The municipal bonds would have been used by AIG to provide the collateral it needed.

We were very carefully vetting the assets being purchased by the property insurance companies to ensure they were of high quality. We were also careful that the amount of securities remaining in the companies was sufficient to pay all claims, meet statutory risk-based capital requirements and still have billions of dollars in extra surplus.

The fact that this was excess surplus is important, so I would like to explain. Insurance companies are required to keep reserves to pay future claims. The amount of the reserve depends on the type of insurance. In addition, they are required to hold a certain amount of surplus, as calculated by a risk-based capital formula. AIG's property insurance companies have excess surplus, more than required. And it was for that excess surplus that we were allowing the parent to temporarily provide different less-liquid assets. So policyholders would still have been protected by the reserves and the surplus. And even the assets transferred to the insurance subsidiaries and temporarily held as excess surplus could have been sold if necessary to pay claims.

The plan then called for the property insurance company to sell the life insurance companies and other assets promptly and then use the cash from those sales to repurchase the municipal bonds back from AIG. This temporary transfer was needed because at the time, AIG had an immediate need for cash in order to post collateral required due to the downgrade by the rating agencies. Selling the life insurance companies would take a few months, more time than AIG could wait after anticipated downgrades from the ratings agencies. The AIG property insurance companies, which had no pressing need for cash, on the other hand, had the time to devote to the sale process.

AIG could not have made any of these moves without the approval of New York and other state insurance departments. We developed this proposal with the help of other states, especially the Pennsylvania Department and its Commissioner Joel Ario.

The Governor's proposal came at a key moment and helped lay the groundwork for the eventual federal rescue, which saved a company which employs more than 8,000 New Yorkers and has millions of policyholders. In the end, this plan was not needed because of the $85 billion federal loan.

It was not the case, as has been stated by some ill-informed individuals, that AIG, the parent company, was going to force its subsidiary property insurance companies to accept bonds backed by subprime mortgages or any other assets of questionable value. Also, no state taxpayer funds were involved. We were considering a method for AIG to exchange high quality less liquid assets, which were the shares of stock of the life insurance companies, for high quality liquid assets, which were the municipal bonds owned by the property insurance companies, in order to solve AIG's problem without putting policyholders at risk.

Originally, Gov. Paterson's proposal would have been part of a three part $40 billion plan, including sale of AIG assets and investment in AIG by private equity firms. When it became clear that the company needed more money and that the original plan was not feasible, the Treasury asked two banks to try to form a private syndicate to raise the necessary funds. At that point, Gov. Paterson's proposal was still an essential part of the rescue. Eventually, it became clear that no commercial private sector rescue was possible. At that point, the Treasury proposed the $85 billion bridge loan and the Governor's proposal was no longer needed.

Was the bailout necessary? I believe it was. Most of AIG's operations, in particular its insurance operations, are solid, profitable companies. Many are leaders in their markets. They have substantial value. But that value could not be realized over a weekend. The bailout will provide time for an orderly restructuring of AIG's operations. It is possible that AIG will survive, as a smaller but much stronger insurance-focused enterprise. At least some of its operations will be sold.

On behalf of the New York Insurance Department, I am chairing a task force created by the National Association of Insurance Commissioners which is comprised of all 50 states to oversee the sale of any insurance operations and coordinate state regulatory responses.

To protect policyholders, we will ensure that insurance operations are purchased by stable, responsible entities capable of operating them successfully. And we will also ensure that the regulatory approval process is efficient and does not hold up transactions.

Some argue that the company should have been filed for bankruptcy, as Lehman did. AIG has business relations with just about every major bank in the world. At a time when the financial system and in particular the credit markets are already deeply troubled, the risks of allowing AIG to file for bankruptcy were in my opinion just too great. The New York Federal Reserve Bank and the Treasury appear to share that view.

But that systemic risk does underline the need for us to heed Governor Paterson's call to regulate the credit default swap market. In a recent statement, Governor Paterson said, "The absence of regulatory oversight is the principle cause of the Wall Street meltdown we are currently witnessing. This is why New York took the crucial next step of planning to regulate an area of the market which had previously lacked appropriate oversight, but that is indisputably as regulatable as insurance. I strongly encourage the federal government to follow our approach and bring stronger regulatory oversight to these markets. New York stands ready to work expeditiously with all concerned to find a workable solution to this problem."

In an interview with the New York Times, Governor Paterson called credit default swaps "gambling" and noted that they were a major cause of AIG's problems. He told the paper that "when we peeled back the onion, we found out that A.I.G. had so many credit-default swaps that we couldn't calculate how much money they probably had" lost.

On September 22, Governor Paterson announced that New York State will, beginning in January, regulate part of the credit default swap market which has to date been unregulated. The State will regulate transactions where credit default swaps are used as "insurance" to protect the value of investments held by the purchaser. These are, both functionally and legally, financial guaranty insurance policies.

Governor Paterson also called on the federal government to regulate the rest of the massive $62 trillion market, which has been a major contributor to the emerging financial crisis on Wall Street. Let me be clear, we are prepared to be flexible and work with the federal government on an overall solution, such as a clearinghouse or central counterparty. We were pleased to see that the day after Governor Paterson's announcement, SEC Chairman Cox asked for the power to regulate the credit default swap market. And we understand that the New York Federal Reserve has called a meeting this week to discuss how to proceed.

Let me explain what we propose to do in the meantime. Under the direction of Governor Paterson, the New York Insurance Department issued new guidelines that, for the first time, explicitly confirm that some credit swaps are insurance and therefore subject to state regulation.

The severity of the current credit crisis was substantially increased by what the government chose not to regulate, principally credit default swaps. Last Sunday, the television news program “ 60 Minutes” did an excellent story about credit default swaps and their impact as a result of the fact that they were not regulated.

What New York State is doing fits our role as insurance regulators. We are providing an appropriate way for those with an insurable interest to protect themselves. Our goal is to ensure the terms of the credit default swaps are written as a mechanism for protecting buyers against actual losses and not for betting on the credit quality of a third-party. We will also ensure that that whoever sells protection is solvent, in other words, can actually pay the claims. There is currently no such protection for parties to credit default swaps that use them as insurance.

However, we are not and cannot regulate “naked” credit default swaps, which are used by speculators in the financial markets to profit on the downturn in a company’s financial condition.

The primary goal of insurance regulation is to protect policyholders by ensuring that providers of insurance are solvent and able to pay claims on policies they issue. The goal of regulating these swaps is not to stop sensible economic transactions, but to ensure that sellers have sufficient capital and risk management policies in place to protect the buyers, who are in effect policyholders.

Credit default swaps played a major role in the financial problems at AIG, Bear Stearns and the bond insurance companies. A credit default swap is a contract under which the seller promises to pay the buyer if the insurance provider of the bond cannot pay principal and interest. Credit default swaps can be used by the owners of bonds who want to protect themselves if the company that issued the bonds is unable to pay interest and principal. In those cases, the swap is insurance, because the swap buyer is like a homeowner insuring a home. But, just as with short selling of stock, most swaps are now used by speculators who do not own the bonds and the value of swaps outstanding are generally much more than the value of a company’s debt. Swaps bought by speculators are known as “naked swaps” because the swap purchasers do not own the underlying bond. Speculation in a company’s bonds can under some circumstances hurt that company’s ability to borrow.

The new guidelines establish that when the buyer owns the underlying security on which he is buying protection then the swap is an insurance contract. Under these new regulations, such swaps would be subject to regulation for the first time and can thus only be issued by entities licensed to conduct insurance business. So called “naked swaps” are not insurance and cannot be regulated by the State.

I think it is vital that you understand the nature of “naked” credit default swaps. Initially, credit default swaps were designed and used to provide risk mitigation. The goal of the buyer was to obtain protection against the default of an underlying bond or loan or other obligation of a company or entity. But with a “naked” swap, there is no risk mitigation, In fact, there is risk creation. In fact, these contracts are not really swaps at all because there is no transfer of risk. Instead, the contract allows the buyer to place a one-sided bet.

Having New York regulate just part of the credit default swap market is not an ideal solution. As the Governor clearly stated, we would much prefer an effective solution for the entire market. But until there is, we will do our job and regulate that part of the market that is insurance.

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