THE CAUSES AND EFFECTS OF THE AIG BAILOUT

HEARING

BEFORE THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

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THE CAUSES AND EFFECTS OF THE AIG BAILOUT

TUESDAY, OCTOBER 7, 2008

HOUSE OF REPRESENTATIVES,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The committee met, pursuant to notice, at 10:04 a.m., in room 2154, Rayburn House Office Building, Hon. Henry A. Waxman (chairman of the committee) presiding.

Present: Representatives Waxman, Maloney, Cummings, Kucinich, Tierney, Watson, Higgins, Yarmuth, Braley, Norton, McCollum, Van Hollen, Sarbanes, Welch, Speier, Davis of Virginia, Shays, Mica, Souder, Turner and Bilbray.

Staff present: Kristin Amerling, general counsel; Russell Anello and Stacia Cardille, counsels; Caren Auchman, press assistant; Alvin Banks, staff assistant; Phil Barnett, staff director and chief counsel; Jen Berenholz, deputy clerk; Zhongrui "JR" Deng, chief information officer; Ali Golden, investigator; Michael Gordon, senior investigative counsel; Earley Green, chief clerk; Karen Lightfoot, communications director and senior policy advisor; David Rapallo, chief investigative counsel; Leneal Scott, information systems manager; Roger Sherman, deputy chief counsel; Mitch Smiley, special assistant; Lawrence Halloran, minority staff director; Jennifer Safavian, minority chief counsel for oversight and investigations; A. Brooke Bennett, minority counsel; Brien Beattie, Molly Boyl, Alex Cooper, Adam Fromm, and Todd Greenwood, minority professional staff members; Larry Brady, John Cuaderes, and Nick Palarino, minority senior investigators and policy advisors; Patrick Lyden, minority parliamentarian and Member services coordinator; and Brian McNicoll, minority communications director.

Chairman WAXMAN. The committee will please come to order. Today we're holding our second day of hearings on the financial crisis in Wall Street. Yesterday we examined the collapse of Lehman Brothers. Our focus today is AIG.

There are obvious differences between Lehman and AIG. Lehman is an investment bank. AIG is an insurance company. Lehman fell because it placed highly leveraged bets in the subprime and real estate markets. AIG's problems originate in the complex derivatives called credit default swaps. But their stories are fundamentally the same.

In each case, the companies and their executives grew rich by taking on excessive risk. In each case, the companies collapsed when these risks turned bad. And in each case, their executives are walking away with millions of dollars while taxpayers are stuck with billions of dollars in costs. The AIG CEOs are like the Lehman CEO in one other respect: In each case, they refused to accept any blame for what happened to their companies.

In preparation for this hearing, the committee has received tens of thousands of pages of documents from AIG. Our review of the documents raises three fundamental sets of questions. Answering these questions will be the focus of today's hearing.

The first set of questions is whether AIG's executive compensation practices were fair and appropriate. AIG has a Seniors Partners Plan that provides cash bonuses for its 70 executives. These are the top 70 executives. This plan is supposed to be performance based. In 2005, AIG's CEO, Martin Sullivan received $2.7 million under this plan. In 2006, his first full year as CEO, he received $5.7 million under the plan. These payments are not in question. Both years were good years for AIG, and as CEO, Mr. Sullivan naturally was well rewarded.

2007 is a completely different story. AIG lost over $5 billion in the final quarter of 2007 due to the losses attributable to its Financial Products Division called AIG-FP. Under the terms of the Senior Partners Plan, Mr. Sullivan and the other top executives should have had their bonuses slashed due to poor performance. But when the compensation committee met on March 11, 2008, the award bonuses for 2007, Mr. Sullivan urged the committee to ignore the losses from the Financial Products Division in calculating his bonus and the bonuses of the other top executives. We obtained a copy of the minutes from that meeting, and here's what they say: Mr. Sullivan next presented management's recommendation with respect to the earn-out for the Senior Partners Plan, suggesting that the AIG-FP unrealized market valuation losses be excluded from the calculation. The board approved this change in the Senior Partners Plan, ignored the losses from the Financial Products Division, and gave Mr. Sullivan a cash bonus of over $5 million. Today we'll ask what could possibly justify this change in the compensation formula.

There are other compensation questions we will also ask. In March, the board approved a new compensation contract for Mr. Sullivan that gave him a golden parachute worth $15 million. We will ask why that was in the interest of the shareholders. And we will ask about the compensation of Joseph Cassano who was the executive in charge of the Financial Products Division. Mr. Cassano was well compensated by AIG. He received more than $280 million over the last 8 years. After his division imploded, AIG terminated him without cause in February and did not seek to recover any of Mr. Cassano's compensation. Instead, AIG allowed him to keep up to $34 million in unvested bonuses and put him on a $1 million-a-month retainer. Last month the taxpayers bought out AIG in an $85 billion bailout. This was a direct result of the mistakes made by Mr. Cassano. Yet even today he remains on the company payroll, receiving $1 million a month.

The Federal bailout occurred on September 16. Less than 1 week later AIG held a week-long retreat for company executives at the exclusive St. Regis resort in Monarch Beach, California. And we have a photograph on display of that resort. Rooms at this resort can cost over $1,000 per night. Invoices provided to the committee show that AIG paid the resort over $440,000 including nearly $200,000 for rooms, over $150,000 for meals, and $23,000 in spa charges.

Well, average Americans are suffering economically. They're losing their jobs, their homes and their health insurance. Yet less than 1 week after the taxpayers rescued AIG, company executives could be found wining and dining at one of the most exclusive resorts in the Nation. We'll ask whether any of this makes any sense.

The second set of questions we'll ask is whether Mr. Sullivan and Robert Willumstad are right when they say they bear no responsibility for the collapse of AIG. Mr. Sullivan was CEO from March 2005 to June 2008. Mr. Willumstad was his successor. He joined the AIG board in January 2006 and has served as chairman from November 2006 until he was named CEO in June 2008. According to their testimony, AIG failed because it was caught in a vicious cycle and hit by a global financial tsunami. Mr. Willumstad says, "I don't believe AIG could have done anything differently."

The information we received paints a different picture. We have obtained a confidential letter from the Office of Thrift Supervision to AIG's general counsel. In this March 10, 2008 letter, the Office of Thrift Supervision writes, "we are concerned that the corporate oversight of AIG Financial Products lacks critical elements of independence, transparency and granularity." Internal documents show that AIG's auditor, PricewaterhouseCoopers, reported similar problems. Minutes from a meeting of the board's audit committee in March 2008 revealed that PricewaterhouseCoopers told the committee that the root cause of AIG's problems was that risk control groups did not have appropriate access to the Financial Products Division.

As part of our investigation, the committee requested information from a former AIG auditor Joseph St. Denis. Mr. St. Denis was a senior SEC enforcement official who was hired by AIG to address its ongoing accounting problems. But when he expressed concerns about how the Financial Products Division was valuing its liabilities, Mr. Cassano told him, "I have deliberately excluded you from the valuation because I was concerned that you would pollute the process."

Ultimately, Mr. St. Denis resigned in protest. As he explains, Mr. Cassano took actions that I believe were intended to prevent me from performing the job duties for which I was hired. Unlike Mr. Cassano and Mr. Sullivan, Mr. St. Denis's actions cost him his bonus.

There are other questionable actions by Mr. Sullivan and Mr. Willumstad. As losses were mounting and resources were getting scarce, AIG depleted its capital by over $10 billion through stock buybacks and rising dividend payments. This prompted shareholders to write the board, "the management and board inexcusably and inexplicably raised the dividend while simultaneously issuing expensive preferred stock at a discount."

And finally, we'll ask whether AIG and in particular Mr. Sullivan misled investors and the public about the financial conditions of the company. On December 5, 2007, Mr. Sullivan told investors, "we are confident in our marks and the reasonableness of our valuation methods. We have a high degree of certainty in what we have booked to date." What Mr. Sullivan didn't tell investors was that, on November 29th, 1 week earlier, PricewaterhouseCoopers had raised their concerns about Mr. Sullivan, informing him that PWC believed that AIG could have a material weakness relating to the risk management of these areas.

There is one witness who should be here today but who will be missing, Maurice "Hank" Greenberg, the long-time CEO of AIG. Mr. Greenberg blames Mr. Sullivan and Mr. Willumstad for the downfall of AIG. Many others think it is Mr. Greenberg who sowed the seeds that led to AIG's failure. Regrettably Mr. Greenberg has told the committee that he is too ill to appear today to answer questions.

There is a lot of ground for this committee to cover today. We will probe AIG's executive compensation arrangements, the leadership of its top officials and the veracity of their public statements. Our goal is to examine the details of AIG's fall so that we can learn lessons about the reforms needed to restore stability to our financial markets.

Like all of our witnesses, Mr. Sullivan and Mr. Willumstad know we will ask hard questions. I also want them and our other witnesses to know that we appreciate their cooperation and appearance before the committee today.

Before yielding to Mr. Shays, who will deliver the statement on behalf of the Republicans, I do want to announce that the request that we have received to look at Fannie Mae and Freddie Mac, which is an investigation already underway, will be pursued in conjunction with the minority on the committee. And we will look at holding a hearing on those two as well as the other hearings that we have scheduled.

Mr. Shays, I want to recognize you at this time.

Mr. SHAYS. Thank you, Mr. Chairman.

Today we consider the case of the American International Group, AIG, a global insurance conglomerate saved from insolvency by an $85 billion loan from American taxpayers. As part of the deal, we, the American taxpayers, own a controlling stake in the company. In these bailouts, the U.S. Treasury is now in the business of picking winners and losers as the global economy struggles to purge the toxins of speculative greed polluting capitalism's bloodstream. We need to understand what makes a private company like AIG too big to fail and what drew such a large and venerable enterprise to the brink of failure.

In the search for causes, all roads lead to the housing market, dominated by the Federal National Mortgage Association, Fannie Mae, and the Federal Home Loan Mortgage Corporation, Freddie Mac. Without question, mortgage-backed assets sliced and diced and scattered throughout the financial system lie at the epicenter of the economic earthquake shaking world markets. Ripples from defaults on subprime loans underwritten by Fannie and Freddie grew to a tsunami that helped swamp Lehman Brothers and others, including AIG. And Fannie and Freddie were able to launch more than $1 trillion, $1 trillion of bad paper into the private market because regulators and Congress let them do it.

This committee cannot conduct a credible examination of the current crisis without focussing on the market distorting power of the

Federal mortgage giants and the firewall against reform, manned by their enablers here in Congress.

No one is disputing the committee's focus on executive pay. We agree; company compensation is a telling indicator of a corporate culture detached from larger market realities and the fundamental fiduciary duty to be frugal stewards of other people's money. And that "me first" self-indulgence was just as rampant at Fannie Mae as in its private sector partners and competitors.

From 1998 to 2003, Fannie Mae CEO Franklin Raines alone took over $90 million in salary and bonuses. The Raines team was even caught manipulating accounting practices to overstate profitability so they could grab what their overseer called, "ill-gotten bonuses" in the hundreds of millions of dollars. The Fannie Mae board gave recently ousted CEO Daniel Mudd a $2.6 million bonus in 2005 on top of his $3.5 million salary based on a set of nonfinancial goals, such as promoting respect, appropriate and productive relationship with regulators.

In the context of a $6 trillion mortgage securities portfolio, those paydays may seem like small change, but it's indicative of a prevalent and noxious rot that threatens the moral underpinnings of the entire capitalist business model. So we need to keep the toxic twins, Fannie and Freddie, at the center of this investigation, not on the edge, not out in the future but right now.

Yesterday we sent a formal request to the chairman asking for a specific commitment to make the Federal mortgage companies a priority in this hearing, not after afterthought. We can't wait until Halloween to unmask these two failed monsters of mortgage finance.

As for AIG, I'm interested in learning more about the corporate decisionmaking that took a solid insurance business into the far less stable world of credit default swaps and other exotic derivatives. They thought they were selling insurance, when in fact they were betting the company's soul in a high stakes game of Russian roulette. We need to ask what AIG knew about the risk behind these novel products, when they knew the bet soured, and how they informed investors, policyholders, regulators and the public that the company was in peril. AIG, like Fannie Mae and Freddie Mac, was considered too big to fail.

Going forward we need to grapple with the implications of the concept, government will be there to break the fall of some large businesses but not others. It's been said, capitalism without failure is like religion without sin. Any doctrine loses its moral authority when bad conduct is rewarded and the consequences of poor choices are foisted on someone else. Investigating the causes and effects of this financial debacle should involve assigning capability, culpability, and restoring integrity and balance to the system of risks, rewards, and penalties our society uses to assign value to labor, capital, and commerce.

Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you very much, Mr. Shays.

Chairman WAXMAN. For our first panel, we'll hear from Lynn Turner, who served as Chief Accountant of the Securities and Exchange Commission from 1998 to 2001. He has served on the boards of public companies as a professor of accounting, as a partner in an auditing firm and as the managing director of a research firm. He is currently a senior advisor at Kroll, Inc.

Eric Dinallo currently serves as the superintendent of the New York State Insurance Department. From 1999 to 2003, he served as the chief of the Securities Bureau at the New York State Attorney General's Office. Mr. Dinallo has also served as general counsel at a large insurance broker and as managing director for regulatory affairs at Morgan Stanley.

We're pleased to welcome both of you to our hearing this morning. It's the practice of this committee that all witnesses that testify before us do so under oath. So I would like to ask if you would stand and raise your right hands.

[Witnesses sworn.]

Chairman WAXMAN. The record will indicate that both of the witnesses answered in the affirmative.

You have given us prepared statements, some quite lengthy. And I want you to know that all of those statements, both of those prepared statements will be in the record in its entirety. What we would like to ask you to do is try to be mindful of 5 minutes that we allocate to the oral presentation. We won't cut you off if you exceed 5 minutes, but we will have a clock in front of you that will be green for 4 minutes. For the last minute, it will turn yellow. After 5 minutes, it will turn red. And then we would like you to then wind down your presentation.

Mr. Dinallo, why don't we start with you.

STATEMENTS OF ERIC R. DINALLO, SUPERINTENDENT, NEW YORK STATE INSURANCE DEPARTMENT; AND LYNN E. TURNER, FORMER CHIEF ACCOUNTANT, SECURITIES AND EXCHANGE COMMISSION

STATEMENT OF ERIC R. DINALLO

Mr. DINALLO. Thank you, Chairman. Thank you, Chairman.

It's an honor to be here. I'm here to try to explain, from our perspective, a little bit about what happened at AIG and what the New York State Insurance Department's role in that was.

The Insurance Department regulates certain insurance companies. I think that's a very important distinction to make at the beginning. AIG was not strictly an insurance company, as was said earlier. It was probably the largest financial services company in the world. And in fact, I think its economic activity on the financial services side exceeded its economic activity on the insurance side.

I agree that a large number of the problems there were due to credit default swaps and collateralized debt obligations stemming from subprime and the mortgage industry. But that activity was largely, if not exclusively, done out of Financial Products Division, which was sort of a subsidiary of the holding company.

The most immediate problem that got our attention was the pending downgrade of the company. So one of the rating agencies had threatened on I think it was September, I don't know, 9th or so to downgrade the company. That's when I received a call from the general counsel and the former CFO asking if we would be able to help provide certain liquidity through the insurance subsidiaries, which were very solvent and well capitalized. For the time before that, we had been monitoring the situation but it was a monitoring of the situation based on the declining stock price of the company and our wanting to confirm that the insurance subsidiaries were solvent and policyholders were protected.

So it was in those conditions that we showed up at the company on Friday, Saturday and Sunday, the long weekend, which went into Monday and Tuesday at the Federal Reserve where different private solutions were looked at. The history is well written now in the press. But I can answer questions about that.

But the solvency problem was fine. The liquidity problem kept on growing over the weekend. And the hole looked larger and larger. And whatever we could have done through New York State, which the Governor of New York, David Paterson, had authorized us to try to help do, became not enough, and we ended up with a larger and larger liquidity holder problem.

We were there to validate the concerns of the company, which were true. We were also there I think to validate for the Federal Reserve that there was real solvency and capital in the insurance companies which was what the bedrock of the transaction was. In other words, the $85 billion could not have been loaned if there was not any hope of getting the money back, and to a large extent whatever returns there are going to be is because of the robustness of the insurance company.

To a large extent, I agree. I think that AIG got well away from its core competency of insurance. It went into very complex instruments called credit default swaps, which I can explain some of the basics as I've been asked. But overall, the State regulation of it, I think, worked quite well. It is a lesson for us to talk about, I hope, about what is the right way to regulate holding company undertakings.

There were 71 U.S. insurance companies. As I said, without them, there would not have been a bailout. But to an almost exclusive extent, the problem was caused by activities conducted out of Financial Products. Those activities were largely through the writing of credit default swaps. They are a legitimate need for hedging of risk, which was the beginning of credit default swaps probably in the 1980's. It's where you own a bond, let's just say, you own Ford bonds. And you want to hedge your risk that Ford is going to default on those bonds, so you go to a third party and you ask them to essentially insure you against that default. That's the swap. That's the part of the swap. You're swapping the risk of the default with a third a party. That is called hedging also. And it is often also called insurance in the sense you are buying insurance against the default of the bond.

But I think that the committee should know that is now only about 10 percent or so of credit default swaps that are outstanding in the world. There are probably over $60 trillion of credit default swaps. An overwhelmingly high percentage are what I termed a couple months ago naked credit default swaps. What that means is you enter into a contract with a party. Neither of you own any exposure to Ford. You're just taking a bet. You're taking a gamble on whether Ford is going to default or enter into bankruptcy or not. It's a form of shorting. It's the way we short the credit-worthiness of our industries. It is far larger than the equity shorting—and you've heard about naked shorting in the equities market and how Chairman Cox asked to have that prohibited and did.

It's interesting that on the bond side, on the credit-worthiness side, we've permitted this to run completely unchecked to the point that it is larger than the entire economic output of the world annually. That's where we are on credit default swaps.

And the Governor has said that he's willing to regulate the piece that we can, which is the insurance piece, that original 10 percent we can easily call an insurance product. We can regulate that because it is an insurance transaction as I described. You own the bonds. You have exposure. You're not going to the track and placing a bet, and that's when you get your exposure. And we can do that. And the Governor has announced that as of January 1st, if there is not a more holistic solution through a central counterparty clearing or an exchange or some kind of clearing house that the Governor and the insurance department is willing to do that to help sort of clarify what Chairman Cox called the regulatory black hole of credit default swaps.

I will note, just because I'm in front of Congress and maybe this is helpful, that it required the Commodity Futures Modernization Act of 2000 which I believe was a statute passed by Congress to exempt credit default swaps, the naked kind that I described, from being subject to the gaming laws of the various States and to what are called the bucket shop laws. That is a very—it's kind of funny, but it is kind of funny. I could read to you that there's a law that's directly on point that prohibits that kind of activity, entering into this agreement without any exposure to the reference. And it required the CFMA to say that's not gambling. And likewise, as Chairman Cox pointed out, it also was required that it be not a security, otherwise it would have been regulated by the SEC.

So the CFMA both in one fell swoop said CDSs are not a security, and they're also not subject to the gaming laws of the land. And I think when you talk about moral hazard and the way they got it right in the 1920's, which is the law I'm referencing, 1907, they probably understood some things then that we sort of forgot along the way. And now we're $63 trillion to the worse. Later on, I can read you if you'd like, but it's pretty well established, and I think it's something that we should at least examine along with whether Glass-Steagall was such a mistake or not and other ways that we sort of protect our depository institutions, like insurance companies and commercial banks, from attendant activities at the holding company level.

Thank you very much.

[The prepared statement of Mr. Dinallo follows:]

TESTIMONY

TO THE UNITED STATES
HOUSE OF REPRESENTATIVES

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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

BY SUPERINTENDENT ERIC DINALLO

NEW YORK STATE INSURANCE DEPARTMENT

TUESDAY, OCTOBER 7, 2008

RAYBURN HOUSE OFFICE BUILDING, ROOM 2154

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.

Chairman WAXMAN. Thank you, Mr. Dinallo.

Mr. Turner.

STATEMENT OF LYNN E. TURNER

Mr. TURNER. Thank you, Chairman Waxman, committee members.

I think this is a very important hearing in light of the fact that we're watching millions of Americans lose their jobs. They've lost their homes. Now, as we watch the stock market come down, they're also losing their savings. Much of this is destruction and devastation I think that could have, and quite frankly should have, been avoided.

Chairman WAXMAN. Could you pull the mic a little closer to you? There is a button on the base.

Mr. TURNER. It is on. Is that better?

Put it in the words of philosopher George Santana, those who cannot remember the past are condemned to repeat it. And certainly we fall in that category today.

AIG serves as a reminder, an unfortunate but excellent example of what is wrong with our financial system today. While there are many capital participants that have operated within sound business, ethical, and legal boundaries, there have been far too many that have not. We began the decade with the mess around names such as Enron and WorldCom, followed by the Wall Street analyst scandal, then on to mutual fund late trading and market timing, then the stock option backdating at such companies as United Health, and now we find ourselves in the midst of the biggest and by far and away the most destructive of all, the subprime fiasco.

This is a crisis that could have and, in my opinion, should have been averted before it cost the American taxpayers what appears to be in excess of a trillion dollars before we're all said and done with it. And certainly there's plenty of blame to go around. All of us I think probably share in that to some degree. But I hope the focus of Congress and this committee would be, on a bipartisan basis, holding hearings that, much like an investigation occurs when a plane crash goes down, determines what went wrong and then promptly turns around and fixes it so we don't repeat history.

From my perspective, some of the causes of this economic crisis include executives and mortgage brokers engaging in unsound if not illegal business practices, compensation and incentives resulting in some business executives being paid both coming and going as they walk away from the equivalent of quite frankly a train wreck with huge severance packages that their corporate boards actually agreed to; accounting standard setters who failed to provide the markets with the necessary transparency; woefully inadequate due diligence by investment banks underwriting the securities; cheap debt set up by our monetary policy people that created low interest rates and led to tremendous leverage in debt in this country; as Eric mentioned, a $62 trillion unregulated credit derivative market which had absolutely no transparency whatsoever; the SEC being handcuffed by a lack of resources, lack of regulatory authority and changes in policy that no doubt have hampered enforcement; the lack of a regulator that could regulate at the holding company level for national and global insurance companies; and the failure of the Federal Reserve and banking regulators whose exams failed to identify and rectify unsound lending practices at institutions such as IndyMac, WaMu, Countrywide, and Citigroup, and often these practices led to what is our fundamental problem, loans got made that people could not repay.

In addition, policymakers and regulators have allowed financial institutions to merge and grow into colossal entities that have shown they can have a devastating impact on our economy when they get into trouble. Some are arguing that, as we've heard, they're now too large to fail. And with their failure now, though, resulting in taxpayers paying hundreds of billions to rescue them, it's time to examine good public policy to ensure that regulation of these entities provide much greater transparency, freedom from some of the conflicts we've seen, accountability for their actions and oversight.

Investor confidence is paramount to the success of any capital market. And transparency is what creates that confidence. Indeed, it is the lifeblood of any capital market system. When people believe they can no longer trust those for whom they invest their money, they withdraw it quickly and find safer havens for it, as we're seeing today. And when they demand their money back from a financial institution for fear of losing it, it can cause a serious liquidity crisis and failure, as we've seen at Bear Stearns, Lehman, and others. And as the money dries up and demand for the investment of the stock in these institutions falls, so does their stock price, making capital difficult if not impossible to raise. It's a vicious cycle. But it is one that has occurred many times in the past.

More specifically, with respect to AIG, there has been, in my opinion, poor management and governance that has led to a poor tone at the top and lack of risk management controls. I heard the chairman talk about Mr. St. Denis and his concerns. Mr. St. Denis worked for me at the SEC. He worked for me when I was a partner in the accounting firm. And his credibility is beyond reproach, and I'd seriously consider the comments that he has provided you.

The company has engaged in questionable business practices, including assisting others engage in illegal activities. This along with a constant slew of errors being reported in its financial statements have led to various investigations by legal authorities and sanctions. It's not a company that has a good track record. And in addition, opaque disclosure has been less than forthcoming. In the summer of 2007 an AIG executive said that the company would not incur a dollar of loss, would not incur a dollar of loss on its derivatives. Yet by December of last year, counterparties to the credit insurance required posting a collateral of over $5 billion, a number that had grown to $14 billion as of June 2008. And in a stunning revelation, the company disclosed on October 3rd that it borrowed $61 billion of the $85 billion made available to it by the Federal Reserve. The rapid changing disclosures on this, from zero to $61 billion in less than 12 months, is phenomenal, and investors certainly have to raise the question of, did we get the straight scoop back a year ago?

At the same time, AIG, in a move that appears to deflect criticism, blamed its problems on accounting rules which required it to disclose losses to its investors. This is like blaming the thermometer folks for a fever. As we saw with the savings and loan crisis and as the GAO, Congress's own watchdog has reported at the time, the ability of financial institutions to reporting—to avoid reporting to clients in the value of assets contributes to unsound business practices and large losses for the government who has to step in with a bailout. Again, we should not forget the past and repeat these costly mistakes. Thank you, Mr. Chairman.

[The prepared statement of Mr. Turner follows:]

United States Congress

House of Representatives

Committee on Oversight and Government Reform

2154 Rayburn House Office Building

Testimony of

Lynn E Turner

October 7, 2008

Thank you Chairman Waxman and Ranking Member Davis for the opportunity to testify before the Committee today. I applaud each of you and the committee members for holding this hearing on the regulatory mistakes and financial excesses that led to the collapse and federal rescue of AIG and what it means for the United States Economy. I ask that my written statement be included in the record.

By way of background, I formerly served as the chief accountant of the Securities and Exchange Commission. Before that, I was an audit partner in the international accounting firm now known as PricewaterhouseCoopers, where I worked on troubled financial institutions during the savings and loan crisis. I also have served as a vice president and chief financial officer of an international semiconductor company, and the vice president and managing director of research of the internationally recognized proxy governance and financial research firm, Glass Lewis. In addition, I currently serve as a trustee on the board of a mutual fund and a public pension fund. I have also served on the boards of publicly listed companies, having chaired their audit committees. More recently I was appointed by Secretary Paulson to the Treasury Committee on the Auditing Profession.

American International Group ("AIG") serves as a reminder and an unfortunate but excellent example of what is wrong with our financial system today. While there are many capital market participants that operate within ethical and legal boundaries, there have been far too many that have not. We began the decade with names such as Enron and Worldcom, followed by the revelations regarding Wall Street analysts misleading investors, then on to the mutual fund late trading and market timing scandal, then the stock option back dating at companies such as United Health, and now we find ourselves in the midst of the biggest and most destructive crisis of all—the subprime fiasco. This is a crisis that could have, and should have, been averted before it cost American taxpayers what appears may be in excess of a trillion dollars before all is said and done.

There is plenty of blame to go around for this current crisis which is resulting in hundreds of thousands of Main Street Americans losing their jobs. This includes:

- Executives engaging in unsound, if not illegal, business practices when they made loans that had a high risk of not being repaid. Predatory lending practices and the making of loans in which lenders fail to determine if the borrowers have sufficient income to repay the loan, are not what American capitalism is about. If reasonable lending practices had been followed, much of this crisis quite simply would not have occurred.
- Incentives designed to pay executives hundreds of times what their average employees made as they engaged in business that would eventually cripple the businesses they ran, placing employees jobs at risk. But some business executives got paid both coming and going as they walked away from the equivalent of a train wreck with huge severance packages their corporate boards had agreed to.

- Credit rating agencies that appear to have been more interested in satisfying the companies who paid them, and facilitating Wall Street's greed, than in protecting investors who clearly relied on them but mistakenly trusted them.
- The accounting standard setters who failed to require that companies provide investors and the capital markets with transparency that might have provided the free markets with the ability and insight to provide discipline that would have reined in abusive and uneconomic practices. And without such standards, companies viewed existing rules as a "ceiling" rather than the "floor." At the same time, as FASB Chairman Herz has noted in a letter to the Chairman of the Senate Securities subcommittee, it appears some accounting and disclosure rules were violated by some public companies.
- The due diligence required of investment banks underwriting securities, including securitizations, appears to have been deficient especially in light of problems in the auction rate securities market.
- "Cheap" debt fueled by low interest rates, which led to higher leverage and debt in this country. And when debt is cheap and easy to get, some business executives tend to take on excessively high levels of short term debt or significant liquidity risks. Unfortunately, as these risks became more significant as evidenced by what was a $62 trillion credit derivative market, the transparency surrounding the market failed to keep pace.
- Regulation also failed to keep pace. At the Securities and Exchange Commission ("SEC"), the Office of Risk management had been reduced to an office of one by February of this year. From 2005, the number of SEC enforcement division personnel was cut by 146 from 1338 to 1192 in 2007. In 2004, the SEC reduced the capital requirements for the largest Wall Street investment banks. The SEC was given insufficient oversight authority over the credit rating agencies when Congress adopted the Credit Rating Agencies Reform Act of 2006. And as Chairman Cox has recently and correctly testified, Congress also failed to give the SEC adequate supervisory powers over Wall Street Investment Bank Holding companies with the passage of the Gramm Leach Bliley Act. Congress also has failed to regulate the credit and other derivative instruments which in some instances are "Toxic Waste" to the financial system.
- Meanwhile, the Federal Reserve and banking regulators examinations failed to identify and rectify unsound lending and banking practices at institutions such as IndyMac, Washington Mutual ("WaMu"), Countrywide, and Citigroup. Often these practices developed as lenders sold loans they had originated, or were able to protect against credit risks through credit derivatives, thereby eliminating any "skin in the game." As these unsound practices grew, the regulators also failed to ensure there was adequate capital in financial institutions that had taken on and retained excessive risks.

Investor confidence is paramount to the success of any capital market. It is indeed the life blood of a capital system. When people believe they can no longer trust those with whom they invest their money, they withdraw it quickly and find safer havens for it. And when they demand their money back from a financial institution for fear of losing it, it can cause a serious liquidity crisis and failure as we have seen at Bear Stearns, Lehman and others. As the money dries up and the demand for investment in the stock of these institutions falls, so does their stock price making capital difficult, if not impossible, to raise.

A Lack of Timely Transparency

Trust and confidence in markets and any company begins with, and ends with, transparency. Transparency that ensures investors can fully understand and assess the risks and rewards of investing in a company. Yet time and time again AIG has failed to provide the requisite transparency to its investors.

In the first part of this decade, AIG's reported numbers were grossly in error leading to a May 2005 restatement of its financial statements for each of the years 2000 through 2004. The company disclosed it had inadequate internal controls and the errors had overstated income by approximately $3.9 billion. Such a huge restatement raises questions about the legitimacy of the value of the stock during these periods. As noted in Exhibit A, the company's stock price went into a sharp decline, losing approximately $8.5 billion in market value as the restatement unfolded.

The restatement was in the wake of settlements with the SEC regarding Brightpoint, inc. and PNC Financial Services ("PNC") and investigations by the SEC, Department of Justice ("DOJ"), and New York Attorney General. The SEC alleged that AIG had failed to produce large quantities of requested documents and failed to provide key documents when requested. AIG also was charged by the SEC and DOJ for its part in assisting PNC allegedly improper shift of $762 million of under-performing loans and volatile venture capital investments to three off-balance sheet structures that had been arranged with the help of AIG Financial Products Group ("AIGFP").[1]

AIG's 2005 Form 10-K was troubling for investors, as it disclosed "In many cases these transactions or entries appear to have had the purpose of achieving an accounting result that would enhance measures believed to be important to the financial community and may have involved documentation that did not accurately reflect the true nature of the arrangements." This is hardly a situation or disclosure that instills confidence or trust.

Subsequent to such serious shortcomings in financial reporting, one would expect the company to "clean up" its act and become more transparent. But in 2006 and 2007, the company continued to report "out of period adjustments" – another way of saying it continued to have errors in its financial statements. It also reported a material weakness in its internal controls in 2006. Then in its 2007 annual report on Form 10-K, AIG reported that internal "...controls over the AIGFP super senior credit default swap portfolio valuation process and oversight thereof were not effective. AIG had dedicated insufficient resources to design and carry out effective

[1] American International Group, Inc. Proxy Paper. Eric Crawley. Glass Lewis. July 22, 2005.

controls to prevent or detect errors and to determine appropriate disclosures on a timely basis with respect to the processes and models introduced in the fourth quarter of 2007."

Such a disclosure immediately raises a question as to the values the company is reporting throughout its financial statements. If a company does not have adequate internal controls to even figure out if its valuation of assets is proper, then how can the company expect to ensure accurate, complete and transparent information is supplied to investors on a timely basis. Yet in August 2007, a former AIG executive, Joseph J. Cassano, had said "It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those transactions."[2] I had also heard a similar response.

If one follows the disclosures made by the company, they also raise questions. For example, in AIG's June 30, 2007 quarterly filing, the company disclosed:

> "…a downgrade of AIG's long-term senior debt ratings to 'Aa3' by Moody's or 'AA-' by S&P would permit counterparties to call for approximately **$847 million** of collateral. Further, additional downgrades could result in requirements for substantial additional collateral, which could have a material effect on how AIGFP manages its liquidity. The actual amount of additional collateral that AIGFP would be required to post to counterparties in the event of such downgrades depends on market conditions, the fair value of the outstanding affected transactions and other factors prevailing at the time of the downgrade. Additional obligations to post collateral would increase the demand on AIGFP's liquidity."

But just six months later in its annual report, the company disclosed:

> "As of February 26, 2008, AIGFP had received collateral calls from counterparties in respect of certain super senior credit default swaps (including those entered into by counterparties for regulatory capital relief purposes and those in respect of corporate debt/CLOs). AIG is aware that valuation estimates made by certain of the counterparties with respect to certain super senior credit default swaps or the underlying reference CDO securities, for purposes of determining the amount of collateral required to be posted by AIGFP in connection with such instruments, differ significantly from AIGFP's estimates. AIGFP has been able to successfully resolve some of the differences, including in certain cases entering into compromise collateral arrangements, some of which are for specified periods of time. AIGFP is also in discussions with other counterparties to resolve such valuation differences. As of February 26, 2008, AIGFP had posted collateral (or had received collateral, where offsetting exposures on other transactions resulted in the counterparty posting to AIGFP) based on exposures, calculated in respect of super senior default swaps, in an aggregate amount of approximately **$5.3 billion**. Valuation estimates made by

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[2] Behind Insurer's Crisis, Blind Eye to a Web of Risk. Gretchen Morgenson. New York Times. September 28, 2008.

> counterparties for collateral purposes were considered in the determination of the fair value estimates of AIGFP's super senior credit default swap portfolio."

In this disclosure, the accuracy of the early statement is seriously called into question as the company discloses (1) that counter parties have questioned the company's valuations and (2) required $5.3 billion in collateral, as opposed to the $847 million amount disclosed earlier. The company did not disclose any information with respect to who the counter parties were. For example, if one of the counter parties was Goldman Sachs, a firm that has a reputation for excellence in valuation models, it might even further call into questions the amounts reported by the company.

Six months later, AIG disclosed in its June 30, 2008 quarterly report:

> " As of July 31, 2008, AIGFP had received collateral calls from counterparties in respect of certain super senior credit default swaps (including those entered into by counterparties for regulatory capital relief purposes and those in respect of corporate debt/CLOs). At times, valuation estimates made by certain of the counterparties with respect to certain super senior credit default swaps or the underlying reference CDO securities, for purposes of determining the amount of collateral required to be posted by AIGFP in connection with such instruments, have differed significantly from AIGFP's estimates. AIG is unable to assess the effect, if any, that recent transactions involving sales of large portfolios of CDOs will have on collateral posting requirements. In almost all cases, AIGFP has been able to successfully resolve the differences or otherwise reach an accommodation with respect to collateral posting levels, including in certain cases by entering into compromise collateral arrangements, some of which are for specified periods of time. Due to the ongoing nature of these collateral calls, AIGFP may engage in discussions with one or more counterparties in respect of these differences at any time. As of July 31, 2008, AIGFP had posted collateral (or had received collateral, where offsetting exposures on other transactions resulted in the counterparty posting to AIGFP) based on exposures, calculated in respect of super senior credit default swaps, in an aggregate net amount of **$16.5 billion.** Valuation estimates made by counterparties for collateral purposes were considered in the determination of the fair value estimates of AIGFP's super senior credit default swap portfolio.
>
> The unrealized market valuation losses of **$26.1 billion** recorded on AIGFP's super senior multi-sector CDO credit default swap portfolio represents the cumulative change in fair value of these derivatives, which represents AIG's best estimate of the amount it would need to pay to a willing, able and knowledgeable third party to assume the obligations under AIGFP's super senior multi-sector credit default swap portfolio as of June 30, 2008."

A recent analyst's report highlights the concerns with the lack of timely transparent disclosures to investors, which have weighed on the valuation of the stock as it has plummeted. The report states:

"According the company's 10-Q, AIG had already posted $16.5 billion of collateral and was required to post an additional $14.5 billion following a downgrade by Moody's and S&P to the mid-A level, bringing total collateral posting requirements to $31 billion if AIG was rated mid-A by both agencies...With S&P taking the company to low-A, AIG faces significant additional collateral posting requirements *that it has not disclosed*."[3] [emphasis supplied]

In one year, the disclosures from the company had gone from not losing a dollar to over $26 billion in valuation losses and counter parties that to this day have not been disclosed demanding over $16 billion in collateral. And on October 3, 2008 the Company disclosed that at the end of September it had borrowed $61 billion from the federal government due to the liquidity crisis such calls on collateral had placed on AIG. Clearly it would seem that in light of this, the company had failed to provide investors with a clear view of the magnitude of the potential demands for collateral. No doubt some investors may question if the SEC's disclosures rules for Management's Discussion and Analysis ("MD&A") have been complied with. In a release in December 2003, the SEC stated:

"The purpose of MD&A is not complicated. It is to provide readers information "necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations." .The MD&A requirements are intended to satisfy three principal objectives:

to provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management;

to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and

to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

MD&A should be a discussion and analysis of a company's business as seen through the eyes of those who manage that business."[4] [footnotes omitted]

The Financial Accounting Standards Board has recently adopted new disclosure rules that should enhance transparency with respect to credit derivatives. However, it appears additional disclosures may be warranted by companies with respect to credit derivative notional amounts, a

[3] AIG: Debt reduction and Asset Coverage Analysis. Credit Sights. September 30, 2008.
[4] Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations. SEC. December 19, 2003.

roll forward of notional amounts as well as fair values of the derivatives, the terms and conditions that can result in a call for collateral, the weighted average duration of such contracts, and information regarding the counter party risk involved.

In addition, in light of recent events, it appears serious consideration needs to be given to further regulation of these instruments, and the market for them. I wholeheartedly support SEC Chairman Cox's recent call for such regulation. It should include the appropriate mechanisms to increase transparency including transparency with respect to risk exposures, pricing, processing of transactions including timely clearing and settlement with appropriate documentation. Consideration should also be given to whether greater standardization of the market might enhance liquidity. In addition, banking regulators need to give greater consideration to how credit derivatives have contributed to banks being lax on credit risks and lending standards as they can now off lay credit risks with derivatives.

Management and the Corporate Board

The 2005 restatements of AIG's financial statements also raise questions regarding the integrity of management and the competency of the Board. This led to the ouster of Hank Greenberg as CEO and Chairman of the Board. In that year, Glass Lewis recommended a vote against 10 of the 15 members up for election to the Board.[5]

Glass Lewis also raised questions were also raised regarding the newly appointed CEO, Martin J. Sullivan, and the new Chairman of the Board, Frank Zarb. Mr. Zarb had been on the board and a member of the audit committee during the years the misleading financial statements had been prepared. In addition, the Board had quickly appointed Mr. Sullivan, previously the vice chairman of the company and co-chief operating office under Greenberg as the new CEO. The Board did not consider other candidates or do an outside search of potential candidates.

Six of those directors who were at the company during the early years involved with the initial restatement and troubling transactions that gave rise to investigations, remained on the board through the end of 2007. One of these board members served on at least seven public company boards, a number considered excessive by most corporate governance experts. Other directors served as executives at not for profit organizations who had beneficiaries of significant contributions from AIG or its affiliates. Mr. Zarb had indicated in the 2005 proxy that he would step down as interim chair at the end of 2005. However, after getting reelected in 2005, Mr. Zarb remained as chairman until age limits required him to step down in 2008. I believe the board should have gone through a complete and thorough overhaul when the first restatement and law enforcement agency investigations arose.

In addition, the board had also approved a severance package for Mr. Sullivan who stepped down as CEO on July1, 2008. Despite investors suffering significant declines in stock value,

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[5] American International Group, Inc. Proxy Paper. Eric Crawley. Glass Lewis. July 22, 2005.

Mr. Sullivan's arrangements include severance of $15 million, a pro rata bonus of $4 million and the continued vesting of outstanding equity and long-term cash awards valued at approximately $28 million. One must question why such a package would have been agreed to, especially when the CEO was hired just three years earlier without an executive search having been performed. In essence, Mr. Sullivan received what many on Main Street would consider a lot of money for very little if any performance.

The competency of the board in overseeing management was also called into question earlier this year when some investors and a former director called for a change in management. When an insider, the chairman of the board, was anointed as the new CEO, an analyst's report stated:

> "Increasingly, investors have lost confidence in AIG's business model and current management...Until AIG is able to regain investor confidence in its business model, we expect to see weakness in spreads.
>
> ...We were hoping for an outside appointment of someone who could take an unbiased view of AIG's portfolio of companies. Although we are negative on the appointment, we would note that Willumstad is a highly capable financial services executive. We simply do not see him as a good fit for the company at this moment in its history."[6]

Clearly a question remains regarding the competency of this board to carry out its responsibility on behalf of investors.

Another issue that calls into question the decisions of the board is its selection of auditors. As part of the settlement with the New York Attorney General, AIG agreed to go through a proposal process for selection of an auditor. PWC has been the auditor for AIG for many, many years, and yet despite its knowledge of the company had not caught and reported the errors leading up to the 2005 restatement. During this time period it has been reported that there was a change in audit partners that was challenged by AIG management, and at their request a different audit partner assigned. The CFO was also a former PWC employee. In addition, there has continued to be constant reporting of "new" material weaknesses and errors – out of period adjustments – that call into question how one can have confidence and trust in the financial statements. To PWC's credit, they have appropriately challenged management and highlighted the shortcomings. But one wonders if they have been constantly behind the curve in surfacing problems. I believe the board would have enhanced shareholder confidence by bringing in a "fresh set of eyes" and a new independent auditor.

The Role of Lax Regulation

[6] AIG 2Q08: Brutalized by Super Senior Swaps. Credit Sights. August 7, 2008.

I believe one of the significant contributing factors that allowed management to engage in their unsound business practices was lax regulation. For example, banking regulators have recently taken actions with respect to mortgage lending standards. One must ask why now, why not several years ago when such loans could have been prevented. Certainly the banking regulators did periodic examinations at institutions they did oversee such as Countrywide and WaMu, and must have been aware of the unsound lending practices that were being engaged in.

Yet the lack of action by the Federal Reserve raises a question that should be considered further when the structure of the regulatory system is revisited. If the Fed, as the central bank responsible for setting monetary policy decides on a policy of increasing the monetary supply, and cheap debt, should it also be responsible for the examination of the lending practices of banks to assess if they are conservative enough? It would appear the most recent crisis would seem to support legislation introduced in 1994 that would have transferred the responsibility for examinations and the accompanying supervision of financial institutions to a single agency, consolidating responsibilities that are now split among the Federal Reserve, Office of the Comptroller and Office of Thrift Supervision.

Likewise, there clearly was a lack of transparency as a result of inadequate disclosure standards for off balance sheet financings, credit derivatives and risks associated with lending activities. These shortcomings have contributed to investors questioning the financial stability and liquidity of companies when investors were unable to get sufficient information as to make informed decisions. As a result, if the FASB is unable to act quickly and responsibly to remedy these shortcomings, the SEC should act before further damage is done to the capital markets.

The SEC also needs to take actions to shore up confidence in the agency which I believe has been seriously eroded as a result of the current crisis. For example, the Office of Risk Management should be adequately staffed to allow the agency on a proactive basis to identify risks in the market place such as those created by excessive leverage, or new financial instruments that carry significant system risks such as credit derivatives. Once identified, a plan for promptly and appropriately addressing regulatory and public policy issues should be formulated and an action plan established on a proactive basis before, not after, the train wreck has occurred.

In addition, the SEC needs to once again establish itself as the investors' advocate and a watchdog rather than a lap dog. Constraints put on its enforcement division under the current chairman should be removed immediately. And reductions in staffing should be reversed.

Likewise, Congress should also provide the SEC with necessary regulatory authority to supervise credit rating agencies as well as credit derivatives in a meaningful fashion. Congress failed to give the SEC the statutory authority necessary to properly regulate investment banks holding companies which it failed to do when passing the Gramm Leach Bliley act. In 2004 this contributed to the SEC making a fatal and flawed decision to reduce the capital requirements for the largest Wall Street investment banks, yet failing to provide adequate oversight or supervision subsequently to evaluate the extent of the leverage and consequent risks being taken on. To prevent further such occurrences, Congress should fill a gaping hole created by the Gramm Leach Bliley act which failed to give regulatory agencies including the SEC, the authority to regulate and set standards for conflicts that arise when banking and securities activities occur within the same financial institution. While it may not be immediately apparent, an objective of safety and soundness is not always consistent with protecting investors

Mark to Market Accounting – Don't Shoot the Messenger

I would also be remiss if I did not address today a question which the staff of the Committee has raised with me regarding the use of what has been referred to as fair value or mark to market accounting. I agree with the Federal Reserve Chairman, the Secretary of the Treasury and former SEC Chairman Levitt that it would be a poor decision to permit banks to have a moratorium from market value accounting.

Perhaps a vivid reminder of what happens when banks are allowed to stray from reporting fair values and losses is highlighted in the General Accounting Office report titled "Failed Banks – Accounting and Auditing Reforms Urgently Needed" issued in April 1991. In citing problems that led to the costly taxpayer funded bailout of the banking and S&L industry, the Comptroller General, Charles Bowsher stated that call reports of failed institutions often failed to reflect timely asset devaluations "...resulting in continued operation and losses by unsafe and unsound banks, at considerable cost to the Bank Insurance Fund." He noted that banking examinations at the time often reflected dramatically lower values than the failed banks had reported. The report states "...we believe that market value accounting should be adopted now for debt investment securities held by financial institutions." The costly lessons cited in the GAO report should be avoided or the cost of the current bailout would likely grow due to a lack of accountability.

But regardless of whether we have fair value accounting, we would still have the current financial crisis. The crisis is brought on by the fact the banks and investment banks have leveraged up, having borrowed many times more than the typical business, and have run out of cash - a liquidity crisis as some say. Think of it this way. If you go out and make a $100 loan but the borrower can only repay say $60, then you have got something worth less than a $100. But if you do that hundreds of thousands of times, as was done by the banking industry and Wall Street, it doesn't take a rocket scientist to figure out that sooner or later one runs out of cash. You can't just keep paying out more than you collect without running out of cash and eventually going bankrupt.

In the crisis at hand, too many bad loans were made and put on the books at $100. But they weren't worth that despite credit rating agencies giving them a AAA rating on paper. In addition, because so often the money used to make the $100 loan with was borrowed, but only $60 was repaid, there also wasn't enough money left over to repay those from whom money was borrowed to make the loan in the first place.

Unfortunately, not all the banks and those on Wall Street told everyone, including investors, what they had been up to. And certainly they didn't at first tell them the loans were not worth

$100. But as liquidity and cash ran short, the losses became apparent and some institutions began to report losses. (Some such as Goldman Sachs had been much more transparent reporting fair values and losses much more timely, and have proven to be more astute and successful managers.)

Unfortunately, when investors of companies such as Bear Stearns and Lehman began to doubt the value of the assets that were reported in their balance sheets, uncertainty and a lack of trust developed. Investors chose to move their money and investments elsewhere. In the case of Lehman, investors had already lost money and been burned on their investments in Bear Stearns. As a result, institutions sold shares in Lehman before they incurred the types of losses that had occurred by holding the investments in Bear Stearns until the bitter end. This left a market for the Lehman stock where there were a lot more sellers than buyers, and as anyone who has taken Econ 101 knows that results in the price of the stock going down - quickly. In fact, much quicker than if just short sellers were to be blamed.

While this had occurred, others (like AIG) had agreed to provide credit protections on these loans. As people found out that the loans were only worth $60, investors also began to wonder what the credit protection was going to cost those who agreed to provide it. With trillions in credit protection granted through contracts that had to be honored, an agreement that could call for collateral or cash if the insurer's own credit worthiness was called into question was now a serious risk to the insurers. And of course, as the subprime loans did not pay off, then the insurance would kick in, and someone would have to pay up for the shortfall in the original $100 loan or put up collateral.

As we have seen with all the foreclosures and defaults, the subprime loans predictably did not pay off - (that is why they are called subprime). People or financial institutions who put up the money for the loans were not receiving payments equal to what they had paid out, thereby creating a shortfall that was insured. And the insurers ran short when called upon to make good on their insurance. So regardless of whether one used fair value accounting or not, the lack of cash and liquidity crisis would have occurred.

But if institutions were allowed to continue to report the value of their loans as worth a $100 when only $60 was being repaid, this is just flat out misleading, if not lying to those who own the company or might be buying the company's stock. It certainly results in less accountability.

Only by reporting the loans or investments at what they are worth, does the market and investors learn of the fact managers were making loans they shouldn't have been, and permit the market to discipline them early on when loans first start going bad. With that information in the public domain, investors will pay less for the stock and challenge management. Informed decisions are an aspect of market discipline that works, but only works when there is transparency, not a shroud of secrecy. On the other hand, if this is all done without disclosure, management is able to get away with such unsound business practices for much longer. Especially when there is lax oversight or a void in regulatory authority as certainly has occurred in recent years.

The poor transparency that investors have been experiencing is very similar to what happened during the savings and loan ("S&L") crisis when reporting of bad loans was delayed. It also occurred with Enron, when so much off balance sheet debt was hidden from investors and the markets. Now after these instances, we are seeing a repeat performance yet again. The question is: how often is Congress going to permit this to occur, each time at great cost to the individual American. The S&L bailout cost taxpayers somewhere between half a trillion and trillion depending on whose estimates one uses. During the Enron corporate scandals, the capital markets bottomed out after losing around $7 trillion in market capitalization, and today, the Nasdaq index is still less than half of what it was in 2000. Now Americans are facing a price tab that some predict could reach one and half trillion dollars. At some point, Americans will lose faith in their government if this continues.

Nonetheless, bankers are once again asking for a suspension of accounting that requires them to report to investors and depositors at a minimum four times a year what their assets are worth including any declines in values during the period. This comes at a time when the International Monetary Fund and Bridgewater Associates have reported mortgage related losses will balloon to between $945 billion and $1.6 trillion. But with institutions only reporting a little more than $500 billion in losses to date, it is apparent that more losses should be forthcoming if data from the banks is reliable. To suspend further reporting of these losses to investors and depositors is akin to a student asking for suspension of a report card when a failing grade is coming.

I note the banks are requesting a moratorium on their fair value report card. But they are also requesting $700 billion of American's money to bail them out for the bad loans they made. And they want both. But if the problem was as they assert, fair value accounting, a moratorium on it should solve the problem without the need for a bailout. Yet they are still asking for ***ALL*** the cash. A true red herring: the problem isn't fair value accounting at all, but rather a lack of cash in the banks themselves because they spent more on assets bought or created than they are subsequently getting paid back on. Ultimately, it is no different than someone who spends more than their paycheck each month. Sooner or later you end up in foreclosure, just as we are seeing with the banks themselves.

And the voice of those who create the problem always becomes loudest when there is a downturn in the markets. We seldom hear such loud screaming and complaining when the markets are rising and gains, not losses, are being recorded under fair value accounting. But when the values of assets have become impaired, managers often don't want to tell their investors that the assets under their stewardship have lost values. That information raises questions about what investors are receiving in return for the compensation being paid, as well as questions about the decisions and competency of management. Instead, companies would just as soon report higher inflated values, even to those who rely on credible financial statements to buy the stock. Companies argue that the stock market will turn around and they will recover the values of their assets. I think that is an argument I have heard AIG saying - that they would not incur losses. Reality has shown that argument and approach does not always work out for investors, like the pension funds who did not and will not recover *their* investments.

Others argue that you can't value these loans and securities, especially those for which there are illiquid markets. These, however, are not the vast majority of investments, that is investments for which prices are readily available. But for those in illiquid markets, one can look to the expected cash flows, using historical data informed by recent market transactions as a guiding light, to determine what cash is expected to be paid, which is ultimately always the determining factor in setting valuations. Of course values are often adjusted down to reflect the risk a willing buyer takes on in purchasing the assets, and the return that will compensate the buyer sufficiently to entice one to take on those risks. Keep in mind there was a reason some institutions chose not to buy subprime securities in the volumes others did, and whose management these day are getting credit for looking a lot smarter than others. While markets are illiquid at times, as with a thinly traded stock, that is no reason to simply ignore the best estimate of a market value or a calculation of a fair value. The reason markets are sometimes illiquid is there is no one who is willing to pay the price the seller wants because that price provides any buyer an insufficient return on their investment. And while that may be a depressing price, it is not a depressed price – it is just what the market says it is worth. If the price is lowered to a number that provides an adequate return, more buyers will enter into the bidding for the investment.

At the same time it is relevant that key indices on housing prices continue to decline. Ultimately, it is either the payments on the mortgage or the underlying value of the house which serves as collateral that determines the value of a mortgage loan, or related security instrument. Of the 55 million homes financed with residential mortgages, it is thought that perhaps 12-13 million are now "underwater." And sales that have occurred in the market place have come at significantly reduced prices, such as sales by E-Trade or Merrill Lynch. Similarly we saw Wachovia received offers that would pay only cents on the dollar compared to its $75 billion net book value.

If the cash payments for a security or loan cannot be determined, one must ask why it is being sold into the public markets or being bought by a bank with depositor's money in the first place. I don't recall seeing a prospectus or offering memorandum with disclosure to the prospective investor saying the seller of the subprime loans didn't have any idea about what the cash repayment streams would be. Of course such a disclosure would have been a red flag to investors and certainly would not have resulted in a AAA credit rating from the credit rating agency, as many of these investments were rated.

Some say we are experiencing a "distressed" market with abnormally low and unjustified prices that will in time return to higher values. That is like saying the market in some years is up, and some years is down, but we will ignore the down years and only use the prices in the up years. I never have heard anyone say you shouldn't use inflated bubble level prices because certainly they will fall when the crash comes. I do think prices currently are "distressing" but then they always are when they are not rising. But that doesn't mean we should give an exemption to companies permitting them to go out and say the markets and the values of their assets are up, when in fact they are not.

Finally, some people don't understand what FASB standard No. 157 is all about and their lack of an informed understanding shows. They often want a moratorium on that standard. But the reality is that it is a standard which in addition to greatly enhancing transparency in the current crisis accomplishes two things. However, one of them is not a requirement for using fair value accounting. That requirement actually rests in other standards.

The two things FASB No. 157 does is that it (1) tells accountants *how* to do fair value accounting when it is required by another standard, and (2) requires some very excellent disclosures on the fair values that have been determined. In fact, this is the standard that requires a company or financial institution to put their investments into three buckets depending on how "hard" or "soft" or independently verifiable those valuations may be. The company must then tell investors how much is in each bucket, so one can understand with greater confidence the nature and types of investments and where greater judgments are required to come up with good and solid valuations. Without such a standard, as we saw during the S&L and banking crisis of the late 1980's accounting sleight of hand is all too common when assets are reported at much more than they are/were worth. To that end, investors can thank the FASB for greatly improving the disclosures.

Closing

In closing, transparency – the ability to get information needed to make fully informed investment decisions – is critical to gaining investors trust in markets. Unless that information is accurate and reliable, investors will not trust it. When investors are provided misleading or incomplete information, they rightfully steer clear of investing in the markets because all too often it leads to losses, as we saw with Enron and more recently, financial institutions. To bring back investors to the markets, they must once again be convinced they are getting reliable information upon which to base informed, not misinformed decisions. Until then, they may prefer Las Vegas where at least the word "Casino" appears on the entrance.

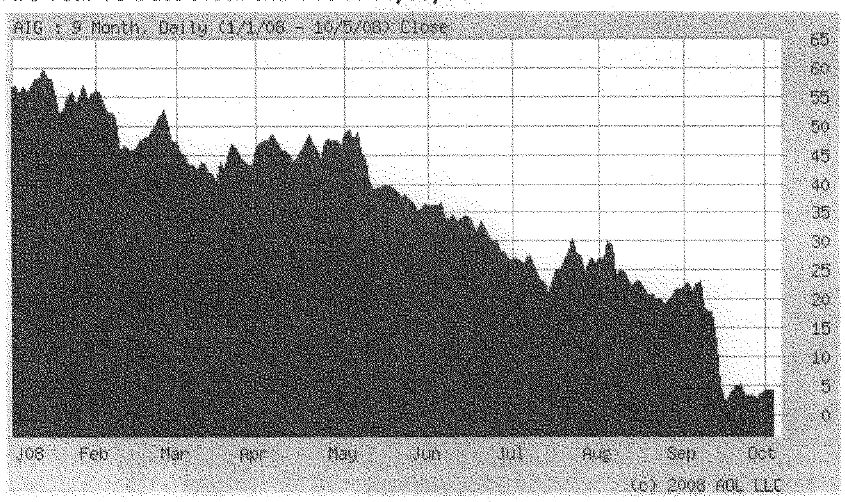
Thank you and I would be happy to take any questions committee members might have.

EXHIBIT A

AIG Stock Charts – As of close of business on October 3, 2008

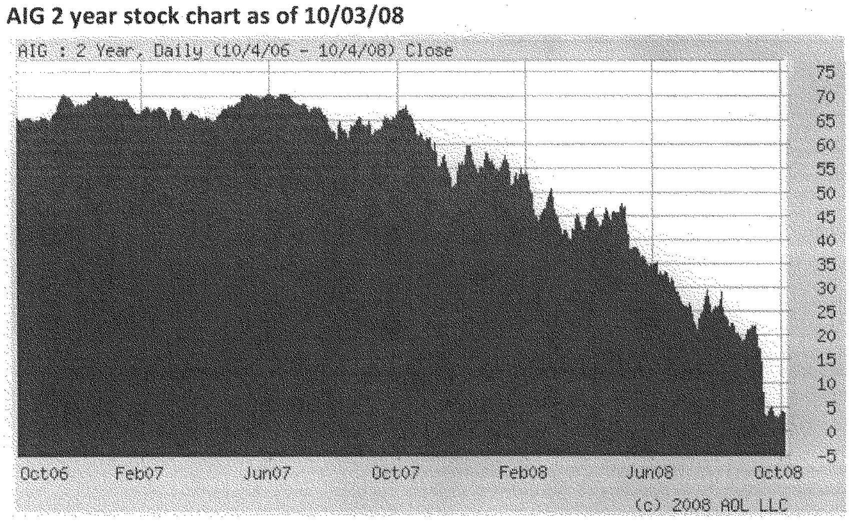
Stock Price $ 3.86

AIG Year To Date stock chart as of 10/03/08



Intraday 1 Mo 2 Mo 3 Mo 6 Mo 9 Mo **YTD** 1 Yr 2 Yr 3 Yr 5 Yr 10 Yr

AIG 2 year stock chart as of 10/03/08

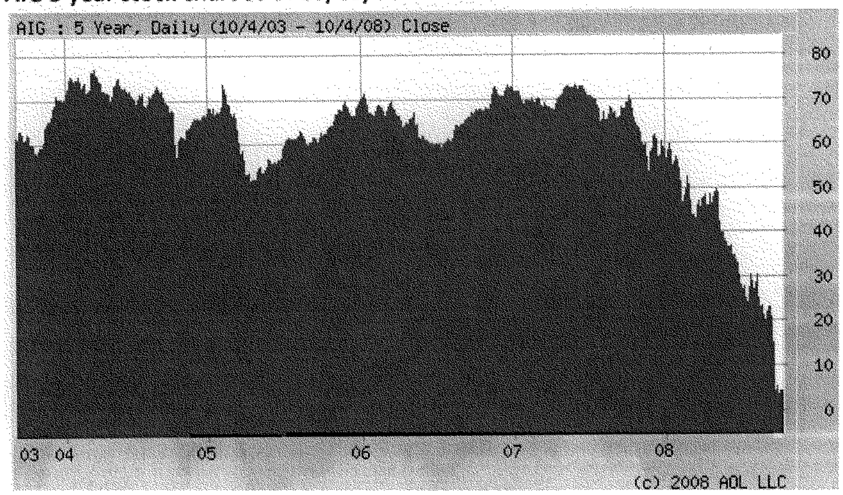


Intraday 1 Mo 2 Mo 3 Mo 6 Mo 9 Mo YTD 1 Yr **2 Yr** 3 Yr 5 Yr 10 Yr

EXHIBIT A

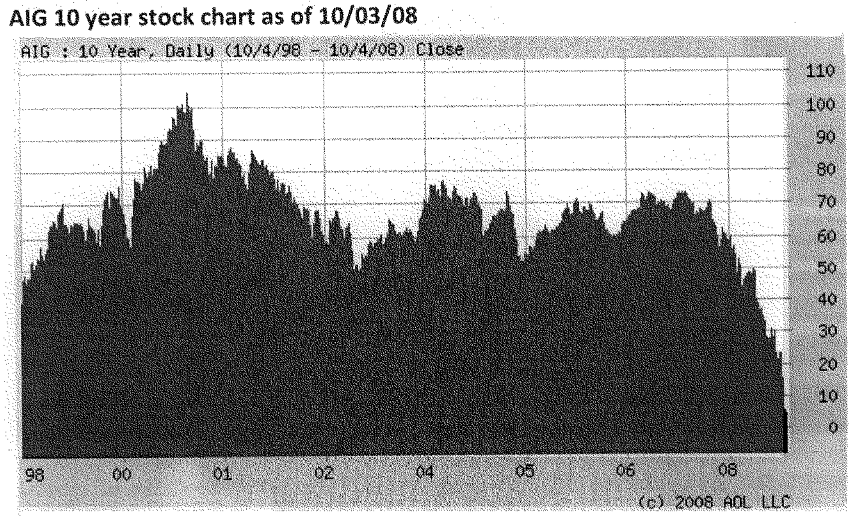
AIG Stock Charts – As of close of business on October 3, 2008

AIG 5 year stock chart as of 10/03/08



Intraday 1 Mo 2 Mo 3 Mo 6 Mo 9 Mo YTD 1 Yr 2 Yr 3 Yr **5 Yr** 10 Yr

AIG 10 year stock chart as of 10/03/08



Intraday 1 Mo 2 Mo 3 Mo 6 Mo 9 Mo YTD 1 Yr 2 Yr 3 Yr 5 Yr **10 Yr**

Chairman WAXMAN. Thank you very much, Mr. Turner. We'll now recognize Members for 5 minutes each to ask the two of you questions.

And I want to recognize Mrs. Maloney first.

Mrs. MALONEY. Thank you, Mr. Chairman.

And I'd like to welcome our panelists and thank them for their public service, particularly Mr. Dinallo from New York State. Thank you and the Governor for your creative response to the AIG crisis.

Last night and this morning I have been criticized for some pundits of my line of questioning on deregulation. Some of them called it partisan. I just want to begin by saying that our financial crisis is not a partisan issue. I truly do believe that every Republican, Democrat, Independent, conservative, liberal are dedicated to working toward a solution, and I believe the Members of Congress want to find a solution.

I am going to ask questions on deregulation and the relationship to the problems we confront. But I want to preface it by saying I am not being partisan. I am not criticizing anyone or any act or any particular thing. I am just trying to understand more about it.

And so with that being said, I'd like to ask Mr. Dinallo a few questions about the lack of regulation around credit default swaps of which seem to be at the center of AIG's downfall. Credit default swaps are basically insurance contracts to protect against defaults on bonds and loans. It's an enormous market.

Since 2000, it has exploded from $900 billion to $58 trillion. That's roughly twice the size of the entire U.S. stock market. It is also bigger, I understand, than the annual output of the entire world economy for 1 year. And yet, incredibly, the market for credit default swaps is entirely unregulated. Although they operate like insurance contracts, parties selling these guarantees are not required to have capital reserves to protect the other party. And I would first like to ask, because they are so huge, $58 trillion, if there is no value behind them, as some economists allege, could they bring down our entire economy?

Mr. DINALLO. Well, I guess we're going to find out. I hope not. But I will say that the distinction between credit default swaps and insurance policies is when you write an insurance policy, you're required to have a certain amount of solvency and capital behind that commitment. For a large, large, large percentage of credit default swaps, you're required to have absolutely no collateral or capital behind them. I—I do agree that it is interesting to note that, as Lynn said, it is not, you know, insider trading or late trading or the analyst cases or lax regulation or firm regulation or hard enforcement or soft enforcement that brought down the global economy.

I think it's politically neutral to observe; it's what we chose not to regulate. And I don't think that's actually very partisan at all. I think we as a country in 2000 made certain choices, along Gramm-Leach-Bliley and the CFMA, to permit this kind of activity as being a way to, ironically, to hedge risk. This is the ironic part. CDSs were to meant to hedge risk. But they multiplied risk incredibly in part because now only about 10 percent of what you describe is actually an insurance policy kind of transaction. The rest is really just a bet about the future of a company's credit-worthiness.

Mrs. MALONEY. So are those products just gambling, as you mentioned?

Mr. DINALLO. Well, the Governor called them gambling.

Mrs. MALONEY. We had the bucket shop laws, and we banned it in New York State. And then the commodities law usurped our position, and you think that should change?

Mr. DINALLO. We did ban it. In 1909, after the crash of 1907, we banned this kind of activity that used to be done in bucket shops where they would just take bets on the market, bucket the trades. And yes, that is what we did. And it required this—and no lawyer, no good lawyer could convince a client that a naked credit default swap was not also possibly prosecutable as gaming, so the CFMA, appropriately, because we do need some kind of futures market—there is a role here—but it completely exempted them. And the results are, in part, what you see today, which is not necessarily all about credit default swaps, as Lynn said, but also just the opacity.

One of the important points, I think, is when we were working through the bond insurers and back at MBIA and all the work we did on those, as you know, and at AIG, no one, including ISDA, could tell you how much credit default swaps were written on those entities as reference points. So if AIG had failed, no one knew how much CDS was written on AIG.

Mrs. MALONEY. My time has expired.

Chairman WAXMAN. Yes. Thank you.

Thank you, Mrs. Maloney.

Mr. Mica.

Mr. MICA. Thank you.

First of all, let me say that I'm pleased that we may be looking at Fannie Mae and some of its responsibility in fomenting the financial crisis and the mess that we see right now.

I'm disappointed, though, that we didn't start with some of the culprits, and we should actually have reviewed some of what took place with the Federal backed agency that helped, again, get us started down this wrong path. Yesterday and today we're sort of splashing around in the wading pool, and we really need to be looking at the cesspool. We're talking today about AIG, a private firm, now with government backing, but it was a private firm; and yesterday about Lehman Brothers, a private investment firm and their compensation, their running away with millions of dollars of investor dollars. And we're ignoring the core perpetrator of all this, Fannie Mae, whose executives ran away with tens of millions of dollars in public-backed bonuses, public-backed activities.

Is it correct that AIG and Lehman are private investor firms as opposed to Fannie Mae?

Mr. DINALLO. Yes.

Mr. MICA. Just for the record, they both nodded their heads affirmatively.

Mr. Turner, I read your written testimony. I agreed with most of it. You didn't mention Fannie Mae or Freddie Mac. Were their practices in any way contributory to the financial mess we're in?

Mr. TURNER. I have actually done work on behalf of OFHEO at both Fannie and Freddie.

Mr. MICA. Ok, then I don't want to hear your opinion——

Mr. TURNER. But let me just say that I see great similarities between both of those institutions and AIG. And I applaud you, very highly, for taking a look at those two because I don't see a whole lot of distinction.

Mr. MICA. Well, I want to do more than applaud because if this committee isn't going to investigate, I intend to ask the now—the special counsel statute has expired, but it's my understanding that the Attorney General can help us drain the swamp and go after those who created the cesspool. And I'm going to ask my fellow Republicans and Democrats to consider asking the Attorney General to go after those folks who robbed the American taxpayer and start with Fannie Mae, which is a federally backed institution, which you both nodded to, which started, in my opinion, this whole mess. There were contributing factors. Glass-Steagall, didn't that contribute? Just answer yes if you agree.

Mr. Turner, did you think Glass-Steagall, the repeal——

Mr. TURNER. I think the repeal of Glass-Steagall was a contributing factor here.

Mr. MICA. OK, Mr. Commissioner?

Mr. DINALLO. I agree.

Mr. MICA. One of the interesting things, too, New York did—in most cases, the States were pretty good regulators of insurance, is that correct?

Mr. DINALLO. Thank you. Yes. I think the record would support that.

Mr. MICA. And default swap is really out of your purview. But even regulation of what Fannie Mae and what they were doing and some of the activities that took place at government-sponsored financial enterprises: 2002, Mr. Shays and I introduced a law that would have brought this activity under the SEC. That would have helped regulate it. 2004, it was introduced and passed, actually, I think in 2005 by the House and blocked in the Senate, is that right?

Mr. TURNER. It was actually—Congressman Frank, much to his credit, did introduce legislation that got passed in the House over here, and I applaud——

Mr. MICA. But it was blocked in the Senate.

Mr. TURNER. But it was not passed in the Senate, and that was greatly unfortunate.

Mr. MICA. Yes, I voted against it—Glass-Steagall, Mr. Waxman and I voted against—not to repeal that. We voted opposite for the regulation in 2005.

But the responsibility lies with Congress, not with a State of New York Department of Insurance or some other State to regulate and go after some of these speculative investment activities at that level. Is that not right?

Mr. DINALLO. The responsibility of the State regulators, which I think they executed on extremely well here——

Mr. MICA. Yes, but you couldn't control the situation, is that correct?

Mr. DINALLO. To protect policyholders and protect the solvency of the insurance company.

Mr. MICA. It's the responsibility of the Congress of the United States, and also it's the responsibility of the Congress to start first with its—and clean up its own dirty cesspool, which is Fannie Mae. And we still don't have a commitment or a date to do that. And I know exactly why.

Chairman WAXMAN. The gentleman's time has expired.

Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

And to the witnesses, I want to thank you all for being here.

And my constituents are concerned about where the $700 billion is going. They want to know, because they get up every morning. They work hard. They give up their tax dollars, and they're trying to figure out where did the money go? Where is it going?

Mr. Turner and Mr. Dinallo, after the bailout of AIG last month, the U.S. Government effectively bought an 80 percent share in the company. That should have caused a fundamental change, you would think, in how the company was spending funds on compensation, bonuses and benefits. But it doesn't look like that's what happened. The committee learned that shortly after the bailout went through, executives from AIG's major U.S. life insurance subsidiary, AIG American General, held a week-long conference at an exclusive resort in California.

The resort is called the St. Regis Monarch Beach. Let me put up some pictures of the hotel up on the screen. It's very impressive. This is an exclusive resort. The rooms start, gentlemen, at $425 a night. Some are more than $1,200 a night. By the way, that's more than some of my constituents pay on a mortgage payment every month on the homes that they're now losing, by the way.

We contacted the resort where AIG held this week-long event. And we requested copies of AIG's bills. We learned that AIG spent nearly half a million dollars in a single week at this hotel. Now this is right after the bailout.

Mr. Turner, have you heard of anything more outrageous, a week after taxpayers commit $85 billion to rescue AIG, the company's leading insurance executives spend hundreds of thousands of dollars at one of the most exclusive resorts in the Nation? Mr. Turner.

Mr. TURNER. I've been a business executive myself, and I tell you what, when our company—you know, when things got tough, you cut back on expenses. You just go out and eliminate those type of things. I'm sure they had the issue, they were probably already committed to it and were going to have to spend it one way or another. But nonetheless, I remember, we—as business executive VP and CFO of a company, we would actually go out and cancel those conferences because we just didn't want to send a message to the employees that we are spending on this type of thing and we need to cut back expenses.

Mr. CUMMINGS. And if a company is drowning, then you're going to go and spend that kind of money? It's crazy. And I agree with you.

Let me describe for some of you the charges that the shareholders who are now U.S. taxpayers had to pay. Check this out. AIG spent $200,000 for hotel rooms. And almost $150,000 for catered banquets. AIG spent—listen to this one—$23,000 at the hotel spa and another $1,400 at the salon. They were getting their manicures, their facials, their pedicures and their massages while the American people were footing the bill. And they spent another $10,000 for, I don't know what this is, leisure dining.

Ms. SPEIER. That's bars.

Mr. CUMMINGS. Oh, thank you very much.

Mr. Dinallo, let me ask you, not as the insurance commissioner but as a taxpayer, does this look right to you?

Mr. DINALLO. I think there are some regrettable headlines in that. But I will say one thing, having been at large global companies and knowing what condition AIG was in when the injection occurred, the absolute worst thing that could have happened to AIG after the Government extended $85 billion would have been for them to basically go into a run-off situation, for employees to leave, for traders and major underwriters to flee the company. So if there was a thinking that they needed to bring everybody together in order to keep the productivity of the insurance companies in tact and protect policyholders by keeping them from going into a run-off status, I do agree there is some profligate spending there, but the concept of bringing all the major employees together to mix— let me just—to ensure that the $85 billion could be as greatly as possible paid back would have been not a crazy corporate decision.

Mr. CUMMINGS. Well, I would tend to disagree with you. When it comes to pedicures facials manicures, the American people are paying for that.

Mr. DINALLO. I agree.

Mr. CUMMINGS. And they're very upset.

Mr. DINALLO. I said there are regrettable and wrong headlines in that. But the idea of making sure that you can get the game plan back on track so you can pay off the loan is not an irrational one.

Mr. CUMMINGS. That is an expensive way to get the game plan back on track.

Mr. DINALLO. I agree.

Chairman WAXMAN. The gentleman's time has expired.

Mr. Bilbray.

Mr. BILBRAY. Thank you, Mr. Chairman.

And, Mr. Chairman, let me say personally, thank you very much for agreeing to do a hearing on Freddie and Fannie. I appreciate you doing that. I hope we can get that date.

Mr. Turner, I appreciate your frankness of saying, even though I'm not talking about it, we need to go back and look, concentrate on Freddie and Fannie.

I appreciate, Mr. Chairman, your ability to respond to that reality.

And in fact, Mr. Chairman I would almost say that we may be sitting in a situation that now that Freddie and Fannie has become public agencies, that we may want to talk to the Attorney General about the possibility of a special prosecutor to go in and take a look at that as one of the public agencies. And I think that's important to show the American people we really are serious at getting to correcting some of these problems and really doing it based on an in-depth study of the problem.

Let me sort of backtrack. This issue of the credit swaps, it seems like there are two—there's a balancing line here, where it is an insurance hedge and then they move into a gambling. Now, the preemption that the feds put in to say it is not gambling totally, wouldn't you agree that maybe we ought to go back and revisit that and try to develop a bright line between what is gambling and the States can intervene on as opposed to what is insurance and States can't intervene?

Mr. DINALLO. Yes. What I would have done is I would have said that each one of those activities had to get some kind of an exemption activity by activity. So there is a good argument that sort of, in crop insurance, you need futures to protect yourself against crop failure, etc. There are lots of hedging activities that are kind of on the border. You don't maybe absolutely own the security or the bond, but you do have exposure. But we basically through the law—I could read to you—we completely exempted all of it. And I think it needs to be seriously revisited.

Mr. BILBRAY. Mr. Chairman, this is the type of line that I wish, instead of just us meeting, and maybe we ought to ask the Speaker to reconvene the Financial Services Committee, to meet now, not out a month from now, to talk about the specific proposals that the House could come back into session and address.

Gentlemen, if you were in Congress, you were a Member of Congress and maybe in the Financial Services Committee, what changes and what proposals would you propose to the Speaker of the House of Representatives, to the President and the leader of the Senate at this time and place?

Mr. DINALLO. I would first revisit the CFMA on its credit default swap decisions that it's a completely unregulated and open field and that it's neither a security nor subject to the gaming laws and get back to the hedging instrument, which is I think core for our society and appropriate. I would take a serious look at Gramm-Leach-Bliley and decide whether the supermarket of financial services is worth it when sometimes things really smell on aisle six and infect the rest of what we view as kind of sacred stuff, which is depository money; whether it's insurance policy proceeds or banking, commercial banking deposits, there needs to be a greater clarity about how the holding company activities, which here did not bring down the insurance companies but did ding them from a franchise value greatly, can harm those two depository type institution activities, and whether it's always good to just let them willy-nilly be together under a holding company type umbrella.

Mr. TURNER. Congressman Bilbray, you actually raised a very good question. My first comment would be that certainly, I think, the American public were concerned about how quick we ran into the $700 billion bailout, but I do applaud you for doing the bailout. I think without a doubt it needed to be done. It could have been done in perhaps a different fashion.

But I think the public is looking for Congress to do what this committee—and I agree with you, what the Financial Services and the Senate Banking Committee should be doing, and that is immediately holding a series of hearings, just like the Pecora hearings were held in the 30's. We need a set of hearings that first identify some of the issues where each of the problems should be. It should be all inclusive. It should be the whole swamp. As people mentioned, let's drain it all out, and then turn around and, once we know where each of the issues are, bring in very knowledgeable people, like a Chairman Volker and like a Chairman Leavitt and the type, to turn around and get the best of their thinking.

And then with that, then let's go take a real good shot at putting in the things that need to be fixed. And there's a gob of things. There's questions about who should be doing the examination of these. There's questions about failures at the Fed and failures at the SEC. Do we need to restructure those examination functions, which I think we probably do? Do we have adequate resources? Do we need to repeal the Gramm-Leach-Bliley in light of what's happened with the growth of these institutions and they're too big to fail?

Certainly there's things that need to be done in terms of transparency because both in the credit derivatives market as well as some of the other subprime stuff, there's been a tremendous, tremendous lack of transparency, which has directly contributed to the lack of confidence. And I serve on two—the boards of two investment funds. And right now, people can't tell which companies they can trust and which ones they can't because of that lack of transparency. Until we get that problem solved, we are going to continue to see days like we saw yesterday in the stock market.

Mr. BILBRAY. Mr. Chairman, thank you.

I just got back from my district. And the outrage is not that we threw money at the problem but that we threw money at the problem and look like we've walked away for a month. And if it such a crisis to throw that much money out there, my constituents are saying there should be a crisis that you get in and not walk away from answers or demanding answers to solve the problem.

Thank you very much for the opportunity to question the panel.

Chairman WAXMAN. Thank you very much Mr. Bilbray.

Of course, that's the purpose of this hearing.

Mr. Kucinich.

Mr. KUCINICH. Thank you very much, Mr. Chairman.

To Mr. Dinallo, Treasury Secretary Paulson is the former CEO of Goldman Sachs. Mr. Paulson, of course, was involved in helping to save AIG. And Goldman Sachs is AIG's largest trading partner. News reports say that Goldman Sachs had at least $20 billion at stake in AIG.

Now you, sir, were involved in negotiations to rescue AIG. Was the CEO of Goldman Sachs Lloyd Blankfein and other Goldman Sachs executives present at meetings to save AIG?

Mr. DINALLO. Yes.

Mr. KUCINICH. Could you speak into the mic.

Mr. DINALLO. Yes. Yes.

Mr. KUCINICH. Was Secretary Paulson at any of those meetings?

Mr. DINALLO. None that I was present at.

Mr. KUCINICH. Do you have any knowledge that Secretary Paulson was present at any meetings relating to saving AIG?

Mr. DINALLO. I'm not trying to avoid the answer. I just had no personal knowledge of that.

Mr. KUCINICH. Do you have knowledge that he was the former CEO of Goldman Sachs?

Mr. DINALLO. Oh, absolutely. Oh, I can talk to you—I am happy to talk to you about this. You're asking me yes-or-no questions, and I'm finding it hard to——

Mr. KUCINICH. Before the bailout, did Secretary Paulson or other Federal officials raise concerns about the impact that the AIG collapse would have on Goldman Sachs?

Mr. DINALLO. Yes, but not only Goldman Sachs. In fact, if I may, I'll just tell you that I—I admire Tim Geithner, the president of the Federal Reserve. He has taught me various techniques in working through some of these problems. One of them is he believes——

Mr. KUCINICH. I'm not really asking you about Mr. Geithner, so I want to know——

Mr. DINALLO. Well, I just want to finish—please, sir.

Mr. KUCINICH. But you are on my time and I want you to answer my questions. Now my question is, the head of global commerce——

Mr. DINALLO. Yes.

Mr. KUCINICH. For Lehman sent an e-mail on July 13, 2008, to Lehman's CEO which said, "it is very clear GS," speaking of Goldman Sachs, "is driving the bus with the hedge fund cabal and greatly influencing downside momentum," meaning that Goldman Sachs was working to intentionally drive down the price of Lehman's stock. This was in mid July; 2 months later, Lehman went down with tremendous impact on the market and impact all over the world. But AIG was saved.

Now, what I'm trying to find out, you know, if Lehman's death was natural causes or murder. Now we're told that Secretary Paulson, as a former CEO of Goldman Sachs, has brought in another former Goldman Sachs employee to manage the $700 billion bailout fund.

Now, Mr. Dinallo, you are the superintendent of New York insurance.

Mr. DINALLO. Yes.

Mr. KUCINICH. You are a regulator. As a regulator, do you have any concerns that Mr. Paulson, as the former head of Goldman Sachs, was and continues to be in a position of conflict of interest with respect to being able to make decisions that would enhance the position of Goldman Sachs or be able to make decisions that would adversely affect those who might be in competition with Goldman Sachs? As a regulator, do you have any of those concerns?

Mr. DINALLO. From what I witnessed in the 4 days and 5 days that I was exposed to what I was exposed to based on my personal knowledge, I don't have concerns. I can't personally attest to Secretary Paulson's management of whatever conflicts of interest.

Mr. KUCINICH. So your answer is you don't know?

Mr. DINALLO. My answer is I don't feel I have the basis to answer the question asked. I could give you reasons that I think AIG was treated differently than Lehman. I could do that——

Mr. KUCINICH. Thank you, Mr. Chairman.

Chairman WAXMAN. The gentleman yields back his time.

The Chair now recognizes Mr. Souder.

Mr. SOUDER. Thank you, Mr. Chairman.

This unbridled greed, this callous abuse of trust of hardworking Americans' savings is just so disgusting it's hard to put into words.

And the anger level in America is coming, as it often has, directly at Wall Street but at everybody. They're worried they're going to lose everything they've worked to save because some people were living so high on the hog, so disrespectful of what was going on. The issue of that hotel wasn't the amount of money. It is the insensitivity of how people behaved with our dollars. And it's just massive discouragement to all of us that—I wanted to ask a few questions about the State insurance fund first in New York.

Is there sufficient guidelines to wall off the divisions from dipping in when they're dealing with these credit futures and money market things and so on to the insurance reserves? How is that walled off?

Mr. DINALLO. Yeah. That's what I—I think the system worked well because there's a fairly strong regulatory moat around each of the insurance operating companies versus the holding companies. So I think that there is—there was kind of an instinct at AIG that maybe there was more capital for liquidity purposes than was really available. And that's how they got it arguably into their liquidity crunch. So policyholders are extremely well protected from the holding companies reaching into the operating companies for capital and liquidity needs——

Mr. SOUDER [continuing]. Disclosure to stockholders at AIG that in fact those assets are walled off and cannot be used, and is part of the problem here that they discovered, the insurance assets were protected, markets started to adjust and caved AIG?

Mr. DINALLO. That's a very sophisticated statement. And I think there is some truth to the—I don't know, because I'm not in their minds. But certainly there is—there is a—I think a good realization among policyholders across this country that their—the operating companies are relatively walled off from that kind of activity.

Mr. SOUDER. In your State insurance fund, we have—I met with one company that's in danger of going under, an insurance company, because they had too much Fannie Mae stock. Do you have an inventory as a State insurance regulator of how exposed your insurance companies are in Fannie Mae? Because right now preferred stock's probably worth zero. Common stock certainly is.

Mr. DINALLO. We do constant examinations of the company. We have—one of the reasons I think insurance companies have done well is there are fairly strict rules and accounting standards which Lynn and I could try about what insurance companies can buy and hold in their asset liability match. I will just tell you right now, the worst exposure an insurance company can have right now is some, but the percentages that we've looked at are very low, some exposure to what had been AAA rated, CDOs, the famous AAA rated mortgage-backed CDOs, but actually the default levels of those are still relatively small, so if you hold them to term, you may be OK for an asset liability match.

Mr. SOUDER. This insurance company I believe had 25 percent liability in Fannie Mae. Do you have a guideline in New York on Fannie Mae?

Mr. DINALLO. As I sit here today, I can't answer that. I do know that we have a bureau that sort of specializes in rehabilitation of distressed insurance companies.

Mr. SOUDER. If I was trying to go through the different guarantee funds and so on, if insurance companies would start to need to be rescued, do you have a fee much like do we for FDIC——

Mr. DINALLO. Yes.

Mr. SOUDER. And others like the insurance companies would kick in?

Mr. DINALLO. You are being very helpful. Thank you. Yes, we have what's called a guarantee fund.

Mr. SOUDER. Do you have right now—because I would assume everybody should be going, because one of the debates here is, can the States do this as opposed to Federal?

Mr. DINALLO. Yes.

Mr. SOUDER. It sounded like you were looking at but do not have a clear analysis of the Fannie Mae exposure but others exposures that you have so that you could have an idea of your kind of your plan at the State level if the economy continues to tank, if more of these risky purchases that didn't seem so risky, because even Fannie Mae just this summer was insured by the Department of the Treasury, investors were told, hey, this is great. And then all of a sudden, it collapses. How are you dealing at the State level?

Mr. DINALLO. We have very frequent reporting through our capital markets bureau. We regulate over a thousand companies. So I can't, on any one company, I cannot sit here and tell you what the numbers are. We do have in place a system where, if there was a distress, we would bring the company into what's called rehabilitation, which is a form of bankruptcy proceeding to protect the policyholders so the capital is there to pay off the loans. If there is a shortfall, there are, as you pointed out, both life and property guarantee funds behind those.

What bothers me about the whole AIG episode the most from what I do for a living is I think it's—it's a broad misunderstanding bordering on the inappropriate that people would use it as an argument that there needs to be Federal regulation of insurance. I actually have been open to discussion of Federal regulation of insurance. I've testified several times in front of Chairman Kanjorski's committee, and I think I am one of the more open to those ideas. But AIG is Exhibit A for how well the States did, not how poorly they did. And that has to be said clearly because it's bad for policy holders if they think that actually their regulators did not execute well on that part of the industry.

Chairman WAXMAN. Thank you, Mr. Souder.

Mr. Tierney.

Mr. TIERNEY. Thank you, Mr. Chairman.

Let me followup on that, Mr. Dinallo. And Mr. Souder makes the point. You noted in your written statement that AIG is a holding company and owns a variety of insurance and other businesses. And Massachusetts' insurance commission was quick to share with me the fact that the problems at AIG are really those that deal not with its insurance subsidiaries but with its operations and holding company, those in the Financial Products Division, securities lending division and that area there. The State-regulated insurance subsidiaries remain solvent and able to that pay their claims, correct?

Mr. DINALLO. Yes, sir.

Mr. TIERNEY. And in fact, it's that solvency and ability to pay their claims that really gives them the basis for the Federal loan and the comfort that it will be paid back.

Mr. DINALLO. Absolutely.

Mr. TIERNEY. Now your office regulates insurance subsidiaries, not the corporate parent. The only agency with authority to regulate the corporate parent is, in fact, the Federal Office of Thrift Supervision.

Mr. DINALLO. Yes. That was a choice by the company back I think a few years ago. They could have chosen us.

Mr. TIERNEY. Yes, they could have chosen a regulatory agency that would have been more difficult to deal with. And then they probably would have supervised them better.

Mr. DINALLO. I didn't say that.

Mr. TIERNEY. They chose the Federal Office of Thrift Supervision, which is not known for its expertise in this area, and we should get that on the table.

But the committee has obtained a letter that the Office of Thrift Supervision sent to the AIG board on March 10, 2008. According to the letter, the agency criticized AIG's management and AIG's oversight of its subsidiaries, including in particular the Financial Products Division. I'd like to read from you a part of the letter and get your reactions.

The letter says, we are concerned that risk metrics and financial reporting provided to corporate management by AIGFP and other key subsidiaries may lack the independence, transparency and granularity needed to provide effective risk management oversight.

It also says, a material weakness exists within corporate management's oversight of AIGFP's super senior Credit Default Swaps, CDS, valuation process and financial reporting.

Last, it says that AIGFP was allowed to limit access of key risk control groups while material questions relating to the valuation of the super senior CDS portfolio were mounting.

So it wouldn't let in the people that would deal with this, and it kept that secret. Now, obviously, it says the oversight in key divisions has failed and that AIG apparently didn't have a full understanding of the risks taken by the financial products division. As an insurance regulator, I imagine you spend a lot of time assessing how well companies manage their risk, so we ask you, do the problems identified by the Office of Thrift Supervision sound serious to you?

Mr. DINALLO. If I authored such a letter as a regulator, I would view those as very serious allegations, yes.

Mr. TIERNEY. The letter also says that the AIG's outside auditor, PricewaterhouseCoopers, had reported the same criticisms to AIG's risk management and the lack of transparency issues. Things were so bad that the agency decided to downgrade AIG's risk management rating, its earnings rating and its composite rating.

Mr. Dinallo, can you tell us what that means in layman's terms?

Mr. DINALLO. It means that they were—I guess if they—I don't know where they downgraded it from and to, but it would indicate that they had some kind of enterprise risk management matrix and they brought them down at least a notch on how they were managing those core risks, which would, again, be something for concern.

Mr. TIERNEY. Mr. Turner, you indicated at the beginning of your testimony, I think we ought to be looking at what went wrong here; and I agree. What's your reaction to the agency's conclusions about inadequate controls at AIG and what does it tell us about the corporate governance there?

Mr. TURNER. Given the fact that AIG had been going through numerous restatements, literally since the beginning of the decade have said they've had errors in their financials, to get a letter like that out of an agency saying you had those type of risk management problems I think is extremely serious. I would agree with Mr. Dinallo on that. And I would say that you've got a serious problem from the top down, tone at the top. People just aren't giving it enough attention and aren't serious enough about making sure these things are dealt with. And in an organization this big that can bring an organization down, and obviously there is a contributing factor here. So I think it's very, very serious.

Mr. TIERNEY. So when our two next witnesses take the stand and tell us it's all about mark to marketing and circumstances beyond their control, in fact, management very much was a part of this problem in your understanding, is that correct?

Mr. TURNER. I would totally agree with that.

Mr. TIERNEY. Thank you very much.

I yield back, Mr. Chairman.

Chairman WAXMAN. Thank you very much, Mr. Tierney.

Mr. Turner.

Mr. TURNER OF OHIO. Thank you, Mr. Chairman.

Thank you both. I greatly appreciate your explanations, your descriptions. This is very helpful, not only just for the American people but for all of us in Congress as we're taking a look at what do we do next and how do we approach what other hearings are necessary.

In looking at your written testimonies, Mr. Dinallo, you say that using its noninsurance operations AIG, just like many other financial services institutions, invested heavily in subprime mortgages.

And then, Mr. Turner, you say—and I love this paragraph in your written testimony. You're talking about mark to market, and that comes into play because of the issue of subprime mortgages and the securitization of the mortgage-backed securities that were having to be mark to market. You say, I note the banks are requesting a moratorium on their fair value report card, but they are also requesting $700 billion of American's money to bail them out for the bad loans they've made, and they want both.

Then you go on to say, it is a red herring, that obviously if it was just mark to market they wouldn't need both the shift on mark to market and the cash.

And then you conclude here, ultimately, it's no different than someone who spends more than their paychecks each month, indicating that the banks spent more on assets bought or created than they are subsequently getting paid back.

And that brings us back to the subprime mortgages. So I think it is so important that we have additional hearings on Fannie and Freddie and the subprime mortgage area. And I've got a question about that for you, and I want to tell you what the experience is in my community.

Yesterday, when we had our hearing on Lehman Brothers, we had a panel that spoke beforehand. And they say that this all comes from a period of easy credit, housing prices escalating and then declining, securitization of mortgages, people using their houses as ATMs; and, of course, excessive CEO compensation was cited. In my community, subprime mortgage lending, predatory lending has had a decimating impact on neighborhoods and families. We are at the forefront of the foreclosure crisis.

In 2001, our community held a hearing on predatory lending. A city commissioner, Dean Lovelace, pushed for this. There was legislation passed to try to deal with it that was ultimately knocked down.

But the community experience is about 5,000 foreclosures a year, Ohio about 80,000 a year. Every 3 years, that's the size of an entire congressional district that we see being foreclosed.

But the experience we found in those hearings and what is happening in Ohio is that, many times, these are loans where the loan origination amount exceeded the value of the property. It's not mortgage values declining, although they are now, which is compounding the problem, but that there was systematic efforts to give people loans that were in excess of the value of their homes. Many times capitalizing the fees, many times giving them terms that either had escalating rates or payments that got them into difficulty, and then also economic conditions causing them not being able to keep up with payments. Then having a house that has a greater mortgage than the value would result in abandonment and foreclosure.

Many of the things that we hear about in this, what we should do and what has happened, fall in the category of bad business judgments or areas of regulation. But to me loaning people a loan greater than the value and then securitizing that and not disclosing that there's a gap between the loan value and the value of the ongoing asset should be, if it's not, a crime; and I believe it is. And I think, ultimately, when we start looking at all these things, we're going to find that there were real crimes committed here that real people stole and that had a big impact on our economy.

What are your guys' thoughts on the subprime mortgage crisis that has brought this about? What are some of the things that we should be looking at, or practices like this, that might lead us to how we stop these practices? Because in the bailout Congress did not stop the practices that got us here.

Mr. DINALLO. I would amend one of my earlier answers. I was asked what are the things that I would have the Financial Services Committee look at working with you, and I said CDSs, and I said Gramm-Leach-Bliley. The third would be that there is only so much good risk in any community. And we have permitted, through securitization underwriters, to basically do a set of loans to their community and then re-up the tank for doing more loans an endless amount of times.

So the first set of loans that were CDO'd, the first set of mortgages performed very well; and that banker probably said, you know, there's at least twice as many loans that I would have made, because I got great people in my community. I wanted them to own homes, so I had to make some tough decisions. And a banker on

Wall Street securitized it, and the second set did really well. And those were made with proper underwriting, due diligence decisions.

After the sixth or seventh or eighth iteration, for however we got there, I think that there is a basic, fundamental issue with people not owning the underwriting risks of their decisions. They have to have exposure to their underwriting risks. And if you put into place a system where they no longer have to worry about whether they get paid back on their loans because they've handed it off to Wall Street who's handed it over to investors seven, eight times, we will repeat this again.

Mr. TURNER OF OHIO. Mr. Turner.

Mr. TURNER. I would agree with Eric on this one, that this intermediation that the banking regulators allowed to happen to whoever was lending the money no longer had any skin in the game and you got paid handsomely for doing those type of deals is a major contributing factor here. And I think you got to go back and look at the regulation of the mortgage brokers. Certainly the appraisal process is going to be part of that.

But I think people have to go back and say, as a matter of public policy, we all love securitization because it gave everyone a chance to get into a home; and no one was complaining about it when we gave everyone the chance to get into a home. But when we loaned up 100 percent on those values, and there were a lot of those homes, I think there's something like 55 million of these of which 10 or 12 to 13 million are now in foreclosure, clearly something wasn't working out about them; and someone needs to go back to the banking regulators. And they've done some work on this, but people need to make sure that they've done enough work to make sure those type of loans can't be made.

And then the bigger question of the role of securitizations, which, quite frankly, Fannie and Freddie play a big role in here, we have to reexamine that policy and say, if there's securitizations, do we have enough safeguards? The underwriting that occurred on them was undue diligence by the investment bankers, was atrocious; and that played a role as well.

Mr. TURNER OF OHIO. Thank you.

Mr. Chairman, I just want to make an additional point that most of the loans that went into default in my community were actually refinances where the family had the American dream but that someone went back and sold them then a product that they could not maintain. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you very much, Mr. Turner.

Mr. Higgins.

Mr. HIGGINS. Thank you, Mr. Chairman.

Gentlemen, I would like to talk to you about internal audits of independent AIG auditors advising the CEO of AIG of a precarious situation that wasn't reported to investors in a conference call. In fact, the internal audits' warnings were ignored and an optimistic picture was painted relative to AIG's financial situation, which I think goes to the heart of credibility and trust. Or, in this case, lack of credibility and lack of transparency.

For example, there was an all-day conference on December 5, 2007. During this investor conference, Mr. Sullivan painted an optimistic picture of the firm's management and fiscal health. He said that we are confident in our marks and the reasonableness of our valuation methods. We have a high degree of certainty in what we have booked to date.

However, according to internal minutes from the audit committee meeting on January 15, 2008, AIG's independent auditor, PricewaterhouseCoopers, raised serious concerns before this investor meeting took place. At this meeting, auditors warned Mr. Sullivan personally back in November in preparation for the investor conference. Here is what the minutes said:

Mr. Ryan, a PricewaterhouseCoopers' auditor, reported, in light of AIG's plan to hold an investor conference on December 5th, PricewaterhouseCoopers had raised their concerns with Mr. Sullivan and with Mr. Bensinger, the Chief Fiscal Officer, on November 29th informing them that PricewaterhouseCoopers believed that AIG could have a material weakness relating to risk management in these areas. Mr. Ryan expressed concern that the access that the enterprise risk management and the AIG senior finance officials have into certain business units, such as AIG Financial Products Group, may require strengthening. At no point during the December 5, 2007, investor conference did Mr. Sullivan mention these warnings from the auditors. He never disclosed them.

Mr. Turner, you used to be a senior official at the Securities and Exchange Commission. What do you think about Mr. Sullivan's failure to disclose the auditor's warnings to investors?

Mr. TURNER. If you go back and look through the filings and go back and look through the third quarter filing for the period ending September 30th—and, Congressman, you raise an excellent question—you don't see any notion of the fact that this company probably doesn't have the necessary models to be valuing this stuff. So if you look at September 30th filings, there's no indication we don't have the ability to value these things in the way we do or no indication that you don't have controls. You're still saying things are fine.

You go then to the communication from PricewaterhouseCoopers and then to an investors day meeting on December 5th where we're saying things are OK; we don't have a problem. If you're an executive and you've known by that point in time that you've got these disclosures out at September 30th saying in essence we don't have this problem—and while this is going on keep in mind you also, as I understand it, have counter parties to these derivatives starting to argue. And I think in fact there's some disclosure by October 31st people were questioning their valuations. So it's not only that you got a September 30th cue out there, you've now got questions from outside parties, not only the auditors but very well—you know, Goldman Sachs might have been one of them raising the questions.

Back to the questions that Mr. Kucinich was raising, if you've got an outfit that is probably no one better in the world at valuing this stuff like Goldman Sachs about these values and your auditors are now raising your value, I think it's unconscionable you go out to the investors on an investor day and pretend like you've got yourself under control and you know what all the numbers are and there's no problem. And subsequent events turn around and I think pan that out when you say you've got $5 billion in collateral at the end of December and then up to $14 and now we've borrowed $61, it raises a serious question about was anyone on top of this.

Mr. HIGGINS. I yield back, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Higgins.

Mr. Yarmuth.

Mr. YARMUTH. Thank you, Mr. Chairman.

In the chairman's opening statement he said we were going to ask questions about the compensation packages of the CEOs at AIG, and so I'm going to ask that now.

You said in your written testimony that one of the problems here is that we had CEOs walking away from a train wreck, essentially, with huge severance packages. And we've seen or heard many times now that in the fourth quarter of 2007 fiscal year, 2008 fiscal year, the loss posted by AIG was $5.3 billion and shortly thereafter that the compensation committee of AIG met and extended the contract of CEO Martin Sullivan, including a $15 billion severance package. And I guess my question that most every American would have is, is there any way that the compensation committee or corporation could justify that type of activity as being responsible, in the best interest of the stockholders if there was such a dramatic turnaround and loss in the corporation and then granting a very generous package in light of that?

Mr. TURNER. I'm a believer that if a company has performed well the executives should be compensated well for that. So I have no problem with people if they've done very well and created a lot of value—like I said, I am on the board of two of these investment funds. If they created a lot of value for our shareholder, I certainly am one that would support them on getting tremendous compensation.

On the other hand, when you don't perform, having been an executive, I don't believe you deserve a bonus. If you've had a lousy year, you just shouldn't get a bonus. And then to walk away and get paid millions for walking away and doing nothing further to create value for us as shareholders I think is just wrong.

In this case, the question probably goes back to did the board agree to that agreement when they first put Mr. Sullivan in place. That was probably not a high mark for this board.

Twice I flew to New York and met with their then chairman of the board Frank Zarb and seriously questioned how they had gone through the process. They didn't go through an outside search for a new chairman. They just very quickly selected and put in place with very little due diligence the next chairman.

And, quite frankly, then when you put in place a severance agreement with the guy and agree to it at that point in time, even if things turn out bad later on, you're committed to it and you need to honor a contract. But for the board to have put something like that in place just shows very, very poor governance, very poor.

Mr. YARMUTH. And it was compounded subsequently because the next quarter the loss was almost $8 billion. So that's $13 billion in two quarters. And at that point they terminated Mr. Sullivan but allowed him to retire so that he could receive that bonus. If they had terminated him for cause, then he wouldn't have received it, as I understand it. Is that something that you would consider to be in the interest of the stockholders or in his interest?

Mr. TURNER. Again, whenever you're paying someone for walking away from the company where they're not creating any further value and haven't been creating value, that's certainly not in the best interest of shareholders.

Mr. YARMUTH. Thank you for that.

I have a question going back to these credit default swaps that I would like to get some clarification on. We threw out the number or you threw out the number $62 trillion that's out there. Is that $62 trillion a potential loss, is it absolute obligation, is somebody going to have to pay $62 trillion at some point to somebody or is that just a potential loss and to whom is that owed? I mean, in general, to whom is it owed?

Mr. TURNER. The $62 trillion, which, by the way, I believe has come down to the mid 50's at this point in time. It's only $55 trillion or $57 trillion, you know. But you raise an interesting question, because I don't think anyone really knows what the real exposure is. That's the nominal value or the amount of debt that these things have been written on, although the actual amount of debt is actually substantially less than this.

As Mr. Dinallo mentioned, some of this is nothing more than wagers of bets against one another in trading, and that's a fairly significant portion of that. But no one knows because there's no disclosure. There's no central market.

And this isn't the first time this thing almost came apart. The Fed in 2005 had to bring about 17 of these institutions together because they had gotten so far late in just doing their paperwork no one knew who owed one at that point in time. Which goes back to your question then, does anyone really know what's going on here? And the answer is probably no. No one can tell you what's going on, there's no regulation, there's no FASB, and no one can answer the questions with a high degree ofcertainty because there's no place that gathers that data.

Mr. DINALLO. This is just a very overly simplistic statement which will not hold in practice, but there's an argument that the total notional value of CDSs should not exceed the total face value of corporate bonds out there. Because if you bought insurance for all corporate bonds that anybody owned it would be—and I'm going to make up a figure. I've heard something like $15 trillion, $17 trillion—$6 trillion, I'm being told $6 trillion.

Well, I'm an optimist. So if you think of it that way, that's why we say 10 percent. Do you remember I said 10 percent? So if it's 10 percent of 62—so, yes, $6 billion is the right number. Ninety percent of it is written on just going to the track and putting a bet on whether Ford is going to fail or not. It does not represent a securitized bond exposure to the companies.

Mr. YARMUTH. If I can ask just one question in followup. So this is one corporation, in this case AIG, betting against another corporation on value that doesn't exist? I mean, they're wagering money, wagering presumably shareholders' money, and in this case it may turn out to be taxpayers' money, on basically you and I betting on a football game.

Mr. DINALLO. Yeah. Just technically I'm going to correct you to the extent it kind of went the other way. People, they sold protection as a triple A or double A rated vehicle, they sold their protection to those who wanted to take a bet on whether Ford was going to say—I'm just making that up. I'm picking on Ford. It's unfair—Ford was going to default or not. And when they got downgraded—I think this is an important fact that didn't really come out. When they got downgraded, the reason they had the liquidity crisis that we've all discussed is when they got downgraded they had to put collateral beyond those obligations. When they were a certain high rating they didn't have to post any collateral.

So getting back to the Congresswoman's point, I would say all the more frightening about all this is there's no "there" there. There's no collateral behind any of these four A, double A and triple A rated companies. And that's a big number that there may not be backing for. Not the case for insurance.

Chairman WAXMAN. Thank you, Mr. Yarmuth.

Mr. Braley.

Mr. BRALEY. Thank you, Mr. Chairman.

Mr. Dinallo, I want to start with you.

Twenty-five years ago, I was a research assistant to Professor Alan Whitus, who was updating the Keeton and Whitus basic text on insurance law; and I think both Professor Whitus and Professor Keeton would be rolling over in their graves seeing what has happened to the industry that they were so passionate about. I think you would agree with me that industry has changed radically in the 25 years that I've been talking about.

Mr. DINALLO. Yes. In particular going from mutual companies to publicly traded companies.

Mr. BRALEY. And a lot of those demutualizations resulted in a significant financial loss to policy owners who owned the shares of those mutual companies—who owned the mutual companies and during the conversion in many cases were screwed out of their financial share of those companies.

Mr. DINALLO. I might not use the same verb, but I will agree.

Mr. BRALEY. I think you get my point.

Mr. DINALLO. Well, I think it's important for everyone to know there's a very strong tension between policyholders' interest and shareholders' interest in a publicly traded company. The board and management has a fiduciary interest to shareholders under our law, fiduciary interest to shareholders, but, at the same time, whenever they release capital to satisfy that to get a bigger return on equity, they are necessarily taking incremental protection against policyholders.

Mr. BRALEY. And you also have a fiduciary obligation to policyholders under their contractual obligation with the policyholder.

Mr. DINALLO. Yes. Sadly, there is some debate, actually, because they've been so trained under our law and after Enron, etc., to worry about fiduciary duty to shareholders that there is a good argument that, although it's in their blood to worry about policyholders, the legal requirements are a little bit gray, actually.

Mr. BRALEY. Well, one of the things we know, in your opening statement you said AIG was not strictly an insurance company. And that's one of the big problems. Because insurance companies are fond of talking to consumers about gaps in coverage and how they should eliminate those gaps. But based on both of your testimonies we've got a massive $63 trillion gap in coverage where we've got a product that according to most commonsense interpretations would be considered insurance. We're not regulating in the State insurance commissioners' offices. We've taken action in Congress before I got here to declare that it's not subject to gaming regulations, which again under the Constitution are historically made by States rather than by the Federal Government, and you've eliminated any oversight from the Securities and Exchange Commission, which has the only Federal capability to exercise jurisdiction over these companies. So how did we get here?

Mr. DINALLO. I wish I could have said it so clearly. I don't know how we got here. We thought it was important to permit leverage, we thought it was important to permit risk mitigation, and we thought that mega holding companies were accretive to shareholder value and to be competitive.

And I will say that we are—that one of the big issues is after Basel II and what's called Solvency II we are in danger of going the European route, which is a lot more holding company control over the operating company, which is code for much more ability to move around policyholder money—that's what we are talking about—around for holding capital liquidity purposes. If AIG had been under a Solvency II regime, I would think we would be in much worse straits than we are today.

Mr. BRALEY. But one of the concerns I have is this blurring distinction between financial services providers—real estate, insurance, banking, other financial institutions—and how you hold accountability when these holding companies are involved in all these different financial services. Because clearly the system we have in place now is not working.

Is it time for Congress to revisit the fundamental premise of the McCarran-Ferguson Act and talk about a Federal intervention that takes into account the need to have some oversight of insurance companies that choose to engage in risky financial propositions like the ones we've been talking about today with no ability to have accountability to their shareholders?

Mr. DINALLO. Earlier, I said we should—I think I would recommend a revisitation of Gramm-Leach-Bliley and the concept of supermarkets when you're dealing with policyholder money and depository commercial—money. I'm not sure—I will just remain agnostic—whether the solution is a Federal oversight or continue with the States or some hybrid.

Because I think that it is important to have States in the solvency business. They've done extremely well on that. They've done not so well, clunky on other things like product registration and licensing of the agencies. We're pretty clunky on that. But the one thing we got right and the reason that we're even here today to the extent there's optimism here is because there was solvency done by State regulators.

Mr. BRALEY. And just to followup on Mr. Souder's comment about the guarantee funds, you would agree that most State insurance laws provide a cap on those guarantee funds typically in the amount of $500,000 or surely $1 million or less. And when you're talking about an exposure of $63 trillion that would have no impact to protect taxpayers.

Mr. DINALLO. Actually, New York is one of the richest guarantee funds; and I think the numbers you just described are New York numbers. Most States—and this is not to be pejorative to other States—but most States are substantially lower. Some people think that lower is better because it stops the moral hazard of writing bad policies because there's always the guarantee fund behind it. But, yes, it would have been a real stress on the system, undoubtedly.

Chairman WAXMAN. Thank you, Mr. Braley.

Mr. Davis.

Mr. DAVIS OF VIRGINIA. Thank you.

Do you think anybody ought to go to jail over this? Do you want to take a stab at that? Do you think anybody should go to jail over this?

Mr. DINALLO. To whom is your question directed?

Mr. DAVIS OF VIRGINIA. Both of you. I'm not asking you to name anybody or build a case. But I'm just saying, looking at the end results, how the companies operated, at this point, were they all within the law or did somebody break some rules along the way because nobody caught it?

Mr. DINALLO. I don't have sufficient evidence to have an opinion about it.

The only thing I would say is I think that as a regulatory society, so to speak, we all did kind of chase after mortgage default numbers. In other words, some of what was described earlier about the escalating losses at AIG were certainly a default rate loss. In other words, we've all seen how the rating agencies have hugely changed the ratings based on how quickly the default numbers are coming in for mortgages.

And I'm not taking a position whether it's criminal or even civil, but it is the case that a lot of us, including the best rating agencies, some of the best securitization people in the world and some regulators, got wrong what was going to be the default rates, which it turned out our global economy was hinged on.

Mr. DAVIS OF VIRGINIA. Well, if it wasn't criminal, was it at least negligent in some areas?

Mr. DINALLO. I won't even opine on that. But I would say that—I did say that the letter, if true, that I heard is something that you would be concerned about.

Mr. DAVIS OF VIRGINIA. Mr. Turner, do you have any thoughts on that?

Mr. TURNER. Yes Congressman. I don't think you send people to jail for making bad business decisions. That happens day in and day out, and people shouldn't be prosecuted for that.

On the other hand, if someone knew there were problems in the company and failed to comply with the security laws and disclosed those to investors who bought them and are now seeing their retirement savings go away and disappear, then, yes, I would turn around and say a little time behind the bars would probably be good.

Mr. DAVIS OF VIRGINIA. Well, let me ask this. How about the people writing the mortgages? You talked about the first tier and the second tier and how it got lax. I mean, at the end, they weren't even asking tough questions.

Mr. DINALLO. I think the term is a NINJNA, no income, no job and no assets, or something like that. It's unbelievable. We were harvesting mortgages at a rate that I think is completely unacceptable as a society; and we were in various ways encouraging people to engage in underwriting decisions that I find shocking, frankly.

Mr. DAVIS OF VIRGINIA. In fact, didn't AIG—they got caught up in this. Their competitors were doing it. They started a new line that they had no expertise in, used an insurance model, and it just blew up on them. Is that basically what happened?

Mr. DINALLO. I think to a large extent people did not—this is what I was trying to say before. We relied on historical default rates in housing that maybe for the first two iterations of loans was wholly appropriate. By the seventh or eighth, we had basically injected—we correlated the system because we weren't securitizing natural loans, we were securitizing created loans.

Mr. DAVIS OF VIRGINIA. Now, your argument, as I understand it, is that the Commodities Futures Modernization Act, in retrospect, went too far. It was a mistake.

Mr. DINALLO. I think that's a fair implication of what I said, yes.

Mr. DAVIS OF VIRGINIA. And that was signed just on the eve of the 2000 election. I think it passed Congress. Fortunately, I did not support it. But as I was looking at that, just going through the votes and everything, it was signed right on the eve of the 2000 election. Obviously, some modernization was needed, because there was a huge congressional and, at that point, administration consensus. But you think it just went too far. You wouldn't have argued it shouldn't have been changed. You just think in retrospect it went too far.

Mr. DINALLO. No, it was just absolute. It says this act shall supercede and preempt the application of any State or local law that prohibits or regulates gaming or the operation of bucket shops other than anti-fraud provisions.

Mr. DAVIS OF VIRGINIA. I agree.

What about the reauthorization act this year, did you follow that, that was reauthorized this year? Do you know how they reauthorized it? They attached it to a farm bill, an agriculture bill, which was vetoed by the President and overridden in Congress. That's how a lot of these things get done. So that's how a lot of this business gets done.

What about Gramm-Leach-Bliley in retrospect? Again, that was done over 8 years ago. In retrospect, obviously, a need to modernize Glass-Steagall. Would you agree with that?

Mr. DINALLO. Yes. Some in need, yes. But I've learned a lot through this process.

Mr. DAVIS OF VIRGINIA. Well, let me finally ask, should the SEC or should Congress have stepped in much earlier to suspend the mark-to-market accounting rules as a way to head off some of the problems we're experiencing today?

Mr. DINALLO. I think Mr. Turner would be better qualified to answer that. I'll just say that insurance companies do it a different way; insurance regulators do it a different way. It's much more conservative and, fortunately, beneficial, I think, to what we're talking about.

Mr. DAVIS OF VIRGINIA. Mr. Turner, do you have any thoughts on that?

Mr. TURNER. I don't think Congress should step into that. As I mentioned in my testimony, the GAO found—actually supported going to mark to market and believes that when you suspend it—when you allow a bank to turn around and have losses, OK, and not tell us as investors about it, I got to tell you we ain't got any confidence in the system or trust. And if Congress goes in and says, we're going to let you hide those things from us, I got to tell you, you're going to see a devastation in spark. We will not be investing in financial institutions if you do that.

Mr. DAVIS OF VIRGINIA. OK. Thank you.

Chairman WAXMAN. Thank you, Mr. Davis.

Ms. McCollum.

Mr. DAVIS OF VIRGINIA. Mr. Chairman, can I ask unanimous consent that Members be allowed to submit statements for the record today?

Chairman WAXMAN. Without objection, that will be the order.

Ms. MCCOLLUM. Thank you, Mr. Chairman.

Mr. Turner and Mr. Dinallo, AIG didn't suddenly collapse and need to be bailed out on September 18th. AIG's financial situation had been growing increasingly dire with each passing quarter, but AIG's executives kept telling shareholders that their finances were in great shape.

And in fact, Mr. Chair, I would like to submit a New York Times article dated September 28th which numerates time and time again how these people have said AIG was in great shape.

[The information referred to follows:]

THE NEW YORK TIMES
September 28, 2008
THE RECKONING

Behind Insurer's Crisis, Blind Eye to a Web of Risk

By GRETCHEN MORGENSON

"It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those transactions."

— Joseph J. Cassano, a former A.I.G. executive, August 2007

Two weeks ago, the nation's most powerful regulators and bankers huddled in the Lower Manhattan fortress that is the Federal Reserve Bank of New York, desperately trying to stave off disaster.

As the group, led by Treasury Secretary Henry M. Paulson Jr., pondered the collapse of one of America's oldest investment banks, Lehman Brothers, a more dangerous threat emerged: American International Group, the world's largest insurer, was teetering. A.I.G. needed billions of dollars to right itself and had suddenly begged for help.

One of the Wall Street chief executives participating in the meeting was Lloyd C. Blankfein of Goldman Sachs, Mr. Paulson's former firm. Mr. Blankfein had particular reason for concern.

Although it was not widely known, Goldman, a Wall Street stalwart that had seemed immune to its rivals' woes, was A.I.G.'s largest trading partner, according to six people close to the insurer who requested anonymity because of confidentiality agreements. A collapse of the insurer threatened to leave a hole of as much as $20 billion in Goldman's side, several of these people said.

Days later, federal officials, who had let Lehman die and initially balked at tossing a lifeline to A.I.G., ended up bailing out the insurer for $85 billion.

Their message was simple: Lehman was expendable. But if A.I.G. unspooled, so could some of the mightiest enterprises in the world.

A Goldman spokesman said in an interview that the firm was never imperiled by A.I.G.'s troubles and that Mr. Blankfein participated in the Fed discussions to safeguard the entire financial system, not his firm's own interests.

Yet an exploration of A.I.G.'s demise and its relationships with firms like Goldman offers important insights into the mystifying, virally connected — and astonishingly fragile — financial world that began to implode in recent weeks.

Although America's housing collapse is often cited as having caused the crisis, the system was vulnerable because of intricate financial contracts known as credit derivatives, which insure debt holders against default. They are fashioned privately and beyond the ken of regulators — sometimes even beyond the understanding of executives peddling them.

Originally intended to diminish risk and spread prosperity, these inventions instead magnified the impact of bad mortgages like the ones that felled Bear Stearns and Lehman and now threaten the entire economy.

In the case of A.I.G., the virus exploded from a freewheeling little 377-person unit in London, and flourished in a climate of opulent pay, lax oversight and blind faith in financial risk models. It nearly decimated one of the world's most admired companies, a seemingly sturdy insurer with a trillion-dollar balance sheet, 116,000 employees and operations in 130 countries.

"It is beyond shocking that this small operation could blow up the holding company," said Robert Arvanitis, chief executive of Risk Finance Advisors in Westport, Conn. "They found a quick way to make a fast buck on derivatives based on A.I.G.'s solid credit rating and strong balance sheet. But it all got out of control."

The London Office

The insurance giant's London unit was known as A.I.G. Financial Products, or A.I.G.F.P. It was run with almost complete autonomy, and with an iron hand, by Joseph J. Cassano, according to current and former A.I.G. employees.

A onetime executive with Drexel Burnham Lambert — the investment bank made famous in the 1980s by the junk bond king Michael R. Milken, who later pleaded guilty to six felony charges — Mr. Cassano helped start the London unit in 1987.

The unit became profitable enough that analysts considered Mr. Cassano a dark horse candidate to succeed Maurice R. Greenberg, the longtime chief executive who shaped A.I.G. in his own image until he was ousted amid an accounting scandal three years ago.

But last February, Mr. Cassano resigned after the London unit began bleeding money and auditors raised questions about how the unit valued its holdings. By Sept. 15, the unit's troubles forced a major downgrade in A.I.G.'s debt rating, requiring the company to post roughly $15 billion in additional collateral — which then prompted the federal rescue.

Mr. Cassano, 53, lives in a handsome, three-story town house in the Knightsbridge neighborhood of London, just around the corner from Harrods department store on a quiet square with a private garden.

He did not respond to interview requests left at his home and with his lawyer. An A.I.G. spokesman also declined to comment.

At A.I.G., Mr. Cassano found himself ensconced in a behemoth that had a long and storied history of deftly juggling risks. It insured people and properties against natural disasters and death, offered sophisticated asset management services and did so reliably and with bravado on many continents. Even now, its insurance subsidiaries are financially strong.

When Mr. Cassano first waded into the derivatives market, his biggest business was selling so-called plain vanilla products like interest rate swaps. Such swaps allow participants to bet on the direction of interest rates and, in theory, insulate themselves from unforeseen financial events.

Ten years ago, a "watershed" moment changed the profile of the derivatives that Mr. Cassano traded, according to a transcript of comments he made at an industry event last year. Derivatives specialists from J. P. Morgan, a leading bank that had many dealings with Mr. Cassano's unit, came calling with a novel idea.

Morgan proposed the following: A.I.G. should try writing insurance on packages of debt known as "collateralized debt obligations." C.D.O.'s. were pools of loans sliced into tranches and sold to investors based on the credit quality of the underlying securities.

The proposal meant that the London unit was essentially agreeing to provide insurance to financial institutions holding C.D.O.'s and other debts in case they defaulted — in much the same way some homeowners are required to buy mortgage insurance to protect lenders in case the borrowers cannot pay back their loans.

Under the terms of the insurance derivatives that the London unit underwrote, customers paid a premium to insure their debt for a period of time, usually four or five years, according to the company. Many European banks, for instance, paid A.I.G. to insure bonds that they held in their portfolios.

Because the underlying debt securities — mostly corporate issues and a smattering of mortgage securities — carried blue-chip ratings, A.I.G. Financial Products was happy to book income in exchange for providing insurance. After all, Mr. Cassano and his colleagues apparently assumed, they would never have to pay any claims.

Since A.I.G. itself was a highly rated company, it did not have to post collateral on the insurance it wrote, analysts said. That made the contracts all the more profitable.

These insurance products were known as "credit default swaps," or C.D.S.'s in Wall Street argot, and the London unit used them to turn itself into a cash register.

The unit's revenue rose to $3.26 billion in 2005 from $737 million in 1999. Operating income at the unit also grew, rising to 17.5 percent of A.I.G.'s overall operating income in 2005, compared with 4.2 percent in 1999.

Profit margins on the business were enormous. In 2002, operating income was 44 percent of revenue; in 2005, it reached 83 percent.

Mr. Cassano and his colleagues minted tidy fortunes during these high-cotton years. Since 2001, compensation at the small unit ranged from $423 million to $616 million each year, according to corporate filings. That meant that on average each person in the unit made more than $1 million a year.

In fact, compensation expenses took a large percentage of the unit's revenue. In lean years it was 33 percent; in fatter ones 46 percent. Over all, A.I.G. Financial Products paid its employees $3.56 billion during the last seven years.

The London unit's reach was also vast. While clients and counterparties remain closely guarded secrets in the derivatives trade, Mr. Cassano talked publicly about how proud he was of his customer list.

At the 2007 conference he noted that his company worked with a "global swath" of top-notch entities that included "banks and investment banks, pension funds, endowments, foundations, insurance companies, hedge funds, money managers, high-net-worth individuals, municipalities and sovereigns and supranationals."

Of course, as this intricate skein expanded over the years, it meant that the participants were linked to one another by contracts that existed for the most part inside the financial world's version of a black box.

Goldman Sachs was a member of A.I.G.'s derivatives club, according to people familiar with the operation. It was a customer of A.I.G.'s credit insurance and also acted as an intermediary for trades between A.I.G. and its other clients.

Few knew of Goldman's exposure to A.I.G. When the insurer's flameout became public, David A. Viniar, Goldman's chief financial officer, assured analysts on Sept. 16 that his firm's exposure was "immaterial," a view that the company reiterated in an interview.

Later that same day, the government announced its two-year, $85 billion loan to A.I.G., offering it a chance to sell its assets in an orderly fashion and theoretically repay taxpayers for their trouble. The plan saved the insurer's trading partners but decimated its shareholders.

Lucas van Praag, a Goldman spokesman, declined to detail how badly hurt his firm might have been had A.I.G. collapsed two weeks ago. He disputed the calculation that Goldman had $20 billion worth of risk tied to A.I.G., saying the figure failed to account for collateral and hedges that Goldman deployed to reduce its risk.

Regarding Mr. Blankfein's presence at the Fed during talks about an A.I.G. bailout, he said: "I think it would be a mistake to read into it that he was there because of our own interests. We were engaged because of the implications to the entire system."

Mr. van Praag declined to comment on what communications, if any, took place between Mr. Blankfein and the Treasury secretary, Mr. Paulson, during the bailout discussions.

A Treasury spokeswoman declined to comment about the A.I.G. rescue and Goldman's role. The government recently allowed Goldman to change its regulatory status to help bolster its finances amid the market turmoil.

An Executive's Optimism

Regardless of Goldman's exposure, by last year, A.I.G. Financial Products' portfolio of credit default swaps stood at roughly $500 billion. It was generating as much as $250 million a year in income on insurance premiums, Mr. Cassano told investors.

Because it was not an insurance company, A.I.G. Financial Products did not have to report to state insurance regulators. But for the last four years, the London-based unit's operations, whose trades were routed through Banque A.I.G., a French institution, were reviewed routinely by an American regulator, the Office of Thrift Supervision.

A handful of the agency's officials were always on the scene at an A.I.G. Financial Products branch office in Connecticut, but it is unclear whether they raised any red flags. Their reports are not made public and a spokeswoman would not provide details.

For his part, Mr. Cassano apparently was not worried that his unit had taken on more than it could handle. In an August 2007 conference call with analysts, he described the credit default swaps as almost a sure thing.

"It is hard to get this message across, but these are very much handpicked," he assured those on the phone.

Just a few months later, however, the credit crisis deepened. A.I.G. Financial Products began to choke on losses — though they were only on paper.

In the quarter that ended Sept. 30, 2007, A.I.G. recognized a $352 million unrealized loss on the credit default swap portfolio.

Because the London unit was set up as a bank and not an insurer, and because of the way its derivatives contracts were written, it had to put up collateral to its trading partners when the value of the underlying securities they had insured declined. Any obligations that the unit could not pay had to be met by its corporate parent.

So began A.I.G.'s downward spiral as it, its clients, its trading partners and other companies were swept into the drowning pool set in motion by the housing downturn.

Mortgage foreclosures set off questions about the quality of debts across the entire credit spectrum. When the value of other debts sagged, calls for collateral on the securities issued by the credit default swaps sideswiped A.I.G. Financial Products and its legendary, sprawling parent.

Yet throughout much of 2007, the unit maintained that its risk assessments were reliable and its portfolios conservative. Last fall, however, the methods that A.I.G. used to value its derivatives portfolio began to come under fire from trading partners.

In February, A.I.G.'s auditors identified problems in the firm's swaps accounting. Then, three months ago, regulators and federal prosecutors said they were investigating the insurer's accounting.

This was not the first time A.I.G. Financial Products had run afoul of authorities. In 2004, without admitting or denying accusations that it helped clients improperly burnish their financial statements, A.I.G. paid $126 million and entered into a deferred prosecution agreement to settle federal civil and criminal investigations.

The settlement was a black mark on A.I.G.'s reputation and, according to analysts, distressed Mr. Greenberg, who still ran the company at the time. Still, as Mr. Cassano later told investors, the case caused A.I.G. to improve its risk management and establish a committee to maintain quality control.

"That's a committee that I sit on, along with many of the senior managers at A.I.G., and we look at a whole variety of transactions that come in to make sure that they are maintaining the quality that we need to," Mr. Cassano told them. "And so I think the things that have been put in at our level and the things that have been put in at the parent level will ensure that there won't be any of those kinds of mistakes again."

At the end of A.I.G.'s most recent quarter, the London unit's losses reached $25 billion.

As those losses mounted, and A.I.G.'s once formidable stock price plunged, it became harder for the insurer to survive — imperiling other companies that did business with it and leading it to stun the Federal Reserve gathering two weeks ago with a plea for help.

Mr. Greenberg, who has seen the value of his personal A.I.G. holdings decline by more than $5 billion this year, dumped five million shares late last week. A lawyer for Mr. Greenberg did not return a phone call seeking comment.

For his part, Mr. Cassano has departed from a company that is a far cry from what it was a year ago when he spoke confidently at the analyst conference.

"We're sitting on a great balance sheet, a strong investment portfolio and a global trading platform where we can take advantage of the market in any variety of places," he said then. "The question for us is, where in the capital markets can we gain the best opportunity, the best execution for the business acumen that sits in our shop?"

This article has been revised to reflect the following correction:

Correction: September 30, 2008
Because of an editing error, an article on Sunday about the financial problems of American International Group referred incorrectly to the timing and participants at meetings at the New York Federal Reserve

between Saturday, Sept. 13, and Monday, Sept. 15. Although there were indeed meetings that weekend, there was also a separate meeting on Monday to discuss financial aid for A.I.G. Lloyd C. Blankfein, the chief executive of Goldman Sachs, was the only Wall Street chief executive who attended the Monday meeting, not the only chief executive who attended weekend meetings. Also, Henry M. Paulson Jr., the Treasury secretary, did not lead or attend the Monday meeting. (Both Mr. Blankfein and Mr. Paulson did attend the weekend meetings.)

Ms. McCOLLUM. In December 2007, for example, Mr. Sullivan told AIG investors, "we believe we have a remarkable business platform with great prospects that represent tremendous value." Two months later, AIG posted $5.3 billion losses for the quarter.

February 2008, Mr. Sullivan said, based on our most current analysis, we believe any credit impairment loss realized over time by AIGFP would not be material to AIG's consolidated financial condition. Then AIG posted $7.8 billion in losses for that quarter.

On May 28th, Mr. Sullivan told investors, the underlying fundamentals of our core business remains solid. The next month the board voted to replace Mr. Sullivan.

Mr. Turner, I have a couple of questions. What do you think of Mr. Sullivan's statements? Do you think they accurately reflected AIG's conditions? And, Mr. Dinallo, I would like to know if have you a view on that as well.

Mr. Turner, in your written statement you said—and I'm going to quote you—trust and confidence in markets and in any company begins and ends with transparency, transparency that ensures investors can fully understand the assets and rewards of investing in a company. You should be able to trust what the CEO is saying.

So if you gentlemen could please elaborate.

Mr. TURNER. As you go through these filings and you look at the disclosures that start to occur and the timeframe in which they are, the one thing I take away from this is I don't think the company ever was honest with the investors about the magnitude of the potential impact of these things. And I think that's what is grossly missing here. And then, as things start to go bad, they go bad very quickly; and we're finding out about everything not prospectively here's what could happen.

Keep in mind, the SEC rules are very clear. They require you to tell the investor right through the eyes of management what's happening with the company. And I don't think we ever get that out of here. I don't think the rules were followed.

I just think it's astounding that all of a sudden you're borrowing $61 billion and yet you've never told the investors up to that point in time, hey, we've got these credit derivatives out there that could cause us such a problem that we could come short.

And granted the market goes down, OK, and certainly people were not wishing for the market to go down the way it was, but, nonetheless, when you've got that type of exposure and that type of potential, you owe it to me as an investor to tell me that's the type of risk I'm taking on when I'm investing in you. You've got this thing that may all of a sudden blow up and cause you to need tens of billions and you can't get to it because all the cash is in regulated subsidiaries that Mr. Dinallo is appropriately trying to protect. And that's the disclosure, the gist I cannot find in these filings.

The SEC and the DOJ I hope will go through, get the e-mails, get the data and then everyone is entitled to their day in court and due process. But, right now, there is a question there that I can't answer for myself as to why we didn't get that.

Ms. McCOLLUM. Mr. Dinallo.

Mr. DINALLO. Obviously, I have to be sort of—I'm not informed enough at the holding company level on some of the disclosures to have a position about this.

I think I did say earlier that I witnessed sort of a very shocking realization as to the liquidity needs of the company on that weekend. I was surprised that some of the risk was being rolled up at that—sort of contemporaneously at that time.

I will say, just one observation that we just touched on, which is one of the lessons learned. There are these things called lines of credit that every company has, and they assume they're there in these liquidity crunches. But what is kind of interesting I think that the committee should know about, and the Financial Services Committee should probably be told about, is if you touch them you get a three-notch downgrade from the rating agencies. And so they're kind of fictitious in some ways.

I don't mean this badly, but people have them and they convince us that they have this line of credit that will help them through these tough times. But God forbid you need to hit the $15 billion line of credit these companies have. The consequences are such that you might as well not have them because you might as well have gone through the downgrade because you're going to go through it for touching the line of credit. We're all learning together to some extent. And I think that's one of the lessons that I would kind of inject in this.

Ms. MCCOLLUM. Thank you, Mr. Chair; and thank you for the hearing because I think this is clearly showing people were gambling—they weren't investing—with the dollars that these investors had.

Chairman WAXMAN. Thank you, Ms. McCollum.

Mr. Van Hollen.

Mr. VAN HOLLEN. Thank you, Mr. Chairman.

Thank you both for your testimony today.

Mr. Turner, I just want to followup on my colleague Mr. Yarmuth's questions. He asked you about some of the golden parachutes that were available for Mr. Sullivan and others at AIG.

I want to talk about the regular compensation and bonus plan. And as you state in your statement you talked about the dangers that bonus plans that are, "designed to pay executives hundreds of times what their average employees made as they engaged in business that would eventually cripple the business that they ran." And you hear a lot of talk from some of the CEOs about how they have these pay-for-performance plans, that in the good times they benefit but when times are bad they take a hit. And I think the more we look at these different companies like AIG you find that they rigged the rules so in good times they do well and in bad times they do well.

I would like to get your opinion of the actions of AIG's former CEO Martin Sullivan at a meeting of the company's compensation committee on March 11, 2008. The committee has obtained documents of that meeting.

AIG has two bonus programs. The first is called the Partners Plan, and that covers the top 700 executives. The second is called the Senior Partners Plan, and that applies only to the top 70 executives. Mr. Sullivan benefits from both plans.

Now, according to the plans—and, again, if you listen to what they're saying, rewards were supposed to be based on the company's performance. But I want to show you or at least mention to you—I don't if we have it on the screen, but we have the internal minutes of the meeting that was held by AIG's compensation committee on March 11, 2008; and, as you can see, what those committee meetings show is that Martin Sullivan, who was CEO at the time, personally urged the committee to waive, to waive the bonus rules right after the company posted a record loss.

And as you can see that what the minutes say is Mr. Sullivan next presented management's recommendation with respect to the earnout for the senior partners for the 2005 through 2007 performance period suggesting that the AIGFP—that's the financial products division—that their unrealized market valuation losses be excluded from the calculation. Essentially what he's saying there is the rules, if we applied them, wouldn't let me get my bonus, so let's change the rules, isn't that right?

Mr. TURNER. That's the way I would read that.

Mr. VAN HOLLEN. And this comes on the heels of the February 8th—28 AIG posting of losses of $5.3 billion for the quarter, which came primarily from the financial products division, isn't that right?

Mr. TURNER. Yes.

Mr. VAN HOLLEN. And the record also makes clear that in fact the board, not surprisingly, agreed with their CEO; and he got his $5.4 million bonus, despite the fact that AIG ran up $5.3 billion in losses in the quarter before.

I just have to ask you, you know, because people understand when people get rewarded for doing well. But everybody else out there operating in the economy, when they don't perform, they get their pay cut. They get fired. These guys, there is absolutely no accountability. So I would like you to comment on the kind of changes that need to be made in your view to make sure this kind of thing does not happen going forward.

And then, Mr. Dinallo, I would like any comment you've got.

Mr. TURNER. As someone who has followed governance and read many of these type of plans—quite frankly, when I was running the research at Glass, Lewis, this is not an isolated occurrence. We've seen this time and time again in corporate America where you set up a pay for performance plan but then, when you didn't hit the performance triggers, you changed the triggers, you didn't change the compensation. And there's just something fundamentally wrong with that.

And that's one of the reasons this institution, quite appropriately so, I believe, last year voted and approved the "say on pay proposal" that is a middle of the ground proposal and a very, very good proposal. It's unfortunate. I know it was in one of the drafts of the bailout legislation and didn't stay in it. That is very unfortunate.

But I think certainly we need to have in this country—give the shareholders the vote and opportunity to pay on—or vote on situations like this with full disclosure so you're aware this type of stuff is going on; and I think only by doing that are we going to get this reigned in. I think anything short of that is going to leave these plans in place, leave this type of behavior in place, and people are going to continue to be outraged about it, and you're not going to get the changes that you need.

So when we have say on pay as investors, when we invest in the U.K., when we invest in Netherlands, when we invest in Australia, but we don't even have that right as investors here in the United States, there's just something fundamentally wrong with it. So we need this institution, the House, and we need the Senate, by golly, to follow your good leadership on that and pass the say on pay proposal now, not a year from now, but now.

Mr. VAN HOLLEN. Thank you. Thank you, Mr. Turner.

Mr. DINALLO. I would only add that a lot of Wall Street and traders—and I think AIGFP is analogous to this—are paid on a revenue basis, as opposed to an end-of-year profit basis, and there is something to that. And you can create a lot of revenues without actually booking a profit sometimes. And so that's something that people have written about recently, about sort of changing that approach to compensation for certain financial services activities.

Mr. VAN HOLLEN. Thank you. Thank you both.

Chairman WAXMAN. Thank you, Mr. Van Hollen.

Mr. Sarbanes.

Mr. SARBANES. Thank you, Mr. Chairman.

I'm trying to understand this in the context or in terms of how we got all these toxic assets infecting the markets out there which at the end of the day just gets back to this insatiable appetite to generate new loans. And when there weren't enough loans out there in the conventional market we then had these people that were reaching into the unconventional market, into a very risky market, and that created this toxin that went up the chain.

So my interest in what AIG was doing is to the extent that it was seen as providing the hedge/insurance backstop to these Wall Street firms that were increasingly getting into the business of trading in very unstable or risky security products, with the effect, I take it—and I would like your view on this—with the effect that it increased their risky behavior, and that gets pushed down the chain. So they begin to encourage more and more risk on the front end. And once you've relaxed the underwriting standards on the front end of this thing, it becomes very difficult to continue to manage the risk up the line, because the original thing that you've created in and of itself is unstable.

So talk to me about that. Talk to me how what the product that AIG was offering basically led to riskier behavior on the part of these Wall Street firms which in turn led them to encourage risky behavior all the way down the chain. Mr. Dinallo.

Mr. DINALLO. Well, I think, Congressman, you sort of said it in there. They were arguably at the end of a chain of exceedingly ridiculous optimism about the value of these mortgages. So people harvested the mortgages. They securitized them. The rating agencies rated those at the highest levels; and, through CDO squared, triple A traders at various trading houses held them. And then wanting to prudently, arguably, have a default protection on those bought a credit default swap from certain guarantors, AIG being one of them.

So I would say that at some level what AIG did was it gave—kind of it was the last line of defense with its high rating—I think it was double A at this time—saying, well, the rating agencies rated it triple A, so we'll even guarantee it against default.

And one of your points I thought you were sort of making was maybe if anyone in that line of activity had acted with—this will be a little bit impolite—but acted with common sense instead of models they might have said this doesn't feel right and I'm not going to put my reputation, assets, shareholder value, rating at risk for this.

Mr. SARBANES. Well, you had two things happening. You had a bunch of people along the way who could keep off-loading the risk to somebody further up the chain. So then they have no incentive themselves to stop or curb their behavior, particularly if they're making money off the deal.

Then you start getting to the end of the chain, right, the people that are actually holding these securities at the end of the line. And the way they, "offload the risk is to go insure against it." So they turn to an AIG as a way of doing that.

And I guess in the initial iteration of that maybe it made sense. But then you have AIG basically opening a casino in London, right, to start this other activity. So at what point should the investors that were purchasing this as an insurance policy, should they have known that AIG, their, "insurer was getting into this other risky enterprise?" Did they know that? Did they realize that they had opened the casino in London and something else was going on that was putting their policies, "at risk?"

Mr. DINALLO. I just want to clarify. I think we're mixing the term insurance policy somewhat loosely. When you ask that, you mean the people who had actual property—the common man and woman who had life insurance policies and property polices with AIG? Is that what you meant?

Mr. SARBANES. No, no. I'm talking about the insurance product that was the CDS, because it began that way, right?

Mr. DINALLO. But my understanding, Congressman, is it was always out of financial products.

Mr. SARBANES. Right. But I'm saying is it began as a legitimate, "hedge against the downside risk of this particular security that you hold." But the reason it got up to $55 trillion or $62 trillion or whatever it was is because it became a betting house. And what I'm trying to figure out is, at the point that happened, no longer should I as an investor who is hedging against the security that I actually own have taken any comfort from the fact that AIG——

Mr. DINALLO. I think I can answer that, yes. I think that at AIG most of the activity in the CDS was off of covered, nonnaked activity. These people really owned the CDOs. These were traders that owned CDOs, and they wanted default protection on the CDOs. But it is actually a profound observation that the Governor has made that for the 10 percent of people who thought that they actually had capital and some kind of insurance protection behind those covered CDSs, it turns out that possibly the continued unregulated activity that is naked could seriously impact their ability to receive payment. I think that's what one of the Congress people was—I think that's what Congresswoman Maloney was very concerned about before.

Chairman WAXMAN. Thank you, Mr. Sarbanes.

Mr. Welch.

Mr. WELCH. Thank you very much.

I really appreciate your testimony. Very informative, very helpful.

A couple of things. One, Mr. Turner, I think you said that the SEC Office of Risk Management was reduced to a staff, did you say, of one?

Mr. TURNER. Yeah. When that gentleman would go home at night, he could turn the lights out. In February of this year, that we had gotten down to just one person at the SEC responsible for identifying the risk at all the institutions.

Mr. WELCH. So that included the $62 trillion credit default swap.

Mr. TURNER. That's correct.

Mr. WELCH. And how did he do?

Mr. TURNER. Well, I suppose he got the lights turned out but didn't get the problems taken care of.

Mr. WELCH. It reminds me we had a hearing earlier on in this committee about these tainted toys kids were buying, or they were getting toys that had lead paint. And it turned out that the Consumer Product Safety Commission apparently had one person—I hope it wasn't the same person—inspecting all the Chinese imports.

Mr. TURNER. In all fairness to the SEC, the staff over there that I've dealt with over the years have been excellent. But when you only have one person there's no way on God's green Earth anyone, Chairman Cox or anyone else, could have even imagined that this person could do the job. When you cut it down to one, you know what you're doing. You know that you're basically saying we're not going to do the job.

Mr. WELCH. Was there a systematic depopulating of the regulatory force so that it was impossible actually for regulation to occur? If you have one person in that office—and then I understand that 146 people were cut from the enforcement division at the SEC. Is that what you also testified to?

Mr. TURNER. Yes. I think there has been a systematic gutting or whatever you want to call it of the agency and its capability through cutting back of staff. We talked about risk management, we talked about enforcement, but as well just in some basic fundamental policies. The enforcement staff are now asked to jump through many more hoops before they can proceed with investigations, a change that's been written a lot about in the media, and it's not a healthy change for the agency.

Mr. WELCH. You in your testimony—and I think it was really supported by Mr. Dinallo—identified a number of things that have contributed—and there is plenty of blame to go around—the executive compensation, people coming and going, making money, the accounting standards being lax, cheap debt, this whole unregulated casino-like $62 trillion credit default swap, handcuffing of the SEC, lack of regulation at the holding company level, failure of the Federal Reserve to tighten up on credit and mergers that were too large.

But I want to get back—and that was quite a laundry list. In all the things that we could act on, but on this specific question of having public servants in the job so they can do the job on behalf of the American public, would it be your recommendation that we've got to boost the personnel levels at these organizations to protect the consumer?

Mr. TURNER. Unequivocally yes. I believe in the Appropriations Committee over in the Senate Banking they've given them about a $30 million increase. And I suspect that falls short. It probably is going to need to be—if you really want the SEC to do a job and you're serious about it, given the cutbacks that have occurred in the last 3 years or so, you're probably going to need an increase at the SEC realistically more in the range of $50 million to $75 million.

Mr. WELCH. And that's paid for by that SEC transaction fee?

Mr. TURNER. Yeah. And, in fact, the SEC collects more in transaction fees, substantially more in transaction fees from businesses than they actually pay out for their costs and their staff.

Mr. WELCH. Let me ask you this. Some of us have suggested that there be an SEC fee or transaction fee that would go into an escrow account to offset any cost to the taxpayer of this bailout. Is that something that you have an opinion on?

Mr. TURNER. I've always believed that the SEC from a funding perspective should be treated solely as an independent agency and that the SEC be given the ability to collect its fees and whatever it collect it spends on that and that those fees don't go elsewhere. They just basically go to fund the SEC so that they don't—you know, they get what they need but not more than what they need.

Mr. WELCH. Mr. Dinallo, how about you, both on this question of personnel to get the job done and establishing basically an escrow fund to help offset the cost of the bailout?

Mr. DINALLO. Obviously, I'm a big fan of hiring regulators. I think the department is—I think we're well—you know, we have a lot of—there's hundreds of people who do what they do at the New York State Insurance Department. It takes a lot of people to regulate closely. I think it is definitely the case that you can design a system. I certainly feel independent in our work, but we are net, we are net, you know——

Mr. WELCH. Thank you.

One last question for both of you.

Mr. DINALLO. So I think you can do it without costing the taxpayer any money.

Mr. WELCH. There are a number of companies that are going to participate in this bailout program, and my question to you is this: Do you believe it would be right and appropriate for the taxpayers to have the right to claw back some of these outrageous executive salaries and golden parachutes from companies that have voluntarily opted to participate in this bailout?

Mr. TURNER. The provisions that are in the legislation, you know, does under what I would consider to be limited situations allow claw back. But people need to understand it's limited. It's not everyone. I thought it should have been everyone, quite frankly.

Mr. WELCH. That's what I'm asking. We have another crack at this. This was a gun-at-our-head piece of legislation we had to pass, we were told, in order to avert a catastrophe. But we have an opportunity to improve it, and we are going to have to. So would you support a stronger claw-back provision?

Mr. TURNER. Yes. And I communicated with Members of Congress already that I think the claw-back provision, the severance provision—there were three provisions there on compensation, and they all could have been much stronger than what was done the first go-around.

Mr. WELCH. Mr. Dinallo, how about you?

Mr. DINALLO. I don't think I have enough of a basis to give an opinion. I think Congress did a pretty good job the first time around. But I would have to see some kind of proposal to know for all such instances.

Mr. WELCH. OK. Thank you.

Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Welch.

Ms. Speier.

Ms. SPEIER. Thank you, Mr. Chairman.

Mr. Dinallo, I am one of those that believes that the regulation of insurance companies should be at the State level. And if there ever was a great example of why it works it is AIG, because the insurance part of AIG is solid.

Now, having said that, you as a regulator have the authority to conserve, to take institutions into conservatorship. And once you do that my understanding is, certainly is in California law, that all bets are off. The contract is off. You are there to make sure that the corpus is protected for the policyholders, is that correct?

Mr. DINALLO. Yes.

Ms. SPEIER. In this situation we now own AIG. The taxpayers of this country for all intents and purposes own AIG. It's in conservatorship. Mr. Cassano, who was the golden boy of the casino in London, had his compensation very attractively devised so that over the course of 8 years he actually earned more money than the CEO, some $280 million, because he was getting $0.30 back for every—on every dollar he was receiving $0.30 back in terms of the products that were being sold. So he also was eligible for bonuses. He was eligible for $34 million of what were unvested bonuses.

But in February of this year he took that company, that division, down by $5.3 billion. And yet he was fired the next day, and the following week the committee has a copy of a letter, that's a contract, I presume, here, that confirms this agreement in which he was given the $34 million, and, oh, by the way, he is now on contract as a consultant to the tune of $1 million a year, and we, the taxpayers, are picking up that tab.

So here's someone who brought the company down, the taxpayers now own this company, it should be in conservatorship, and this man is still getting $1 million a year. Now, in conservatorship as an insurance company, you would be able to void those contracts, wouldn't you?

Mr. DINALLO. Yes.

Chairman WAXMAN. Let me intervene just to say it's $1 million a month.

Ms. SPEIER. Excuse me. $1 million a month.

Mr. DINALLO. If those contracts were——

Ms. SPEIER. Thank you, Mr. Chairman, for that clarification.

Mr. DINALLO. If those contracts were with an operating company that we brought into rehabilitation, which you would call conservatorship, we do have incredibly potent powers over policies and contracts. The company, we basically step in and become the management at our, you know, salary.

Ms. SPEIER. So that fancy conference in California could have been stopped under those circumstances?

Mr. DINALLO. Yes. Although I presume—yes. Although again we're talking about a holding company activity.

Ms. SPEIER. So Mr. Turner, knowing what we know, knowing that Mr. Cassano now is getting a million dollars a month paid for by the taxpayers even though he's no longer working there and he did get his bonus even though he didn't earn it, do you think we should claw back?

Mr. TURNER. Well, there is always the legal question of legally what you can or cannot do. Unfortunately, one of our problems is we've paid out or investors are quite frankly going to pay out now, as you mention taxpayers time and time again, it's not just this situation, it's this situation as you aptly describe, others at their institutions, Merrill Lynch, Countrywide and the likes. If there's a way you could find legally to go enact legislation that would allow clawbacks of those sums where there was absolutely no pay and no performance, if not destruction, I would be a big fan of it. And the real question is legally whether or not you could do that. I would certainly say though we've learned a lesson and let's not repeat it again and let's go fix this going forward as well. If you can do something in the past, I'm sure—I've heard from a number of my fellow neighbors that they'd love to see you go get what you couldn't back from the past as well.

Ms. SPEIER. One last question to Mr. Dinallo. You determined to take $20 billion from the insurance company and give it to the holding company.

Mr. DINALLO. Yes.

Ms. SPEIER. Explain to us why you did that. Did you think that was going to be enough to hold them over?

Mr. DINALLO. Yes. So we didn't actually do it. But we did at a certain point offer to do it as part of a holistic solution. We did believe at the time that the liquidity problem of the downgrade that I talked about before was on the order of $15 billion, a need for liquidity. So there was a plan to take what was excess surplus—this is an important point. There's the asset liability match, promises versus assets held. There's a statutory surplus above that. And then there's excess surplus even above that which companies often have the right to decide how to use. And we thought that prudently we could loan that essentially through the property and casualty companies to fix the liquidity problem on the basis that the life insurance companies were going to be sold, which is part of the AIG plan, or some companies to repay that loan. So at the time the Governor thought given AIG's presence in the community, the number of jobs at stake, etc., that was a—and given it was not in any way going to put policyholder protection at risk, it was a reasonable use of excess surplus.

Ultimately we didn't need to do to it. But that was the beginning of that weekend where I was called in and the Governor sent me in to understand how we could be pragmatic on a liquidity basis, yes.

Ms. SPEIER. Thank you.

Chairman WAXMAN. Thank you very much, Ms. Speier. Ms. Watson.

Ms. WATSON. Mr. Chairman, I want to thank you for this opportunity to have the public listen in as we try to unscramble eggs. And Mr. Dinallo, Mr. Turner, thank you very much. I don't know if your responses are really doing that, but at least I hope at the end of the series of hearings, we as the policymakers will have a little more clarity as to where we need to go forward and what we need to do.

Mr. Turner, in your written testimony you told the committee about AIG's disclosure on May 2005 that it had inadequate internal controls. You also said the errors overstated AIG's income by approximately $3.9 billion. And Mr. Turner, AIG has had a history of internal control problems. Would you say that's true?

Mr. TURNER. Yes.

Ms. WATSON. OK. As part of the committee's investigation, we reviewed internal minutes from AIG's audit committee meetings, which are not public, and these minutes show that the company's independent auditor, PricewaterhouseCoopers warned the company as recently as this year that there were significant problems and that these problems were growing worse. Now here are some of the examples, and they might be up on the screen.

As of February 7th, the meeting of the audit committee, PWC warned that the role and reporting of risk management needs a higher profile in AIG. And at a February 26th meeting, PWC indicated that the process at AIG seemed to break down, in that—and it was kind of unlikely that other companies, where there was good dialog at appropriate levels of management on the approach, alternatives considered and key decisions—at AIG only AIG-FP was involved in the December valuation process.

At the next meeting on March 11th PWC reported that there is a common control issue and root cause for these problems and that AIG does not have appropriate process or access or clarity around the roles and responsibilities of critical control functions.

Mr. Turner, as a former SEC accountant, do you consider these deficiencies serious? Can you elaborate?

Mr. TURNER. Yeah. Again going back into 2007, there's obviously some questions about whether the company at a time it had disclosed—and in all fairness to the company they had disclosed that they had a half trillion in nominal value of these derivatives. They didn't tell people just the magnitude of what that could turn into, but they had told the public they had a half trillion. But in light of that and the fact there was some very, very serious concerns about the models and where they could do the valuation right, which would raise the question of could you actually disclose something with integrity, I think the things that PWC is telling the company here are extremely serious. If I was—I must say though if I was sitting on the audit committee—and I've chaired a couple of audit committees—one of my concerns would be obviously the company has been doing credit derivatives for quite some period of time. And now all of a sudden we're just seeing it from the auditors for the very first time as we get down to a very critical stage and things are in essence imploding on us. I would have the question for AIG management, one, why hadn't you solved the problem before now? Why didn't you have the systems in place to make sure you could get your hands around these and get the right disclosures? But I'd also have a question for PWC, who had been for a number of years auditing the internal controls, why are you just now coming and telling me about this at December—November/December 2007 going into 2008? If I was audit committee Chair, I would feel almost blinded that the auditors hadn't come and told me about this beforehand as well. So—and quite frankly, if the auditors were just coming and telling me this as CEO, if I was sitting there in Mr. Sullivan's position, I would be raising the same question with the auditors.

Ms. WATSON. OK. And I would just like to get Mr. Dinallo's opinion on this, too, as well.

Mr. DINALLO. I think that those are—I think that those would certainly get my attention. Whether they were rectified or not, I can't say. So I think it's—I think it's important. I think you want outside auditors and risk management to come in and make those kinds of assessments. And the way you should—this is my modest opinion. The way you should judge sometimes is what the company did in response.

Ms. WATSON. Thank you very much, gentlemen.

Chairman WAXMAN. Thank you, Ms. Watson.

Mr. Shays.

Mr. SHAYS. Thank you. Mr. Turner, Fannie Mae had assets ranking at No. 2—only Citigroup had a larger asset ranking. Freddie Mac ranked No. 5. Just to give you some perspective, GE ranked No. 11, Goldman Sachs No. 12, Ford Motor Co. 15. That was in the year 2002 when I introduce a bill to say they need to be under the SEC. Did it ever strike you as curious that the second highest ranking asset company in the marketplace and the fourth were not under any oversight by the SEC?

Mr. TURNER. I just think it was flat out wrong. That's the only way to say it. I think that someone that's selling that much of—you know in the securities market in trading and being held by public investors, I think unquestionably it should have been from the git-go underneath SEC regulation, nonexempted.

Mr. SHAYS. Would you take issue with Federal Chairman Alan Greenspan's warning to Congress in 2005 about the growth of Fannie and Freddie's portfolios when he said, so I think that going forward, enabling these institutions to increase in size, we are placing this total financial system of the future at a substantial risk. Would you disagree with that?

Mr. TURNER. At the beginning of 2007 I think these two institutions were doing somewhere in the mid 30, 35 percent of the total mortgage loans in the country. And by September or so of last year it had gotten up to about 75 to 78 percent. There is no question as that risk expanded—and keep in mind the decision was made quite frankly going back into the late 90's to allow these two institutions to grow the way they did. If you allow them to grow, you have to make sure you've got adequate controls and processes around them. And regulator. And quite frankly——

Mr. SHAYS. And we had a weak regulator named OFHEO.

Mr. TURNER. A very weak regulator.

Mr. SHAYS. The Federal Housing Enterprise Regulatory Reform Act of 2005, under the previous Congress, passed and was sent to the Senate. It would establish what we basically did in 2008. But when it got to the Senate, it was unanimously opposed in committee by, candidly, the Democrats. And therefore it never had a vote on the House floor.

When I introduced this bill with Mr. Markey, it had 22 cosponsors. And one of the individuals when we were talking about having a stronger regulation in committee said that this was a political lynching because we were questioning Frank Raines and our oversight of this committee. I want to know, do you think that somehow Mr. Raines who got $190 million, do you think that somehow he should be exempt from coming before this committee if we're going to have others with less responsibility getting the same sums? If you don't want to answer, you don't have to.

Mr. TURNER. No, no. You asked the question, and the question's fair, OK? First of all, I go back to what Congresswoman Maloney said at the beginning. This is not a partisan issue. And as I said, this issue needs to be dealt with on a bipartisan basis. I think you need to drain the entire swamp, Congressman, and I think you need to take a good look at what went wrong at all of these institutions. Freddie and Fannie are two humongous institutions that we've had to bailout here and it has an impact. And having worked with OFHEO on both of those institutions, I would encourage you to bring the executives, the appropriate executives and appropriate board members before the committee.

Mr. SHAYS. In that bill that we sent to the Senate we had a clawback provision to be able to go back after these outrageous salaries. Would you recommend that be part of any bill?

Mr. TURNER. As I said earlier, I am a big supporter of the clawback. What was in the bill was exceedingly weak to the extent that Congress can determine that there is a legal—an appropriate legal remedy to go back and give power to someone to claw back. For prior severance where there was no performance, I would certainly support that.

Mr. SHAYS. Thank you, Mr. Turner.

Chairman WAXMAN. The gentleman yields back the balance of his time. I agree with you, Mr. Turner, that this should not be a partisan issue. And that's why I was somewhat taken aback when the Republicans on—some Republicans on this committee started making a big deal about Freddie and Fannie. It is an important issue. And they're right. And our committee staff has already been looking into this thing, and we are going to hold a hearing on it. So I think it's appropriate.

Mr. SHAYS. When?

Chairman WAXMAN. We'll have to negotiate that with the minority to get a day that will be convenient for the staff. But obviously we're going to do it.

Mr. Shays talked about a bill that he introduced which you thought was a good idea. I'm a cosponsor of that bill. And some of the proposals that have been put forward Democrats and Republicans have supported. Unfortunately some of the proposals have not been agreed to, as we were discussing with the clawback provision in the Barney Frank bill that was just adopted. We would have wanted it to be stronger. The transparency provisions that we suggested to Chairman Frank as well as some of the other provisions that you've mentioned that we ought to adopt, we've also recommended should have been in that bill. When you do legislation, you get what you can. You don't always get what you want.

But I want to thank both of you for your presentation. I think you've been superb witnesses. You've educated this committee enormously. And I have to say about the members on both sides of the aisle, I thought the questions had been asked of the two of you in the conversation—more of a conversation than anything else has been very, very constructive and generally not partisan because these are not partisan issues. Our country and our economy is at stake, and therefore we've got to work together and not look for—even though we're a short time before an election—opportunities to try to zing the other party. These are not the kind of issues that ought to be put out—in my view—on a partisan basis. They're the kinds of things that we need to look at very carefully together. I don't know that there's a Republican or a Democratic response to abuses of shareholders and taxpayers. I don't think there's going to be any difference as we look at those issues together. And that's why we're holding these hearings to find out how we got to where we are and what kinds of suggestions we want to put forward for the future. We don't have the jurisdiction that the Banking Committee has, but we certainly can put ideas out there. And I would hope that on a bipartisan basis not only are we going to hold these hearings but we may come out with some suggested proposals that I hope the committees in charge and the leadership of both the Democratic and Republican side of the House and the Senate will entertain.

Mr. SHAYS. Would the gentleman yield for a question?

Chairman WAXMAN. Yes.

Mr. SHAYS. Thank you. I want to compliment this committee on the way they have asked their questions. I do think we're trying to get at the answer both on a bipartisan basis. What is troubling to us though is we scheduled five hearings. And Fannie Mae and Freddie Mac are not scheduled. And we didn't hear that you were even doing this investigation, which our side isn't a part of, until we raised this question. Is it fair to assume that we will have this hearing within this five hearing range? Or is it your intention to do it after the election?

Chairman WAXMAN. Well, we'll have to look at the schedule. We have, for the interest of the witnesses and the public, we had a hearing yesterday on Lehman, which many people say triggered the stampede. We had the hearing today on AIG. Next week we're going to have a hearing on the rating—I think it's the rating agencies. And we're going to hear—have a hearing from the regulators. And what is—what am I missing?

Mrs. MALONEY. Hedge funds.

Chairman WAXMAN. And we're going to have a hearing on hedge funds, because they're involved in this whole new world that our regulatory system did not anticipate. So while we've scheduled those hearings, Members on the other side of the aisle say, well, what about Freddie and Fannie, Fannie Mae and Freddie Mac? Well, we're looking at that in preparation for hearings. I will work with the Republican staff and Republican Members to make sure that we have all the hearings that's necessary and I think it's appropriate that we will look at them and we will hold a hearing on it. And we will have to discuss the date.

Mr. DAVIS OF VIRGINIA. Mr. Chairman, let me just add that we look forward to working with you on that. I think Freddie and Fannie are huge pieces of this puzzle, and our testimony today illustrates that as well. It's a shame that the committees of jurisdiction didn't hold hearings on this 18 months ago. I think we might not have been in the bind we're in. But I very much appreciate you calling this now and that we can examine what happened and what we might do as we move forward in the future.

Chairman WAXMAN. Thank you. I do want to mention that one of the reasons we hadn't scheduled that as the first hearing, as some Members suggested, is that the committee of jurisdiction just held a hearing on Freddie Mac and Fannie Mae 2 weeks ago with their CEOs. So we thought we would go into this in a different direction.

Mr. SHAYS. Would the gentleman yield just for a second question?

Chairman WAXMAN. Yes.

Mr. SHAYS. We have 360 degrees jurisdiction over every activity of government for investigation. We have no jurisdiction in any of these issues to promulgate legislation. So I just don't want there to be the impression that somehow we don't have jurisdiction over Fannie and Freddie. We have total jurisdiction to examine anything they have done.

Chairman WAXMAN. I don't think anybody would deny that.

Mr. DAVIS OF VIRGINIA. We don't have jurisdiction over anyone. We have oversight.

Chairman WAXMAN. Oversight jurisdiction. I think that's what the gentleman from Connecticut was referring to.

You've been very generous in your time and in your answers to the questions.

Mr. DAVIS OF VIRGINIA. Mr. Chairman, can I just say thank you very much. I think they're great witnesses. I think you've added a lot to both sides of the record.

Chairman WAXMAN. And let me ask unanimous consent of the committee that all the documents and exhibits that have been referred to by members of the committee be made a part of the hearing record.

Mr. DAVIS OF VIRGINIA. Mr. Chairman I also just ask unanimous consent to have AIG's PAC contributions over the last decade be put in the record as well.

Chairman WAXMAN. Without objection, they will be put in the record as well.

Thank you very much. We will move on to the next panel, but we will break for sufficient time for these witnesses to leave and for the next two witnesses to come to the table.

[Brief recess.]

Chairman WAXMAN. The committee will please come back to order.

We're pleased now to welcome to our committee hearing Martin Sullivan, who served as the CEO of AIG from March 2005 until June 2008. Before being named CEO, Mr. Sullivan served as vice chairman and co-chief operating officer of AIG. And Robert Willumstad, who served as CEO of AIG from June 2008 until September 2008. Prior to being named CEO, Mr. Willumstad served as chairman of AIG's Board of Directors beginning in November 2006. He was first elected to AIG's Board of Directors in January 2006.

We're pleased to welcome both of you to the hearing. It's the practice of this committee that all witnesses who testify before us do so under oath. So I'd like to ask if you would to please stand and raise your right hands.

[Witnesses sworn.]

Chairman WAXMAN. The record will indicate that both the witnesses answered in the affirmative. And before we even begin, I'd like the police officer in charge to take the person who's holding up a sign and let's get that cleared out of the room right now. That woman who was holding up the sign, who intends to hold up a sign and to make a raucous. I don't think it's appropriate in a congressional committee.

Gentlemen, your prepared statements will be in the record in full. And we want to recognize you for any oral presentation that you wish to make. While we usually give 5 minutes and I know you're mindful of that, I don't want to limit you in any way in the amount of time you have to make your statement.

Mr. Sullivan, why don't we begin with you?

Mr. SULLIVAN. Thank you very much, Mr. Chairman.

Chairman WAXMAN. There's a button on the base of the mic.

Mr. SULLIVAN. It's on. Is that much better? OK. I have it now. Thank you.

Chairman WAXMAN. OK. That's better.

STATEMENTS OF MARTIN J. SULLIVAN, FORMER CHIEF EXECUTIVE OFFICER, AIG; AND ROBERT B. WILLUMSTAD, FORMER CHIEF EXECUTIVE OFFICER, AIG

STATEMENT OF MARTIN J. SULLIVAN

Mr. SULLIVAN. Thank you, Mr. Chairman, and a very good afternoon. My name is Martin Sullivan. As you said, from March 2005 until June of this year, I was president and chief executive officer of AIG. Though I was no longer with the company as the events of last month unfolded, I'm here today to assist the committee in understanding the events that led to the Federal rescue of AIG, how the example of AIG fits into the broader financial crisis currently plaguing the world economy, and the regulatory lessons that we can learn from AIG's experience.

People around the world are reeling from the financial tsunami that has ravaged the global economy. While we had all hoped the unfortunate collapse of Bear Stearns this past spring would be an isolated incident, instead the financial storm gained momentum and many of the world's most respected financial institutions crumbled one after another. The Federal Government took control of

Freddie Mac and Fannie Mae, Lehman Brothers and IndyMac declared bankruptcy and Washington Mutual and Wachovia had to be taken over to avoid a similar fate.

Meanwhile, other prominent institutions sought additional capital, merger partners and redefined their corporate status. Of course AIG avoided potential bankruptcy only with the help of the government.

Now the U.S. Government is establishing a $700 billion fund to provide additional relief to threatened financial institutions.

I hope that my testimony about these events that occurred during my tenure at AIG can help the committee understand the formation of what is best described as a global financial tsunami. While we're all struggling to understand how this crisis happened in the first place and to find out what might have prevented it, there are no simple answers to these questions. I'm not an accountant nor an economist. I've been an insurance man all my life. However, many factors appear to have been at play, including lending and borrowing practices, illiquid markets, the absence of credit, loss of investor confidence, and even accounting rules which require companies like AIG to take billions of dollars of unrealized mark-to-market losses.

When in 2005 the AIG board asked me to step into the role of Chief Executive Officer, the company was straining under the weight of several crises very different from the financial crisis currently threatening our financial institutions. I became COO of AIG at a time when the company was in the midst of governmental investigations that had cast a cloud of suspicion over the company's future. In the face of that crisis my responsibility was to stabilize the ship and improve our relationships with our regulators. I think I succeeded.

It was against that backdrop that I began my tenure as CEO of the company. I'm very proud to say that in spite of these challenges AIG emerged as a successful and resilient company. In 2006 and in early 2007 AIG was enjoying great success, and those of us within the company's management had tremendous confidence in our company's future.

However, as we now know, the different storm was gathering over the global financial markets. No disaster as massive or as unforeseen and as unprecedented financial market disruption that has occurred over the past year is the result of a simple or single cause. The world's current economic challenges are obviously related to multiple actions by multiple parties.

To assist the committee, I would like to focus on one particular factor, the role played by one accounting rule applied to corporations. The accounting rules require that certain assets be mark to market. In other words, companies must declare the value of those assets on a quarterly basis at the price such assets could sell for on the market at that point in time. Companies must declare these values on their books even if they have no intention of or immediate need to sell the assets or even if they have not realized any actual gain or actual loss.

FAS 157, which was adopted relatively recently, set out specific guidelines as to how companies must determine the market price of certain categories of assets. However well FAS 157 operates under any reasonably foreseeable market conditions in the unprecedented credit crisis which began in the summer of 2007, FAS 157 had, in my opinion, unintended consequences. In a distressed market where assets cannot be readily sold companies are forced to declare the value of those assets at fire sale prices.

Just last week the SEC made changes with respect to the application of FAS 157 when entire markets stop functioning. Of course AIG did not have the benefit of this guidance during my tenure. At AIG I encountered FAS 157's unintended effects through the credit default swap portfolio of AIG financial products, the business that my predecessor had established and funded many years earlier. These credit default swaps essentially provided insurance to counterparties in the case of default on underlying bonds. The underlying bonds were very highly rated and the risk of default was viewed as extremely remote.

Finally, the credit default swap business had since its inception in the late 1990's generated a reliable and steady source of income for AIG-FP. In fact, AIG-FP intended to retain its derivative interest in these highly rated bonds until they reach maturity. When the credit market seized up, like many other financial institutions, we were forced to mark our swap positions at fire sale prices as if we owned the underlying bonds even though we believed that our swap positions had value if held to maturity. The company nevertheless began reporting billions of dollars of unrealized losses on the basis of then current market valuations. Suddenly a company with a trillion dollars of assets was reporting unrealized losses on its income statement that ultimately climbed into the tens of billions. As AIG's reported losses mounted, there was a domino like series of repercussions. Although we had raised approximately $20 billion in capital, it appears that even this precaution was not sufficient protection in the face of the overwhelming and unprecedented market crisis that exists today. AIG nevertheless suffered credit rating downgrades which triggered billions of dollars in collateral cause leading to the most recent events.

Of course by the time the board was presented with the Federal plan, I had been out of the company for 3 months. In fact, just last week both the Securities and Exchange Commission and this Congress recognized the effects of FAS 157. The SEC recognized that FAS 157 can have unintended consequences for financial institutions where markets seize up. The SEC has attempted to provide more flexibility for companies operating and reporting under the rule.

In the recently passed legislation Congress directs the SEC to further examine mark-to-market accounting and grants the SEC authority to suspend mark-to-market accounting requirements. These measures make a lot of sense to me.

I have spent my entire adult life in service to AIG, and I am heartbroken as to what has happened. I hope to see the company and indeed the entire global economy emerge from this crisis.

I hope that my testimony today has been helpful to the committee, and I will do my very best to answer any questions you may have. Thank you, sir.

[The prepared statement of Mr. Sullivan follows:]

TESTIMONY OF MARTIN SULLIVAN
BEFORE THE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
UNITED STATES HOUSE OF REPRESENTATIVES
OCTOBER 7, 2008

My name is Martin Sullivan. From March 2005 until June of this year, I was the President and Chief Executive Officer of American International Group, a leading international insurance organization with operations in more than 130 countries and jurisdictions. Though I was no longer with the company as the events of last month unfolded, I am here today to assist the Committee in understanding the events that led to the federal rescue of AIG, how the example of AIG fits into the broader financial crisis currently plaguing the world economy, and the regulatory lessons that we can learn from AIG's experience.

I thank the Committee for holding this important hearing. People around the world are reeling from the financial tsunami that has ravaged the global economy. We had all hoped that the very unfortunate collapse of Bear Stearns this past spring would be an isolated incident. Instead, the financial storm gained momentum, and many of the world's most respected financial institutions crumbled, one after another. The federal government took control of Fannie Mae and Freddie Mac, Lehman Brothers and IndyMac declared bankruptcy, and Washington Mutual and Wachovia had to be taken over to avoid a similar fate. Meanwhile, other prominent institutions sought additional capital, merger partners, and redefined their corporate status. Of course, AIG avoided potential bankruptcy only with the help of the government. Now, the U.S. government is establishing a $700 billion fund to provide additional relief to threatened financial institutions.

I hope that my testimony about events that occurred during my tenure at AIG can help the Committee understand the formation of what is best described as a global financial tsunami. We are all struggling to understand how this crisis happened in the first place and to find out what might have prevented it. There are no simple answers to these questions. I am not an accountant or economist - I have been an insurance man all my life. However, many factors appear to have been at play including lending and borrowing practices, illiquid markets, the absence of credit, loss of investor confidence, and even accounting rules which required companies like AIG to take billions of dollars of unrealized "mark to market" losses.

I would like to start by telling you a little bit about myself and my career at AIG. I was born in Essex, England, and I began working for AIG when I was seventeen years old. My first job in the company was as a clerk in one of AIG's offices in London. Over the next thirty-seven years – my entire adult life – I literally worked my way to the top of the company, ultimately becoming CEO in 2005. I have held management positions at AIG in three different countries, working here in the United States for the past twelve years.

When, in 2005, the AIG Board asked me to step into the role of Chief Executive Officer, the company was straining under the weight of several crises very different from the financial crisis currently threatening our financial institutions. I became CEO of AIG at a time when the company was in the midst of governmental investigations that had cast a cloud of suspicion over the company's future. In the face of that crisis, my responsibility was to stabilize the ship and improve our relationships with our regulators. I think I succeeded. I worked very closely with the auditors and with government regulators to resolve these issues and to improve the company's compliance culture and process. I believe that my entire tenure as CEO was marked by unprecedented transparency with our investors and regulators. Every quarter we published a wealth of detailed information in our public filings and in the supplemental data we provided on our website.

Even as I worked to shepherd AIG through the initial crisis that I had inherited, three more disasters struck, namely Hurricanes Katrina, Rita, and Wilma which left American cities under water and left countless Americans devastated. In addition, an enormous amount of money, in excess of $2 billion, was required to meet the needs of the hurricane victims that we insured. As CEO of the company, I personally visited the affected area to offer my support to our customers and AIG employees. As much as these hurricanes affected AIG's business, the human toll and devastation were greater than I could have imagined.

It was against this backdrop that I began my tenure as CEO of the company. I am very proud to say that, in spite of these challenges, AIG emerged as a successful and resilient company. In 2006 and early 2007, AIG was enjoying great success, and those of us within the company's management had tremendous confidence in our company's future. However, as we now know, a different storm was gathering over the global financial markets.

No disaster as massive as the unforeseen and unprecedented financial market disruption that has occurred over the past year is the result of a simple or single cause. The world's current economic challenges are obviously related to multiple actions by multiple parties. To assist the Committee, I would like to focus on one particular factor—the role played by one accounting rule applied to corporations.

The accounting rules require that certain assets be "marked to market." In other words, companies must declare the value of those assets, on a quarterly basis, at the price such assets could sell for on the market at that point in time. Companies must declare these values on their books even if they have no intention of, or immediate need to, sell the assets, and even if they have not realized any actual gain or actual loss. FAS 157, which was adopted relatively recently, set out specific guidelines as to how companies must determine the "market price" of certain categories of assets. However well FAS 157 operates under any reasonably foreseeable market conditions, in the unprecedented credit crisis which began in the summer of 2007, FAS 157 had, in my opinion, unintended consequences.

In a distressed market where assets cannot be readily sold, companies are forced to declare the value of those assets at fire-sale prices. Just last week, the SEC made changes with respect to the application of FAS 157 when entire markets stop functioning. Of course, AIG did not have the benefit of this guidance during my tenure.

At AIG, I encountered FAS 157's unintended effects through the credit default swap portfolio of AIG-Financial Products, a business that my predecessor had established and funded many years earlier. These credit default swaps essentially provided insurance to counterparties in the case of default on underlying bonds. The underlying bonds were very highly rated, and the risk of default was viewed as extremely remote.

The credit default swap business had, since its inception in the late 1990s, generated a reliable and steady source of income for AIG-FP. In fact, AIG-FP intended to retain its derivative interest in these highly rated bonds until they reached maturity. When the credit markets seized up, like many other financial institutions, we were forced to mark our swap positions at fire-sale prices as if we owned the underlying bonds, even though we believed that our swap positions had value if held to maturity. The company nevertheless began reporting billions of dollars of unrealized losses on the basis of then-current market valuations.

Suddenly, a company with a trillion dollars of assets was reporting unrealized losses on its income statement that ultimately climbed into the tens of billions. As AIG's reported losses mounted, there was a domino-like series of repercussions. Although we had raised approximately $20 billion in capital, it appears that even this precaution was not sufficient protection in the face of the overwhelming and unprecedented market crisis that exists today:

AIG nevertheless suffered credit rating downgrades which triggered billions of dollars in collateral calls, leading to the most recent events. Of course, by the time the Board was presented with the federal plan, I had been out of the company for over three months.

In fact, just last week both the Securities Exchange Commission and this Congress recognized the effect of FAS 157. The SEC recognized that FAS 157 can have unintended consequences for financial institutions when markets seize up. The SEC has attempted to provide more flexibility for companies operating and reporting under the rule. In the recently passed legislation, Congress directs the SEC to further examine mark-to-market accounting and grants the SEC authority to suspend mark-to-market accounting requirements. These measures make a lot of sense to me.

I have spent my entire adult life in service to AIG, and I am heartbroken at what has happened. I hope to see the company, and indeed the entire global economy, emerge from this crisis. I hope that my testimony today has been helpful to the Committee. I will do my best to answer any questions that you have.

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Chairman WAXMAN. Thank you very much, Mr. Sullivan. Mr. Willumstad.

STATEMENT OF ROBERT B. WILLUMSTAD

Mr. WILLUMSTAD. Good morning, Chairman Waxman, Ranking Member Davis, and members of the committee.

AIG remains a great company, and I want to stress that AIG's problems never threatened AIG's policyholders. The crisis that required AIG to accept assistance from the Federal Reserve is a crisis in confidence that has affected the entire global economy. When I became CEO of AIG in June of this year, the decline in the U.S. housing market had already been underway for months. Though most homeowners were still making their mortgage payments, there was an unexpected and unprecedented breakdown in the market for mortgage-backed securities that were held by many banks and other financial institutions.

Mark-to-market accounting rules forced AIG along with Citigroup, Merrill Lynch, and others to book tens of billions of dollars in accounting losses. By the end of the second quarter of 2008, AIG had booked $50 billion of losses. AIG was downgraded by the major rating agencies in early May. And AIG's stock price fell from a high in 2007 of $72 per share to $26 per share this June. This decline occurred despite raising $20 billion in new capital and the vigorous actions of AIG's board and Martin Sullivan before I became CEO.

In June 2008, the board asked me to replace Martin Sullivan as CEO. I was initially reluctant to do so. However, the board ultimately persuaded me that my experience in the financial services industry, including my time as President and Chief Operating Officer of Citigroup, put me in a position to lead AIG in this difficult period.

On my first day as CEO I publicly announced that I would present my plan for AIG in 90 days. It became apparent that if the markets continued to decline and if AIG were further downgraded by the rating agencies, AIG could potentially face a liquidity problem.

I met with the rating agencies in July, and they told me they would not review AIG's ratings until after I announced our plan, which was then scheduled for September 25. Even so, I immediately took steps to cut expenses and further protect AIG in the event of a liquidity problem.

We identified nonstrategic businesses, retained financial advisers and began the process of selling those businesses to raise cash. To conserve cash, we stopped discussions relating to a number of acquisitions. We were negotiating a transaction with Berkshire Hathaway that would have protected billions of dollars of AIG's liquidity.

In late July I met with the President of the Federal Reserve Bank of New York to discuss the situation. These were precautionary steps. Through the first week of September we believed AIG could weather the difficulties in the financial markets. When the market meltdown began the week of September 8th, the rating agencies indicated they would no longer wait to review AIG's ratings until September 25. AIG was in a vicious circle. The rating agencies were considering a downgrade largely because of market-driven liquidity concerns. But it was a downgrade or the threat of one that would trigger a liquidity crisis.

We worked around the clock during the week of September 8th to take measures that would provide AIG the liquidity needed to make it through the crisis, but the private markets simply could not provide enough liquidity. On September 9th I met again with the Federal Reserve Bank, and during the rest of the week I stayed in contact with the Federal Reserve and the Treasury Department.

On Tuesday, September 16, 2008, AIG was preparing for the unthinkable, bankruptcy. That afternoon the Federal Reserve and the Treasury Department told AIG they would provide the necessary liquidity because an AIG bankruptcy would have massive negative effects on the stability of the entire financial system. Terms of the offer were nonnegotiable. After a long discussion and with the advice of counsel and our financial advisers, the AIG Board of Directors accepted the Federal Reserve's plan as the best available option.

As part of that plan I was asked by the Treasury Department and the Federal Reserve to step down as CEO, and I did so.

Looking back on my time as CEO, I don't believe AIG could have done anything differently. The credit default swap contracts had been in place for years. The market seizure was an unprecedented global catastrophe. We and our advisers explored every avenue. There was no private market solution to AIG's situation.

I regret the pain that events in the market have caused AIG employees and its shareholders. I'm grateful that the Treasury and the Federal Reserve and, most important, the American people offered their assistance to preserve a vital part of the financial system and a great American institution.

Because my 3-month tenure as Chief Executive Officer did not provide me the opportunity to execute my restructuring plan and in light of the fact that AIG shareholders and employees have lost so much value, I have notified the company I do not intend to accept the payments available to me under the AIG severance plan.

Thank you.

[The prepared statement of Mr. Willumstad follows:]

STATEMENT OF ROBERT B. WILLUMSTAD
BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
OCTOBER 7, 2008

Good morning Chairman Waxman, Mr. Davis and Members of the Committee. I am glad to help the Committee in any way that I can.

I want to begin by saying that AIG's problems never threatened its policyholders. AIG has been a great company for more than thirty years and remains a great company today. AIG's franchises around the world in insurance and financial services are unparalleled. Its entrepreneurial culture and the dedication and talent of AIG's 100,000 employees are unmatched.

I became CEO of AIG a little more than three months ago, at a time when the financial markets around the world were already in crisis. Before becoming CEO, I had been non-executive Chairman of AIG's board of directors for a roughly a year and a half. But, today I am going to focus my comments on the period when I was CEO.

The crisis that required AIG to seek assistance from the Federal Reserve is not limited to AIG. It is a market wide crisis of confidence that has affected the entire financial industry and the American and global economy. In June 2008, when I became CEO, the decline in the U.S. housing market had been under way for months. Though most homeowners were still making their mortgage payments, there was an unprecedented and unexpected breakdown in the market for mortgage backed securities which were held by many banks and other financial institutions, including AIG. As a result, "mark to market" accounting rules – the interpretation of which I understand the SEC is now revisiting – forced Citigroup, Merrill Lynch, UBS, Morgan Stanley and other financial institutions, including AIG, to book tens of billions of dollars in accounting losses, despite the fact that most of the underlying securities were not in default. Those accounting losses in turn forced many of the affected companies to raise capital in the public markets or from sovereign wealth funds in China, the Middle East and elsewhere. Bear Stearns failed in March, being acquired by JP MorganChase with significant government assistance. Banks and brokerage stocks here and abroad had declined significantly.

The unforeseen and extreme market conditions that were destroying billions in shareholder value at other companies hit AIG also. By the end of the second quarter of 2008, AIG had booked $50 billion of unrealized losses on credit default swaps and on declines in the value of mortgage related securities held in its investment portfolio. AIG was downgraded by the major rating agencies in early May. AIG's stock price fell from a high in 2007 of $72 per share to $26 per share in June 2008.

These events occurred despite extensive actions by AIG's Board and Martin Sullivan before I became CEO. In May 2008, AIG raised $20 billion in new capital. AIG brought in new management at its Financial Products division, the source of much of AIG's exposure to the faltering mortgage backed securities market. AIG had also begun a search process to bring in a new Chief Financial Officer from outside of AIG, seeking to add another talented executive with deep experience in the capital markets.

In June 2008, the Board asked me to replace Martin Sullivan as CEO. I was initially reluctant to do so. However, the Board ultimately persuaded me to accept this responsibility and I felt that my experience in the financial services industry, including my time as President and Chief Operating Officer of Citigroup, put me in a position to successfully lead AIG in a difficult period. On my first day as CEO, I publicly announced that I would present my long-term strategic plan for AIG in ninety days. This was an ambitious time-frame for a strategic review of a company that in 2007 had $1 trillion in assets and $110 billion in revenue, and which employs more than 100,000 people in more than 100 countries and includes a diverse array of businesses operating under scores of different regulatory regimes. To meet that schedule, the AIG team worked tirelessly, and the plan began to come together.

While we were formulating the plan, I also took immediate actions. The markets declined further, and it became apparent that if the decline continued and AIG were again downgraded by the rating agencies, AIG could potentially face a liquidity problem. A week after I became CEO, I retained a pre-eminent financial services firm, BlackRock, to provide an outsider's view of AIG Financial Products' exposure to mortgage backed securities. I met with the rating agencies in July, and they told me that they would not review AIG's ratings until after I announced our strategic plans, which was then scheduled for September 25. Even so, to be prudent, we immediately put in place a number of additional measures to further protect AIG in the event of a liquidity problem. We worked through July and August to further strengthen AIG's balance sheet should a crisis arise. We identified non-strategic businesses, retained financial advisors and began the process of selling those businesses to raise cash. To conserve cash, we stopped discussions relating to a number of acquisitions. We developed and implemented an aggressive plan to further reduce expenses. We were negotiating a transaction with Berkshire Hathaway that would have protected billions of dollars of AIG's liquidity. We were working with JP MorganChase and other banks to obtain additional credit lines. These were precautionary steps. Through the first week of September, we believed AIG could weather the difficulties in the financial markets, and we believed we would be able to announce and implement the new strategic plan on September 25.

In late July, and again on September 9, I met with the President of the Federal Reserve Bank of New York to apprise him of the situation and discuss ways in which AIG and the Federal Reserve might work together in the event that a liquidity problem did arise.

With the market melting down during the week of September 8, the counterparties with whom we had been negotiating became unwilling to complete those deals. In addition, as the markets spiraled downward, with Lehman and others under increasing pressure, the rating agencies indicated they would no longer wait to review AIG's ratings until the investor meeting on September 25.

AIG was caught in a vicious circle. The rating agencies were considering a downgrade in large part because of market driven liquidity concerns. But it was a downgrade by the ratings agencies – or the threat of one – that would trigger a liquidity issue. The potential for a downgrade and the market's fears caused AIG counterparties on its securities lending program and on many other transactions – not just those related to the credit default swaps – to require AIG to post additional collateral or to demand the return of cash or investments, further increasing the need for liquidity.

We worked around the clock during the week of September 8 to take measures that would provide AIG the liquidity needed to make it through the crisis. We worked with potential private investors and new lenders. With assistance from the New York and Pennsylvania departments of insurance and the Governor of New York we were able to make available as much as $20 billion of additional liquidity. But the private markets, even with the help of New York and Pennsylvania, simply could not provide enough liquidity. On September 9, I met again with the Federal Reserve Bank of New York, and during the rest of the week I stayed in contact with the Federal Reserve and the Treasury Department.

On Tuesday, September 16, 2008, AIG was preparing for the unthinkable: bankruptcy. That afternoon, we met again with representatives of the Federal Reserve Bank of New York and the Treasury Department. The regulators said that they would provide the necessary liquidity, because an AIG bankruptcy would have massive negative effects on the stability of the entire financial system. The terms of the offer were non-negotiable. After a long and detailed debate, and with the advice of counsel and our financial advisors, the AIG Board of Directors accepted the plan offered by the Federal Reserve and the Treasury Department as the best available option. As part of that plan, I was asked by the Treasury Department and the Federal Reserve to step down as CEO. Though I would have liked to continue to work for AIG and its shareholders, I complied with this requirement two days later.

Let me explain what I believe were the major elements that led AIG to September 16. Fundamentally, AIG was affected by an unexpected and unprecedented market-wide crisis of confidence and the resulting seizure of the credit markets. This impacted AIG in many ways, including through the complex financial company AIG operated: AIG Financial Products or FP for short. FP wrote a large number of instruments called "credit default swaps" – essentially a kind of insurance on a bond. Over time, FP had written this insurance-like swap on bonds with a face value of approximately $500 billion. Approximately $70 billion of those swaps were on bonds that AIG referred to as "multi-sector" bonds, backed by student loans, credit card receivables and residential mortgages. AIG's multi-sector credit default swaps were almost all written before the end of 2005, when the housing market was still strong. Moreover, AIG only wrote these swaps on what are referred to as "super senior" bonds. That means that AIG only covered the safest bonds possible and had a built in cushion to further protect AIG from losses. They were viewed as extremely safe – better than AAA. Through June 30, 2007, these credit default swaps were carried on AIG's books at "par value." That means that AIG had analyzed them and did not expect to lose any money on them.

However, when the market for the underlying bonds froze toward the end of 2007, accounting rules required AIG to "mark to market" the value of its swaps. But the market was not functioning. The way the accounting rules were applied in this unprecedented situation forced AIG to recognize tens of billions of dollars in accounting losses in the fourth quarter of 2007 and the first two quarters of 2008, even though, as far as I am aware, AIG has made very few payments on any of the credit default swaps it wrote and the vast majority of the securities underlying the swaps are still paying and are still rated investment grade or better by the rating agencies.

In my view it was largely as a result of these unrealized mark to market losses that the rating agencies downgraded AIG's credit rating. The downgrade and the low accounting valuations on the bonds required AIG to post billions of dollars of additional collateral to its credit default swap counterparties as security for AIG's promise to pay if the underlying securities did not. In the unprecedented market wide crisis of the week of September 8, fears of a further downgrade and the frozen credit markets fed into the crisis of confidence that led AIG to need the liquidity ultimately provided by the Federal Reserve plan.

Looking back on my time as CEO, I don't believe AIG could have done anything differently. The market seizure was an unprecedented global catastrophe. We took every step we could to protect AIG's balance sheet and its liquidity. We and our advisors explored every avenue to protect AIG's shareholders. There was no private market solution to AIG's situation – just as there was no private market solution for Bear Stearns, Fannie Mae, Freddie Mac, Washington Mutual, or Lehman Brothers. The freezing of the mortgage backed securities market, the “mark to market” losses that decimated AIG’s book equity, the resulting downgrades by the rating agencies and the collateral posting requirements that arose after the downgrades were beyond our control. I regret the pain that events in the market have caused to AIG’s employees and its shareholders. I am grateful that the Treasury and the Federal Reserve – and most importantly the American people – offered their assistance to preserve both a vital part of the financial system and a great American institution.

Chairman WAXMAN. Thank you both very much. We are now going to have questions for members of the panel. And without objection, the chairman and the ranking member will be allotted 10 minutes each to use as they see fit. And without objection, that will be the order.

Both of you seem to be saying that these events had nothing to do with your management. It had to do with the tsunami of activities over which you had no control. And we're trying to assess whether that's true or whether there was mismanagement by the executives at AIG.

Now I want to submit for the record a disturbing letter that I've received from Joseph St. Denis. He's a very reputable man. He was Assistant Chief Accountant at the SEC Enforcement Division. He was hired by AIG to address material weaknesses cited by AIG's auditors and to provide greater visibility and control with respect to the operations and accounting policy process of AIG-FP. Mr. St. Denis says that in 2007—and without objection, his letter will be made part of the record—he says in 2007 he became concerned about the valuation model used by AIG's Financial Products Division. But when he tried to audit this division he was blocked by Mr. Cassano, who was the head of that division. Mr. St. Denis wrote the committee that the only—what Mr. Cassano said was that I have deliberately excluded you from the valuation of the super seniors because I was concerned that you would pollute the process. That's what Mr. Cassano said to Mr. St. Denis. And Mr. St. Denis said to the committee, the only pollution Mr. Cassano was concerned about was the transparency I brought to AIG-FP's accounting policy process.

[The information referred to follows:]

Joseph W. St. Denis

October 4, 2008

Henry A. Waxman, Chairman
Thomas M. Davis III, Ranking Member
House of Representatives
Committee on Oversight and Government Reform
2157 Rayburn House Office Building
Washington, DC 20515-6143

Dear Chairman Waxman and Ranking Member Davis:

I am providing this letter in response to the Committee's subpoena in lieu of a deposition per agreement with Committee staff. The staff has provided questions, which are addressed below.

* * * * *

Question 1: *Briefly describe your professional history.*

I received a B.A. and M.B.A. from the University of Colorado at Boulder, and have been a licensed Certified Public Accountant in Colorado since 1993. I began my career as an auditor in the Denver office of Coopers & Lybrand. I served as a Staff Accountant and later as an Assistant Chief Accountant in the Division of Enforcement of the United States Securities and Exchange Commission from 1998 to 2004.

Question 2: *What was your position at AIG?*

I served as Vice President of Accounting Policy at AIG Financial Products ("AIGFP") from June 2006 through October 1, 2007. My responsibilities included documenting the accounting for AIGFP's proposed transactions, and building consensus around that proposed accounting with my accounting policy counterparts at AIG's Financial Services Division ("FSD") and Corporate Office of Accounting Policy ("OAP"). Additionally, I served initially as a resource, and ultimately as a member, of AIGFP's Transaction Review Committee, which was responsible for evaluating and documenting the accounting for proposed transactions by customers of AIGFP[1].

[1] My understanding was that the Transaction Review Committee, or TRC, was formed in response to the Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities. The TRC

My understanding was that the position was created 1) as part of an entity-wide effort to address material weaknesses cited by AIG's auditor, 2) to address the desire on the part of FSD and OAP for greater visibility and control with respect to the operations and accounting policy process of AIGFP and, 3) to provide an on-site resource for AIGFP business people as they developed proposed transactions.

Question 3: *What were your duties as Vice President for Accounting Policy?*

My duties as Vice President for Accounting Policy were to research and document AIGFP's accounting policy issues and conclusions through a rigorous process of consensus building with my corporate counterparts at AIG, Inc.'s Financial Services Division ("FSD") and Office of Accounting Policy ("OAP"). The process of building consensus around AIGFP's complex accounting issues followed the progression below for material and/or unusual transactions:

a) Meet with business people at AIGFP responsible for the proposed transactions to gain an understanding of the transaction and identify potential accounting and financial reporting issues:

b) Prepare a memorandum describing the proposed transaction and documenting the analysis and disposition of accounting and financial reporting issues;

c) Share the memorandum with the CFO of FSD. Discuss and clear any review comments and resolve any new issues identified at this level of review, and update the draft to reflect FSD's review;

d) Share the updated draft with OAP. Discuss and clear any review comments and resolve any new issues, and update the draft to reflect OAP's review and signoff. Upon signoff by OAP, the documentation was complete, unless AIG's auditor, PricewaterhouseCoopers ("PwC") identified new issues or suggested changes that all the parties agreed should be made;

e) Provide relevant conclusions to appropriate operational personnel within AIGFP for implementation;

f) Share the final memorandum with the PwC auditors; and

g) Revisit previous conclusions arrived at through the above process and update related documentation as necessary.

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included Joseph Cassano, President; Doug Poling, General Counsel and later head of the Transaction Development Group; Pierre Micottis, Chief Risk Officer; and others at various times.

The above process did not necessarily involve intermediate review of accounting analyses by AIGFP personnel. The CFO of AIGFP generally did not review my work product unless he had specifically requested it, nor, to my knowledge, did Joseph Cassano, president of AIGFP. My understanding of my role, as noted above, was in large part to provide a control point and window for FSD and OAP into the operations and accounting policy process for AIGFP transactions. This understanding was confirmed through numerous conversations with senior managers within FSD and OAP.

Question 4: *What dates were you employed by AIG?*

I was employed at AIGFP from late June of 2006 through September 30, 2007. During this entire period, I worked out of the Wilton, CT office of AIGFP.

Question 5: *To whom did you report?*

I initially reported to Mark Balfan. Upon Mr. Balfan's transfer to the consulting position of "Transitional CFO" in January 2007, I reported to William Kolbert, Executive Vice President and Chief Administrative Officer. Mr. Balfan's successor as CFO started on September 10, 2007, and I reported to her briefly prior to my resignation on October 1, 2007[2].

Functionally, I reported to the leaders of the Marketing and Transaction Development groups at AIGFP, and to the senior financial managers of FSD and OAP.

Question 6: *What was your relationship with Joseph Cassano?*

My relationship with Mr. Cassano was one of employer and employee. Until the late summer of 2007, I had very minimal contact with Mr. Cassano. Beginning in early 2007, I replaced Mark Balfan on AIGFP's Transaction Review Committee, which met briefly twice per month to, as noted above, review the accounting by AIGFP's customers in proposed transactions. Mr. Cassano also participated in this committee.

Question 7: *How was your performance rated and when?*

I received two "formal" performance evaluations at AIGFP. The first was in mid-December of 2006, in connection with the awarding of my 2006 bonus. This evaluation

[2] As detailed below, I resigned on September 9, 2007, but withdrew that resignation on September 10. My final resignation was effective at 8 a.m. on October 1, 2007.

was with Doug Poling, then Chief Administrative Officer; and Mark Balfan, then CFO of AIGFP. During this evaluation I was told that senior management of AIGFP thought that I was a "fantastic hire," and they were "thrilled" to have me as an employee. I was awarded a bonus that exceeded the guaranteed amount by $50,000, or 15%. According to Mr. Poling, "this [was not] supposed to happen," but my outstanding performance had warranted it.

I received the second evaluation in June of 2006, from AIGFP President Joseph Cassano and William Kolbert, then Chief Administrative Officer. During this evaluation, Mr. Cassano told me that I was "doing a great job," and that I "should continue to work closely with [FSD] and OAP." Mr. Cassano told me that AIGFP's relationship with AIG was AIGFP's "most important asset," and that my position was "critical" to that relationship.

Question 8: *Prior to your departure, did AIG initiate a review of the valuation of AIG's Super Senior Credit Default Swaps portfolio? What was your role? Did you have any concerns about this?*

Historically, my understanding was that the Super Senior Credit Default Swaps ("SSCDS") portfolio had been accounted for at market value, in conformity with Statement of Financial Accounting Standards No. 133, *Accounting for Derivatives and Hedging Activities* ("SFAS 133"), as amended. Prior to the credit market turbulence in the late summer of 2007, it was my understanding that AIGFP's SSCDS portfolio was in an aggregate unrealized gain position. However, as there was no active market for these bespoke instruments, recognition of a day-one gain on these instruments would not have been in conformity with FASB Emerging Issues Task Force Issue No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities* ("EITF 02-3"). Therefore, no mark-to-market adjustments were made to these instruments through the quarter ended June 30, 2007. My understanding was that the instruments were monitored for significant *deterioration* through the use of a "value at risk" ("VaR") model that tracked movements in credit ratings for the underlying collateral.

As the credit crunch began to unfold in July and August of 2007, and with the planned implementation of SFAS 157, *Fair Value Measurements* (which superseded parts of EITF 02-3), effective January 1, 2008, the attention of the senior financial management in AIG, Inc.'s FSD and OAP turned to the valuation of AIGFP's SSCDS portfolio.

Upon returning from a vacation in early September of 2007, I learned that AIGFP had received a multi-billion dollar margin call on certain SSCDS. I was gravely concerned about this, as the mantra at AIGFP had always been (in my experience) that there could *never* be losses on the SSCDS. I was questioning this mantra in light of the margin call, as were the professionals in FSD and OAP, in my belief. I am not an expert in the valuation of derivatives, but I was concerned that the valuation model of at least one of AIGFP SSCDS counterparties apparently indicated that AIGFP was in a potentially material liability position.

Despite my position and FSD's and OAP's interest in the issue, I had no involvement with efforts to value AIGFP's SSCDS portfolio. This was, in my understanding, due to the actions of Mr. Cassano to exclude me from the SSCDS valuation process. During the final week of September of 2007, the final week of my employment at AIGFP, in a meeting with Mr. Cassano, the newly hired CFO of AIGFP, and an AIGFP quantitative risk expert, Mr. Cassano made the following statement to me:

"I have deliberately excluded you from the valuation of the Super Seniors because I was concerned that you would pollute the process."

My belief is that the "pollution" Mr. Cassano was concerned about was the transparency I brought to AIGFP's accounting policy process.

My understanding is that sometime during the late summer or early fall of 2007, AIGFP executive and Credit Risk personnel began an effort to develop a so-called "Binomial Expansion Technique" ("BET") model to provide valuations for the SSCDS portfolio that would reflect ongoing credit market developments. I had no involvement in this process whatsoever, other than attending a meeting held during the last week of September of 2007, a few days before I resigned, during which the BET model was discussed. My knowledge of the process was gained solely from my attendance at this meeting. AIG's Controller, Director of Internal Audit, and Director of OAP attended this meeting, held at AIGFP's Wilton office. During this meeting, Mr. Cassano had one of the Risk Management people distribute a PowerPoint presentation that purported to show the application of the BET model to AIGFP's SSCDS portfolio and represented to the assembled group that the SSCDS portfolio continued to be in an aggregate unrealized gain position.

Question 9: *What precipitated your resignation?*

I resigned because on multiple instances beginning in the late summer of 2007, Mr. Cassano took actions that I believed were intended to prevent me from performing the job duties for which I was hired. One such instance involved AIGFP's investment in Tenaska, a natural gas storage and distribution operation in Omaha, NE.

In December 2006, I traveled to Omaha to perform pre-transaction accounting due diligence and immediately identified errors in Tenaska's hedge accounting. I communicated these findings to AIGFP's senior management, specifically Doug Poling and Mark Balfan, and to Tenaska. Tenaska told me that it would fix these problems prior to the effective date of the merger. In June of 2007, I went back to Tenaska and found that it had not corrected the problems. Again I reported these findings to Poling and

Balfan. At the time I left AIGFP, it was my understanding that Tenaska had indeed corrected the issues, but I left before I was able to verify this.

During August of 2007, Mark Balfan pulled me out of a meeting with Doug Poling and brought into AIGFP's HALO room where Mr. Cassano was on from London. Mr. Cassano berated me for several minutes for going to Tenaska and finding the problems. He shouted obscenities at me, and seemed especially angry with Elias Habayeb, the CFO of FSD, whom he repeatedly referred to in disparaging language. The source of Cassano's anger was, in my understanding, a list of "closing issues" that Mr. Habayeb had prepared relating to third quarter issues. At one point Mr. Cassano held up the list and shrieked, "I've bent over backwards for this [expletive deleted] and still I get these [expletive deleted] lists!!" Mr. Habayeb had expressed interest in my findings at Tenaska, which was not surprising to me given that it was his job to make sure that AIGFP's accounting followed GAAP, and an error in Tenaska's financial results would be carried through to AIGFP's financial statements through the equity pickup. Mr. Habayeb had included the item "Tenaska hedge accounting" on the list, apparently to prompt him to follow up. Mr. Cassano told me in no uncertain terms during this session that I worked for him, not FSD or OAP. Doug Poling, Mark Balfan, and William Kolbert also attended this meeting.

This was the first time Mr. Cassano had expressed criticism of any of my close working relationships with FSD or OAP. As previously noted, during my evaluation with Mr. Cassano in June of 2007 two months earlier, Mr. Cassano had told me that I was "doing a great job," and that I should "work closely with [AIG]." He also volunteered during this meeting in June 2007, which was also attended by William Kolbert, that he had "no desire to be promoted, because it would separate [him] from the money," and that AIG's corporate management was "scared to death" of him.

Another instance occurred in early September of 2007. While on vacation in Puerto Rico, I began receiving emails from the credit traders in London asking me for assurances that AIGFP would not have to consolidate the Nightingale structured investment vehicle ("SIV") if AIGFP were to purchase all of the outstanding debt of the vehicle. This was the beginning of the Credit Crunch, and the SIV could not roll its paper. I said no; I could not make such assurances, as this would likely be a reconsideration event under FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* ("FIN 46(R)"), and the expected gain/loss model, originally formulated in late 2006,would have to be revisited. Upon return from my vacation, I began conversations with one of the quantitative risk experts at AIGFP and an accountant in OAP to evaluate this reconsideration event.

Also upon return from my vacation, I found a new organizational chart on my desk. It indicated that I would report to the controller of AIGFP going forward. I felt this to be a change that was designed to isolate me from OAP and FSD accounting policy personnel, as I believed that the controller would require all communications with OAP and FSD to go through him. The change also represented a substantial demotion, as I had previously been a peer to the controller. This, in addition to the episode described above regarding Tenaska, placed me in a conflicted position in that I believed that there was a rapidly escalating level of interference in my communications with OAP and FSD. Further, I believed that this interference represented a fundamental departure from the terms of the position I had agreed to undertake in June of 2006.

For these reasons, I resigned on Sunday, September 9, 2007. I was contacted on Sunday by William Kolbert and told that the organizational chart was the result of a "clerical error[3]" and that I would report to the new CFO, who was to start on Monday, September 10, 2007. I was also told that no one was trying to control or interfere with my communications with FSD and OAP. I agreed to meet and discuss potentially staying at AIGFP on Monday morning, September 10.

I came into AIGFP on Monday morning and discussed the situation with Mr. Cassano, again in AIGFP's HALO room. Mr. Cassano assured me during this meeting that I would have unfettered access to corporate going forward, although he insisted that going forward I should skip the step involving Elias Habayeb and go straight to OAP. "Elias is NOT an accounting policy person," he said. I decided to give it one more chance. I had moved my wife and myself from Washington, DC to Connecticut and now had a substantial investment of time in AIGFP. I had also put a lot of effort into building relationships with the business people at AIGFP and the accounting policy people at OAP and FSD. Given Mr. Cassano's assurances that I would have unfettered access to AIG, Inc. going forward, as well as the fact that by resigning, I was potentially walking away from a substantial guaranteed bonus (which was never paid to me), I agreed to return to work.

Two weeks later, on the morning of Tuesday, September 25, 2007, I was at my desk on a conference call when Mr. Cassano walked up. He appeared to be agitated. He asked me where the "SIV analysis" was, and told me that he had been asking for it for three weeks. I did not recall his ever having asked for the SIV analysis, although, as indicated above, I had been working on it with the AIGFP business people and with OAP. I indicated to Mr. Cassano that I was to have a conference call with an accountant in AIG's OAP at 10:30 that morning to discuss it. Mr. Cassano glared at me and walked off.

At 10:30 I had the call with OAP as planned. Also on the call at AIGFP were an AIGFP quantitative expert and the new CFO of AIGFP. The call went well, and we agreed that the quantitative expert would rerun the Monte Carlo analysis for the SIV with the new assumptions implied by the reconsideration event. (I had found out after I returned from vacation that AIGFP had already purchased much of the outstanding debt of the SIV.) At the time of my resignation, the evaluation of the SIV reconsideration event had not been signed off by OAP.

[3] I spoke later in the day to Mark Balfan, who told me that he had "told those guys that when Joe sees the org [organization] chart, he's going to resign." This indicated to me that the organization chart was not a "clerical error."

The instant the call was over, Mr. Cassano burst into the conference room we were in. He appeared to be highly agitated. "What the [expletive deleted] is going on here?" he asked. I replied: "We've just finished a call with OAP, they agree with our approach..." Mr. Cassano cut me off and shouted several expletives regarding the OAP person we had spoken to on the call.

This was after I had told him earlier about the call with this individual, one of the highly experienced accountants in OAP. Mr. Cassano shouted at me for several minutes, and then said, as previously noted: "I have deliberately excluded you from the valuation of the Super Seniors because I was concerned that you would pollute the process."

I finished out a very busy week that included attending the meeting referenced above with the controller of AIG during which the topic of AIGFP's SSCDS valuation was discussed.

Over the weekend I had time to reflect, and determined that I believed Mr. Cassano's actions to be inconsistent with the terms we had agreed to in our HALO room meeting on September 10. I could not continue in light of what I perceived to be Mr. Cassano's efforts to isolate me from OAP and FSP personnel, and in light of Mr. Cassano's decision to exclude me from the valuation of the SSCDS portfolio.

On Monday morning, October 1, 2007, I called Bill Shirley, general counsel of AIGFP, and re-submitted my resignation. My message to Mr. Shirley was that I had lost faith in the senior-most management of AIGFP and could not accept the risk to AIG and myself of being isolated from corporate accounting policy personnel, especially given the situation with the SSCDS.

<u>Question 10:</u> *Did you speak to anyone within AIG about the reasons for your departure? Describe these communications?*

Subsequent to my resignation, in October of 2007, AIG's Chief Auditor, Michael Roemer, contacted me. Mr. Roemer told me that he wanted to understand the reasons for my departure, and that he would report those reasons to AIG, Inc.'s Audit Committee. I had intended to write a detailed memorandum to AIG, Inc's Audit Committee, but decided to speak to Mr. Roemer in lieu of writing the detailed memorandum. I spoke telephonically to Mr. Roemer for approximately an hour during the latter half of October. I related the events described above to Mr. Roemer, including the proximate cause of my resignation – e.g. Cassano's statement that he had excluded me from discussions relating to the valuation of AIGFP's SSCDS.

When I related this to him, Mr. Roemer stated that I had been "painted into a corner" by Mr. Cassano and had no choice but to resign. In addition to Mr. Roemer, the PwC engagement partner on AIGFP also contacted me to inquire as to my reasons for leaving AIGFP. I had a similar, though much higher-level conversation with him. I did not get into specific conversations with the PwC engagement partner. I did, however, relate to him that I had left because of what I perceived to be Mr. Cassano's efforts to impede my communications with my counterparts at the parent organization.

Question 11: *How were bonuses awarded in AIG Financial Products? What is your understanding of the arrangement between AIG Corporate and AIG FP regarding the calculation of AIG FP's annual bonus pool?*

I had no access to payroll records or any compensation-related materials. The following is based on my experience and conversations with other AIGFP employees. My understanding is that bonuses were paid in cash in late December of each year, based on results through November 30. For "highly compensated" employees, my understanding is that salaries were capped at $125,000 per year, and that bonuses could be substantial – in some cases running to eight figures. It was also my understanding that certain portions of some employee's bonuses were deferred.

My bonus for 2006 was $375,000, and I never received my contractually guaranteed bonus for 2007 of $325,000.

My understanding of the arrangement between AIGFP and AIG regarding the bonus pool was derived wholly from conversations with other AIGFP employees. This understanding was that for each dollar of AIGFP's operating earnings – which excluded certain GAAP accruals, such as mark-to-market adjustments on derivative positions – AIGFP received 30 cents, which went to AIGFP's bonus pool.

Question 12: *Do you have any concerns about the accuracy of AIG's public disclosures regarding its swaps portfolio?*

I have not reviewed all of AIG's public disclosures regarding its SSCDS portfolio subsequent to my departure from AIGFP, and do not feel that it would be appropriate to comment on their accuracy.

That said I have been shocked at the speed at which the losses in AIGFP's SSCDS portfolio have apparently developed. There are two things that I would note:

1. In my understanding and experience, AIG has always been a staunch defender of its assets. As an outside observer, it has struck me as odd throughout the SSCDS crisis that AIG was apparently unable to defend itself from claims on those portions of the SSCDS that were written on subprime collateral. It is common knowledge that underwriting standards on subprime loans had deteriorated dramatically, even going back to the earlier vintages. Given this, I have been surprised that AIGFP apparently either did not write the SSCDS contracts to provide exclusions for collateral that was

non-compliant with prudent underwriting standards, or has been ineffective at enforcing such exclusions. Having never reviewed a SSCDS agreement, I cannot answer the question, but I would ask management, "how did this happen?"

2. I believe that certain statements made by Mr. Cassano and other senior AIG managers in the early stages of the SSCDS crisis were ill-advised. Specifically, statements made at the December 5, 2007 Investor Meeting that characterized margin calls that AIGFP had received from its SSCDS counterparties as lacking a legitimate basis, especially given the apparent state of AIGFP's valuation models, were statements that I would not have made or condoned. I believed at the time of the Investor Meeting and continue to believe that full disclosure of margin calls by, and resulting collateral postings to, AIGFP's SSCDS counterparties was of critical importance.

Sincerely,

Joseph St. Denis

Chairman WAXMAN. Mr. Sullivan, you were the CEO at the time. Mr. St. Denis was hired to give you insight into Mr. Cassano's activities. And he said he was blocked from doing that. And he resigned.

Were you aware of this?

Mr. SULLIVAN. To the very best of my knowledge, sir, I don't believe I ever saw the letter. But I do recall the content being brought to my attention. And I understand that a very thorough investigation both from our compliance people and from I believe the audit committee—I'm not sure on that. But certainly compliance and legal looked into what Mr. St. Denis was saying. Of course at that time we were already putting in place compensating controls to make sure that our valuation process was obviously accurate.

Chairman WAXMAN. You were trying to put these controls in, but the man who was hired by your company to give you the information as to what controls were needed was fired because he was told he couldn't look into what was happening in this particular division of AIG, the FP Division, from which all the problems seemed to arise.

Mr. SULLIVAN. From the very little I know about Mr. St. Denis, and I have no reason to believe he's not a first-class individual, I think he resigned, sir. I don't think he was terminated.

Chairman WAXMAN. He resigned because he was blocked from doing his job.

Mr. SULLIVAN. Exactly. And I think, as I said, from what I recall about the letter, it was investigated from the legal and compliance people. But at the same time obviously we were trying to put compensating controls in there to make sure that our results were as accurate as possible.

Chairman WAXMAN. He said he reported Mr. Cassano's actions to AIG's independent auditors. He also said that he spoke with AIG's Director of Internal Audit Michael Roemer. Mr. Roemer thought this was a serious matter, and on November 6, 2007, he personally briefed the board's audit committee on Mr. St. Dennis' resignation, according to minutes from that meeting.

Mr. Willumstad, you were the chairman of the board at this time. What steps did you and the board take to investigate this matter?

Mr. WILLUMSTAD. I actually don't remember the comments in the audit committee.

Chairman WAXMAN. You do not remember?

Mr. WILLUMSTAD. I do not.

Chairman WAXMAN. Well, we don't have a full record of the committee. But we did request all the minutes of the audit committee. And there's nothing we can see that indicates that AIG took any action to respond to Mr. St. Dennis' concerns. So it looks like you both brushed it aside. Is that an unfair characterization?

Mr. WILLUMSTAD. I don't recall the audit committee or the comments. So I can't answer that.

Chairman WAXMAN. And you were the chairman of the board at that time?

Mr. WILLUMSTAD. I was.

Chairman WAXMAN. And Mr. Sullivan, you were the CEO. And you don't have much recollection of this either.

Mr. SULLIVAN. Other than I believe I recall that it was investigated by legal-compliance, and as you refer to, the internal audit division, sir.

Chairman WAXMAN. Well, the reason of course why this is significant is that this man was brought in to find out about these kinds of problems which ended up bringing AIG to its knees, and it could have given you that information except he was blocked by the fellow in London, Mr. Cassano, who didn't want him to know what Mr. Cassano was up to. So I just find that very disturbing.

I'm going to reserve the balance of my time and recognize Mr. Davis.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Chairman. Mr. Sullivan, according to the documents obtained by the committee, on March 11, 2008, it was recommended that losses in AIG-FP not be considered when calculating your compensation package. How do you justify this while also advocating pay for performance as a prudential standard for executive compensation?

Mr. SULLIVAN. First of all, sir, can I just clarify that my compensation was obviously discussed in executive session and with the compensation committee. And they ultimately made a recommendation to the board at large who ultimately had to approve my compensation. From what I can recall, and if—if you're referring—it would be helpful if I could know the minutes you're referring to, but some were put up on the screen earlier. But if you're referring to the discussions we had on the super senior—the senior partners and the partners plan, is that what you're referring to, sir?

Mr. DAVIS OF VIRGINIA. We asked the staff to get that. I will go on for another question.

I was just looking at your resume. And I saw that you went to the Sydney Russell School and were very generous to them afterward. Did you have further education after that?

Mr. SULLIVAN. I put myself through night school, sir, and became a chartered insurer. I received my associateship at the Charter Insurance Institute in the United Kingdom.

Mr. DAVIS OF VIRGINIA. OK. You joined AIG in 1971?

Mr. SULLIVAN. Yes, sir, when I was 17.

Mr. DAVIS OF VIRGINIA. When you were 17 years old.

Mr. Willumstad, can you tell us how the mark-to-market accounting rules affected AIG's position and do you think it contributed to the deterioration of the company?

Mr. WILLUMSTAD. Well, I would like to make a couple of comments. I have no concern or problems——

Mr. DAVIS OF VIRGINIA. Could you move that closer to you? Thank you.

Mr. WILLUMSTAD. I would make a couple comments about mark to market. One, I have no concerns about the validity of mark-to-market accounting. I think the concerns that I've shared in my written statement is that when there is no market, the ability to value securities based on FAS 157 becomes somewhat difficult and requires a fair amount of judgment. There are, as I said, no specific market for these securities. And the company, along with others, has to go through a process which uses formulas and other indicative prices to come up with these values. So accordingly, it's very difficult to determine whether the values are actually correct.

According to the procedures that AIG followed, there were very substantial writedowns in these securities.

Mr. DAVIS OF VIRGINIA. So did it help or hurt you?

Mr. WILLUMSTAD. Well, it obviously resulted in substantial writedowns, which were obviously not helpful to the company.

Mr. DAVIS OF VIRGINIA. Your statement alludes to the fact that in 2005 AIG stopped writing policies on multi-sector credit default swaps. So somebody I guess at AIG saw that there were problems or questions with this portion of the business. Why did AIG stop writing these policies?

Mr. WILLUMSTAD. I don't know. I was not on the board at that time.

Mr. DAVIS. Mr. Sullivan, do you know why?

Mr. SULLIVAN. Sorry, sir?

Mr. DAVIS OF VIRGINIA. In Mr. Willumstad's statement he talked about that AIG in 2005 stopped writing policies on multi-sector credit default swaps. Obviously they did that—somebody recommended this inside and this was an early warning signal. Can you tell us——

Mr. SULLIVAN. Yes. From the best of my recollection based on what I understood, because obviously at that time I was very focused on resolving the regulatory issues that AIG was facing and making sure that we got our accounts issued. Obviously there was a big delay in 2005 in our issuing our accounts. From what I understand on investigation, that decision was made by AIG-FP in conjunction with the risk management—the risk—the chief risk officer and chief credit officer of AIG.

Mr. DAVIS OF VIRGINIA. So they saw a problem obviously.

Mr. SULLIVAN. Again, from what I understand, they saw a deterioration in pricing and were beginning to get concerned about credit quality. So they took a very proactive step in 2005.

Mr. DAVIS OF VIRGINIA. Did AIG rely heavily on the mortgage-backed assets of Fannie Mae and Freddie Mac? And did their demise play a role?

Mr. SULLIVAN. I don't know the answer to that, sir.

Mr. DAVIS OF VIRGINIA. Is there any linkage between AIG and the GSEs in terms of what was happening with Freddie and Fannie buying these with implied government backing?

Mr. SULLIVAN. I'm not aware of what our exposure was to Freddie or Fannie off the top of my head, sir.

Mr. DAVIS OF VIRGINIA. OK. I have your statement up here on the board. And I'll ask you——

Mr. SULLIVAN. Thank you for putting that up. I appreciate that.

When I was talking to the compensation committee on March 11th, what I was proposing there was the—what they—proposing what they should actually award the partners and the senior partners. And as I think somebody mentioned earlier, there was 700 partners and there were about 70 senior partners. And I was making a recommendation—and by the way, I should stress, nobody in AIG-FP participated in this partners plan or senior partners plan. And what obviously I was anxious to do was to make sure that we retained our key people. See, shareholders would expect me to be focused on retaining our key people in those parts of the business, the insurance businesses and other sectors of the businesses that were performing well whilst these unrealized losses but nonetheless losses—nobody is differentiating between——

Mr. DAVIS OF VIRGINIA. So what you are saying is with these sectors, they were meeting their goals, they were doing their job. In other sectors they weren't.

Mr. SULLIVAN. Not everybody was hitting targets. Some were exceeding, some were not exceeding, as you would expect in a business. But what I was anxious to do is to make sure that we retained the 700 key executives that, you know, were running other parts of our business and participating in other parts of our business and were not in AIG-FP. The important distinction there is nobody is in AIG-FP participated in these programs.

Mr. DAVIS OF VIRGINIA. Mr. Willumstad, you don't see any relation between what was happening with Freddie and Fannie and what was happening with AIG then? Do you agree with Mr. Sullivan?

Mr. WILLUMSTAD. I do not.

Mr. DAVIS OF VIRGINIA. Did the accounting scandals there raise a red flag, that you were insuring investments that could be tainted that were coming out of there?

Mr. WILLUMSTAD. I'm sorry. Could you——

Mr. DAVIS OF VIRGINIA. You were buying, you were getting into some of the business. Did the accounting scandals at Fannie and Freddie raise any red flags as to whether you were insuring investments that might be tainted?

Mr. WILLUMSTAD. No.

Mr. DAVIS OF VIRGINIA. OK. Let's take you both to the early 2000 timeframe. Is there anything in government regulation going back to this early timeframe that would have changed your business model and would have prevented this catastrophe?

You were somewhere else at that point, Mr. Willumstad. But with Citigroup.

Mr. WILLUMSTAD. That's correct.

Mr. DAVIS OF VIRGINIA. Mr. Sullivan.

Mr. SULLIVAN. Can I just clarify? You mentioned the year 2000, sir?

Mr. DAVIS OF VIRGINIA. In that timeframe, yes.

Mr. SULLIVAN. Maybe it's helpful for the committee there. But from the best of my knowledge, the CDS portfolio started to be underwritten in the late 1990's, 1998. And obviously as I testified——

Mr. DAVIS OF VIRGINIA. But the rules were changing as we speak. What happened in that timeframe of course is you had several rule changes taking place at Congress statutorily.

Mr. SULLIVAN. Well, if you're referring to my comments regarding FAS 157 in particular?

Mr. DAVIS OF VIRGINIA. Well, no, I'm talking about the regulatory framework on the commodities futures and Glass-Steagall repeal, those kinds of things.

Mr. SULLIVAN. Right. I don't think anything in the regulatory field to the very best of my knowledge would have changed what occurred. You're going back to 1998.

Mr. DAVIS OF VIRGINIA. That's what I'm asking.

Mr. SULLIVAN. I don't.

Mr. DAVIS OF VIRGINIA. I'll reserve the balance of my time.

Chairman WAXMAN. Mr. Sullivan, just so I have this correct, you asked that your bonus based on performance not count the losses at AIG-FP, is that right?

Mr. SULLIVAN. No, sir. What I was referring to here was what should be paid under our partners and senior partners plan.

Chairman WAXMAN. You were included in that.

Mr. SULLIVAN. I was included in that. But at the time I was speaking——

Chairman WAXMAN. So everybody in that group, including you, got the bonuses as if you performed very well because you didn't count the losses?

Mr. SULLIVAN. But with respect, sir, the compensation committee of our board sets my remuneration and it's then discussed with the board at large. They could have.

Chairman WAXMAN. But you requested the board to take that position?

Mr. SULLIVAN. On behalf of the employees of AIG, yes, sir.

Chairman WAXMAN. Including yourself?

Mr. SULLIVAN. But trust me, I was focusing on them more than me.

Chairman WAXMAN. AIG-FP, they were getting paid bonuses that were even higher than the bonuses you were getting, isn't that correct?

Mr. SULLIVAN. In certain instances, yes, sir. In most instances.

Chairman WAXMAN. So everybody did really well even though there were losses. You didn't get penalized, you and the others you represented. You are getting penalized because of the losses, even though your bonus was dependent on—getting a bonus higher if you got earnings, higher earnings, higher bonus. You got lower earnings and therefore you still got the bonus. And AIG-FP got their bonuses because they were being handled in a different way even though they were the ones bringing on the losses. Is that a fair statement?

Mr. SULLIVAN. Just for clarity, sir, with regard to my bonus it was substantially reduced in 2007 by AIG's Board of Directors, which I concurred with. With regard to AIG-FP, I don't believe—and again, this is from the very best of my recollection—that they received their bonuses in 2007. I think we put in place a deferred compensation plan—again I'm doing this from memory. But they certainly received their bonus for 2006 and prior.

Chairman WAXMAN. OK. Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman. We heard from our first panel that one of the key factors that caused this financial mess was not accounting rules that shed light on these risky exotic tools that you were investing in, have no value and that people don't want to buy them. What the first panel said was that one of the key factors was inadequate deregulation of so-called credit default swaps. And it is a $58 trillion market, double the size of the entire New York Stock Exchange. The market is four times larger than our national debt. But unlike the stock exchange, the swap market has no transparency, no rules and no oversight.

The result of the failure to regulate these credit default swaps seems pretty clear. AIG had to be bailed out by the taxpayers because of your risky investment in credit default swaps. And I for one don't think any of the management deserves a bonus or any pay from the taxpayers' purse and certainly not an exotic weekend to discuss the future of AIG, which was a great company.

You have cost my constituents and the taxpayers of this country $85 billion and run into the ground one of the most respected insurance companies in the history of our country. And the company's failure has tremendous implications in our entire economy. I got hundreds of calls from constituents concerned about AIG because of their interaction with this company.

So I would like first to ask you, Mr. Sullivan, do you believe the swaps markets should be regulated?

Mr. SULLIVAN. Well, obviously with the benefit of considerable hindsight, if there is good regulation that can be put in place, personally I would support that.

Mrs. MALONEY. And Mr. Willumstad, do you believe that a swap market should be regulated?

Mr. WILLUMSTAD. Yes.

Mrs. MALONEY. Could you give to this committee how much AIG lost in these swaps? Do you have any idea? Out of the $58 trillion, how much is held by AIG? Could you get to us back in writing? Maybe that is something you would need to look at.

I would also like to ask you, Mr. Sullivan, that if the same rules that had applied to your insurance company where you had some backup and some reserves, would this have avoided the bailout that AIG is confronting now?

Mr. SULLIVAN. Well, Congresswoman, at the time I left the company I believed it was well capitalized and had the liquidity to work its way through.

Mrs. MALONEY. But the swaps had no capital behind them. Do swaps have any capital behind them?

Mr. SULLIVAN. Well, only the capital ultimately of AIG.

Mrs. MALONEY. Pardon me?

Mr. SULLIVAN. Only the capital ultimately of the holding company.

Mrs. MALONEY. I'm talking about the swaps. There was no capital reserve behind those swaps, right?

Mr. SULLIVAN. That's right.

Mrs. MALONEY. So you were gambling billions, possibly trillions of dollars.

Mr. SULLIVAN. Well, I wouldn't refer to it as gambling. These transactions were individually underwritten very carefully. And maybe I can provide some more background to you that may be helpful.

Mrs. MALONEY. If they were carefully underwritten how come no one wants to buy them? And our first panel said when you securitize them the first time, maybe the second time they had value. But when you get to the sixth and seventh time that there's no value there. That's what the first panel said. And you did not follow the insurance rules of having any collateral or capital behind these risky swaps.

Mr. SULLIVAN. Maybe it would be helpful—because there was a lot of generalization in the first panel. Maybe it would be helpful if I just explain. And as I say, I'm not an accountant.

Mrs. MALONEY. But you did make a good decision not to sell them anymore after 2005?

Mr. SULLIVAN. Or underwrite. To accept any more swaps after 2005.

Mrs. MALONEY. You must have realized that they didn't have any value. And what I'm angry about now is when you blame accountants for coming forward looking at a product and saying it has no value because absolutely no one in the entire world wants to buy it. It's not their fault. You want them to say there's value there when there's none? I believe in the fair market value. If no one wants to buy it, I think there's an indication that there's no value there, that you were generating fees, making all of your employees rich, wrecking a great company, and tearing down our economy, and now turning to the taxpayers and asking us to bail you out.

I think you should be apologizing to the American people for your mismanagement.

Mr. SULLIVAN. Well, maybe it would be helpful if I can. First of all, I'm not blaming accountants. I said in my testimony——

Mrs. MALONEY. You said the mark-to-market rules, which is how accountants determine whether there is fair market value, they have determined no one wants to buy it. Therefore, it does not help their market value. That—I believe they're shedding light on the problem. And there have been many memos from many executives saying they should change the accounting rules and say there's value there when there is no value.

Chairman WAXMAN. The gentlelady's time has expired.

Do you want to make any comment?

Mr. SULLIVAN. With the utmost respect, what I said in my testimony was the unintended consequences of FAS 157. I have never criticized FAS 157. My concern, which ultimately the SEC and this Congress have concurred with, when I made my remarks, I started making these remarks back in March of this year, was the unintended consequences of trying to mark to market these assets in an illiquid market.

And one of the concerns I had, if I may, again which may be educational, is back many years ago, many of you may recall the Piper Alpha exploded in the North Sea, if you remember the tragic circumstances of Piper Alpha exploding. There was something in the London market insurance area that was called the London market spiral. And what Piper Alpha precipitated was a spiraling effect throughout the market that forced the market ultimately to collapse. The London market insurance fire was no longer there.

What I saw in early 2008 was what I believe was an unintended consequence of FAS 157. I wasn't attempting in any way, shape, or form to criticize it. What I was trying bring to everybody's attention and what I'm trying to bring to everybody's attention today was the unintended consequence of trying to mark to market assets that had value, that you were happy to hold to maturity, that interest was being paid, dividends were being paid, but you couldn't mark to market in an illiquid market. And that was, with the greatest respect, the point I was trying to make.

I don't think there is any one individual, any one entity, any one body that you can point the finger to. I think when you look back and see these great institutions that we are addressing today and this committee has addressed in the past, if you look at the German Government guaranteeing bank deposits, you look at the Irish government——

Chairman WAXMAN. Mr. Sullivan, we're going to have more questions.

Mr. SULLIVAN. I'm terribly sorry, but I'm trying to bring it in perspective if I may. I'm not trying to point the finger at accountants or FAS 157; I'm trying to raise the issue of unintended consequences.

Chairman WAXMAN. Mr. Davis you wanted to say something else?

Mr. DAVIS OF VIRGINIA. I yield myself a couple of minutes because I'm still puzzled by both of your comments about not relying on Freddie and Fannie.

My understanding is people would buy these secondary mortgages. And you had said you would sell them credit default swaps; isn't that what happened?

Mr. SULLIVAN. Yes. We were selling, to the very best of knowledge——

Mr. DAVIS OF VIRGINIA. But you weren't relying on the fact that this government-backed group was insuring them and that had bought them originally. That had nothing.

Now let me just tell where you I'm going with this. In documents submitted to the committee, a former AIG CEO Hank Greenberg asserts that in the 8 years from 1988 to March 2005 AIG wrote credit default swaps on only about 200 CDOs; those are collateralized debt obligations. Only a handful, he says, of these were exposed to subprime mortgages. He goes on to assert that after his departure from AIG, the company under your leadership, Mr. Sullivan, wrote about 200 CDO credit default swaps in just 10 months, from March to December 2005, but that these, unlike his CDOs, were heavily exposed to subprime mortgages.

Essentially, as I read it, Mr. Greenberg is blaming you for exposing AIG to the most risky credit default swaps. Do you agree with that assertion or not?

Mr. SULLIVAN. Clearly not, sir. But what I again would point out, that these CDS swaps were being written since the late 1990's, not just in 2005——

Mr. DAVIS OF VIRGINIA. I know they were written in the 1990's. But my question here is, he's saying that in the early stages, it was not heavy on subprimes; that after this, it became very heavy with subprimes.

You claim Freddie and Fannie have nothing to do with this, is what I heard you saying. You weren't relying on the fact that they were buying these up and that they had government backed. But you went ahead with this, according to Mr. Greenberg, and that in the 10 months before you stopped, that the alarm went out, that you were buying these up and that he says that's basically what put you at risky credit default swaps.

In fact, in earlier testimony from Mr. Willumstad, he notes that the FP wrote a large number of instruments called credit default swaps over time, that they wrote insurance bank swaps on bonds with a face value of over $500 billion. Is that correct?

Mr. SULLIVAN. From recollection, I don't believe the number got to $500 billion, but it was certainly in totality around $400 billion, yes.

Mr. DAVIS OF VIRGINIA. And what are they actually worth?

Mr. SULLIVAN. Well, that's the notional value, sir. Let me just point out if I may. Up until the time I left AIG, to the very best of my knowledge AIG had not suffered $1 realized loss.

Mr. DAVIS OF VIRGINIA. They're still holding them, aren't they?

Mr. SULLIVAN. They're still holding them. At the time, this valuation can come back. As these contracts mature, and they have an average tenure of 4 or 5 years, as these contracts mature, the valuation, assuming there is no loss under the contract, the valuations would come back.

Mr. DAVIS OF VIRGINIA. But you carry them on the books as zero.

Mr. SULLIVAN. Well, I'm not sure they're carried at zero, sir. They're mark-to-market valuation. But coming back to the point of 2005, I don't want to underestimate the fact that AIG was in a different sort of crisis in 2005. We had advised the market that they couldn't rely on our accounts. We had major regulatory issues that were dominating the focus of my attention. I had to negotiate with the SEC, the DOJ, my friends at the New York Insurance Department, as well as the New York Attorney General. And we had to stabilize a ship that could have come very much unglued. During that process of time obviously the capital markets division, AIG-FP, continued to write their business. Nobody had any concerns about the profitability of that business at the time. And as they progressed through 2005, as the Congresswoman said, you know, fortunately, you know, those people involved in the underwriting of that, including the corporate risk and corporate credit offices, made the determination that the market was deteriorating, not only in pricing but in credit quality, and made the decision fortunately to stop. That's the point I would like to make.

The day I left the company, sir, all of these losses to the best of my knowledge were unrealized at the time, nonetheless losses but unrealized.

Chairman WAXMAN. Thank you, Mr. Davis.

Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

Mr. Sullivan, are you, like Mr. Willumstad, considering giving back some of that money?

Mr. SULLIVAN. No, I'm not, sir.

Mr. CUMMINGS. After the bailout on September 16th, the taxpayers in effect became the owners of AIG. That should have meant a change in its approach to executive compensation and benefits, but apparently, it did not. The committee has learned that a week after the bailout, executives from AIG's main life insurance subsidiary, AIG American General, held this week-long conference at an exclusive resort in California. Are you all familiar? Are you familiar with that at all?

Mr. WILLUMSTAD. I am not.

Mr. CUMMINGS. The resort is called the St. Regis Monarch Beach Resort. We've gotten somepictures, and we put them up. And let me give you a sense of how exclusive the resort was. Rooms start at $425. Some cost as much as $1,200. And it's interesting, they've got, 5 nights they had a room for, a Presidential suite, for $1,600. And then they had 5 nights the royal suite, really nice and swanky, another $1,600 for 5 nights; that was $8,000. And we contacted the resort, and we got a copy of the bill. AIG spent $200,000, $200,000, Mr. Sullivan, for rooms and $150,000 for banquets. They spent $23,000 for the hotel spa. I don't know whether you heard me asking the experts questions earlier. And of course, that was for the pedicures manicures facials massages and whatever they do in the spa. And they spent about $1,400 at the salon. The guests in the spa and salon actually had different amenities. They had all kinds of things at St. Regis. But they spent $7,000 on something very, very, important; that is green fees at the golf course. And then, I'm not even sure what this charge means, but my colleagues tell me that the $10,000 for leisure dining was for drinking.

Mr. Willumstad, you're no longer CEO, and I understand that. When this all happened, do you—I mean, what's your opinion? I mean, you seem to be a very honorable man. Would you have gone along with that?

Mr. WILLUMSTAD. Absolutely not.

Mr. CUMMINGS. And what do you think of it.

Mr. WILLUMSTAD. It seems very inappropriate.

Mr. CUMMINGS. And it seems kind of—a very bad thing when you think about the fact that the U.S. taxpayers would be basically ending up paying for this, was that not correct?

Mr. WILLUMSTAD. I'm not aware of the facts, but I'll take your word for it.

Mr. CUMMINGS. But could you understand why taxpayers would be upset?

Mr. WILLUMSTAD. Of course.

Mr. CUMMINGS. And, Mr. Sullivan, I'm curious what were your views on this?

Mr. SULLIVAN. Well, obviously I share Mr. Willumstad's comments. You know, obviously, I left the company many months earlier prior to Mr. Willumstad.

Mr. CUMMINGS. I understand.

Mr. SULLIVAN. But if I had seen bills like that, I can assure you, as the CEO, I would have been asking questions. At the time I left, AIG within its travel department had a unit that organized conferences that were supposed to, obviously, get the best rates and make sure that the conferences were being held in appropriate locations. This is obviously some months later.

Mr. CUMMINGS. But you can understand why taxpayers would be very upset, wouldn't you? Couldn't you?

Mr. SULLIVAN. Yes, sir.

Mr. CUMMINGS. I'm going to contact the AIG to find out who was responsible for all of this, because I think that person ought to be fired don't you.

Mr. SULLIVAN. Well, without knowing the full facts, you may reach that conclusion when you reach those facts, but I don't know the facts, sir. I had left many months earlier.

Mr. CUMMINGS. One of the experts earlier said they wanted to make sure these kind of things did not happen again. What kind of—now that we the taxpayers of America are part of this process, what kind of things and procedures can we put in place to make sure these kinds of things don't happen again?

Mr. SULLIVAN. Well, I think you have to look, and I think with respect to, Mr. Dinallo mentioned this at the time, that you need to look at for what purpose is this conference being used. You know, obviously, the company at that stage had gone through a transition. Maybe they believed it was an appropriate thing to calm everybody down. I think Mr. Dinallo made some reference to that.

But as you look going forward as a manager, you would look at the appropriateness of, one, what's the reason for the conference? Is it appropriate? And what's the benefit to the company? And what's the appropriate cost that should be associated with that, as you would do with any management——

Mr. CUMMINGS. I do find it interesting that Mr. Willumstad knows nothing about it, but this came just a week after you left. Did you know that, Mr. Willumstad?

Mr. WILLUMSTAD. I've heard you say that, but I was totally unaware that there was any plan for any conference.

Mr. CUMMINGS. So you wouldn't have been aware of this subsidiary spending some $500,000——

Mr. WILLUMSTAD. I was not aware of that.

Mr. CUMMINGS [continuing]. In a week.

Mr. WILLUMSTAD. I was not aware of it. And had I been aware of it, I would have prevented it from happening.

Mr. CUMMINGS. Thank you very much.

Mrs. MALONEY [presiding]. Mr. Cummings' time is expired.

The Chair recognizes Mr. Souder.

Mr. SOUDER. Thank you. One of the big frustrations that anybody watching this across America has is, both of you used the term market driven, financial tsunami, as if you weren't part of it. Do you feel you have any responsibility for what's happened in our economy with a huge company that the taxpayers now have put $61 billion in with $85 going, do you feel you have any personal responsibility?

Mr. Sullivan.

Mr. SULLIVAN. I take responsibility for everything that occurred as my tenure as AIG's president and chief executive. And that's the role of a president and chief executive——

Mr. SOUDER. In other words, you're acting like, during your period, you were doing fine. You were having all these nice profits, and that somewhere between July and September, your company lost $61 billion that we've already had to bail out that—and you're claiming that the accounting rule which was the law, it was just a matter of interpretation of how to apply it, and I basically don't agree with how it was enforced and like many others have argued that was a wrong enforcement, but quite frankly, what it did was it showed up that your assets didn't have great value. And do you acknowledge that you are part what triggered the financial tsunami? That your risky strategies in your company—let me ask you another question. Your insurance division is fine, correct?

Mr. SULLIVAN. To the very best of my knowledge at the time I left, certainly.

Mr. SOUDER. Mr. Willumstad, wouldn't you say your financial division, we heard earlier, your financial division appears to be in good shape—I mean your insurance division.

Mr. WILLUMSTAD. That's correct.

Mr. SOUDER. Now, if your insurance division is in good shape, it means that this is concentrated in your financial services division. And your insurance division, which is also investing assets, chose not to invest in as risky of assets that didn't yield as much but were less risky. Is that not true? Or how would you explain that one division in a short period of time could have had $61 billion in taxpayer investment and your other division not needing it when your other division, as insurance companies do, also invests in properties, also have been struggling with mark to market, have also had, but have more regulation on the value of those assets prior to that decision? Why does not your risky strategies in the financial services show that, in fact, to get higher return you went for more risk in that category?

Mr. Sullivan.

Mr. SULLIVAN. Well, again, what I would like to point out is that we actually stopped running that business, thank goodness, in 2005. That's a point I would like to, because I don't think it was made clear in the first session that, fortunately, we had been in that business for some 10 years. But as my colleagues determined that market—you know, the credit quality was changing and the pricing of these——

Mr. SOUDER. Let me clarify, because you referred to this several times. Are you saying that the $61 billion that we put in is mostly of things that were pre-2005.

Mr. SULLIVAN. I don't know what the $61 million is, sir.

Mr. SOUDER. $61 billion is what the taxpayers have already put in of the 85 to cover the losses of AIG. And are you maintaining that this is just to rescue bad decisions pre-2005, or is any of that money because you had questionable decisions between 2005 and 2008? Do you bear any responsibility? That's what I'm asking.

Mr. SULLIVAN. Well, I want to be clear——

Mr. SOUDER. You asked for raises because you said you were making profits a little bit ago. You said that you were making profits, that you hadn't lost any money. But yeah, but you had a shell that was anchored in less than secured mortgages that had been leveraged multiple times. Your insurance division, which also presumably has mortgages and other types of investments, seems fine. The question is, why weren't you warning your stockholders? Why weren't you making declarations that would leave your company—I mean, I have a business background, an MBA, just a small town business guy. But at the same time, you took incredible risk without warning people, and the evidence of that risk is that, one accounting—by your own explanation, one accounting rules change put your company under, and the taxpayers are putting $61 billion in; how in the world does an executive leave their company so vulnerable that, when they leave, all of a sudden they go broke when they were claiming they were making money before, and they act astounded like everything was just fine if they hadn't done this one accounting rule, which I don't agree that you have to balance out when the assets are going to be sold, I understand that, you're holding them long term. But the reason they're trying to do some of this kind of thing is we might have had a complete collapse if we hadn't done any mark to market here, we hadn't done any of these kind of accounting changes. Our assets were deteriorating, and we would have had an even bigger blowup later potentially. We needed some kind of a mix in there. But in effect, you left your company so exposed that when a little bit of softness came to the economy and it started down and they do an accounting change, you go belly up and stick everybody else in America with it, and you're saying, oh, it was a market tsunami, as if you didn't help cause it.

Mr. SULLIVAN. Again, if I may, sir, with the utmost respect, in my testimony, if I emphasize FAS 157 as being the only cause, it was not, again with the greatest respect, I was not criticizing FAS 157. I was referring to its unintended consequences, which of course this Congress has now and the SEC have now recognized.

There were many other reasons that have affected many other companies and many other countries around the world. It's not just the United States. This tsunami that many have referred to—others have mentioned the equivalent of financial Pearl Harbor, you know, much more intelligent people than I. There were many issues that contributed to this. As I mentioned, whether it was inappropriate lending or borrowing, whether it was lack of investor confidence, whether it was the freezing of the credit markets, I just in my testimony to be helpful to the committee focused on what I believed back in my tenor as AIG something that I was concerned about, which was the unintended consequences of FAS 157.

And I responded to the Congressman earlier, at the time I left, as Mr. Willumstad articulated in his testimony, we had taken substantial unrealized losses, losses nonetheless. But at the end of the day, these CDS transactions at the time I had left the company had not incurred, to the best of my knowledge, $1 of realize. That's not to say they wouldn't as the situation progressed. But at the time I left the company, this was multiple issues, not one entity, not one individual. And that was the point I was trying to make. If I referred to FAS 157 too much in my testimony, it was only because that was something I was particularly concerned about as—not being an accountant, but as, again, like you. Sir——

Mrs. MALONEY. The gentleman's time has expired.

I yield 1 minute to the ranking member.

Mr. DAVIS OF VIRGINIA. I guess the thing to all of us is puzzling is, how come you get bailed out, Lehman doesn't? Who makes these choices? It is kind of mysterious, I think, to a lot of us. The regrettable thing here is that you get bailed out. Your employees get to stay. Your shareholders take a bath, but you're bailed out because there would be a lot of collateral damage if we were to have not stepped in. That's at least the rationale that we are hearing from Treasury. But, frankly, given the quality of some of the decisions that were made, you deserve to fail.

And it is, I think for a lot of us, puzzling why you were singled out and kept your doors open, your employees kept moving, while other companies were left to fail and just fall on their sword. And I think that's what's troubling to me and I think to a lot of other

Members up here. And I think we'll explore more of that in the testimony and the questions as we follow.

Thank you.

Mrs. MALONEY. Thank you.

The Chair recognizes Congressman Kucinich for 5 minutes.

Mr. KUCINICH. I thank the gentlelady.

It appears that in the last month this country has taken steps, unprecedented circumstances, unprecedented steps. We interfered in the free market. We bailed out Wall Street. The market is not responding. We see today's headline in the Wall Street Journal, "Markets Fall on Doubts Rescues Will Succeed." And I think what this does is I think it raises questions as to whether it was wise for government to intervene directly in the markets and whether or not a financial rescue plan should have addressed the core problem, which is, tens of millions of Americans losing their homes, needing government to get a controlling interest in these mortgage-backed securities, so that we can work out a plan where people can get a break on their interest rates, on their principal, extended terms of their loan, and help people save their loans. We had other choices of priming or pumping the economy. We didn't do any of that.

Now, questions are raised. For example, you talk about mark to market. AIG went into the government's hands on about September 18th. Interesting, mark to market was basically suspended on the 30th. I think the timing of that needs to be explored a little bit more carefully. We know it went into effect on November 15th. We've got a bailout plan by the Secretary of the Treasury which clearly is not working, and we've got—which the taxpayers are paying for, and we've got another $85 billion of a bailout for AIG.

And according to the testimony submitted to this committee by former CEO of AIG Mr. Greenberg, he raises questions as to whether or not a government bailout of AIG was absolutely necessary. In fact, he admits there was a liquidity crisis that required action. But he goes on to say in his testimony, the action was, it was not necessary to do a government bailout. He said that it was not necessary to wipe out virtually all of the shareholder value held by AIG's millions of shareholders, including tens of thousands of employees and many more pensioners and other Americans on fixed income. He said that perhaps they could have filed bankruptcy, limited the parent company, and that millions of stockholders would have fared better. This goes back to a question of my friend that the stockholders would have fared better. But he says that other stakeholders, like AIG's Wall Street counterparties, would have fared worse.

So, according to the testimony of another CEO of AIG, private sector solutions for AIG were rejected. He talked about the tens of billions of capital that were offered. He talked about the State of New York ready to permit AIG to use $20 billion in excess capital of its insurance subsidiaries, plus he says there was no effort made for a temporary and limited bridge fund from the government; plus we have this mark-to-market problem, and plus you have, without the mark-to-market problem, you have possibly $1 trillion that could have been pledged to secure an, instead of trying to secure an $85 billion loan from the government.

Now, instead, the government takes over. AIG, now we have 85 percent ownership of AIG. Here's what's going on with AIG. AIG is paying interest on undrawn capital. They're paying interest on money it doesn't borrow. The company is encouraged to draw down the full amount of the loan even if it doesn't need the money. Now, in order to service the principal and loan, the AIG has to engage in a fire sale of profitable assets.

Who buys though assets, Mr. Sullivan, who buys AIG assets.

Mr. SULLIVAN. Well, obviously, I can't comment on the events that——

Mr. KUCINICH. Who buys their assets?

Mr. SULLIVAN. Well, if you recruit investment bankers, they will go out and I assume get the best deal that they possibly can for the assets for sale.

Mr. KUCINICH. Mr. Willumstad, you were involved with negotiations with Treasury Secretary Paulson. Why do you think AIG was bailed out while Lehman Brothers was allowed to fail?

Mr. WILLUMSTAD. I'm not sure why Lehman Brothers was allowed to fail. I think it was understood that the consequences to the financial system if AIG failed would be very significant.

Mr. KUCINICH. My time is expired, Madam.

Mrs. MALONEY. The Chair recognizes Congressman Bilbray of California for 5 minutes.

Mr. BILBRAY. Thank you, Madam Chair.

You know, Madam Chair, I do an editorial note. I'm not going to ask you gentlemen from prepared statements that somebody else has written up before this hearing. I'm going to ask questions that basically respond to your testimony.

Madam Chair, I do have to point out that it's sort of interesting the way we throw around terminologies. And somebody born and raised on the ocean and spent some time in the water myself, I find it funny that we use the terminology like tsunami. We can't even use plain language like tidal wave. But maybe because some people don't understand some of the words they're using.

Gentlemen, the term tsunami or tidal wave is not just a wave coming in. You land lovers and people that don't surf may not understand that long before that crest breaks, there's an indication that something is going on. Granted, usually tourists see the tide going out and think it's a good time to go out and pick up seashells. And a lot of people seem to have seen that the tide shifting and the major changes that were happening were an opportunity to go in and clean out, and they got caught below the high water mark.

I hope the Chair doesn't mind me using that analogy, but as an old surfer, I just can't go back addressing that. When Freddie and Fannie went from 30 percent to 70 percent of a certain part of the market; when we saw major portions of our oil money that's going overseas coming back and buying up paper and inflating a market; don't you think that we should have seen some concern there, when we say—well, let me just ask it out.

When Freddie and Fannie went from 30 to 70 percent, how much of the problem should have been seen by all of us that we have a portion of the market that was very, very vulnerable, and did that vulnerability have an effect to your operation and the problems we're facing with AIG, with Freddie and Fannie?

Mr. SULLIVAN. Would you like me to respond, sir?

Mr. BILBRAY. Yes.

Mr. SULLIVAN. First of all, I don't believe, with the greatest respect, I'm qualified to comment on Freddie and Fannie and the implications thereof.

But what I did say in my testimony was one of the factors that I think has contributed to, and the tsunami equivalent, I defer to your expertise, sir, but what's contributed to what has impacted the global financial economy is, you know, one of the things could be inappropriate borrowing and lending. And if that correlates to your analogy of Freddie and Fannie, maybe that's helpful, I don't know. But I certainly don't know enough about Freddie and Fannie to pass any qualified opinion.

Mr. BILBRAY. And I apologize, I had to fly back from the West Coast just to be here at this hearing, and I just got to look at the waves and didn't get to enjoy them at all this weekend, so we're here getting our work done.

Let's just talk about the mark to market. We developed a concept based on the Enron model of how to address Enron. Now, would you agree that when it applies to mortgage-backed securities, when there's real estate involved, the existing or the traditional accounting process with mark to market really didn't reflect the real value, the real assets, and the real situation on the ground and gave an artificial appearance of volatility that scared the hell out of the market in a lot of ways that maybe it shouldn't have.

Mr. SULLIVAN. I would agree with that statement.

As I testified, sir, I think what occurred was when FAS 157 of mark-to-market accounting was put in place, you know, it was really the ability to mark to market in an illiquid market when there is no visible valuation. And again, maybe it's helpful if I can just give an example. It's like owning an apartment block. And the valuation of that apartment block goes up and down. But all of the tenants, you're the owner of that building, and you've got it fully occupied. Everybody is paying their rent on time. You can pay your mortgage, and you can pay your—any capital expense you have in repairs or whatever. And you don't have to sell that building. You can hold it for as long as you want. It doesn't really matter what the valuation of that building is because you can hold it, and you'll get in all the cash that you need in from that.

And what's occurred in the illiquid markets is that you're trying to value assets that are still paying their rent, they're still providing you with the cash-flow that you need, but there isn't a valuation that—you know, response to that in an illiquid market. And that was the point—that's a very simplistic example. But that was the point I was trying to make about the unintended consequences.

Mr. BILBRAY. So, in other words, our theory of trying to go in and correct the Enron, we need to go back and readdress it because we've moved too far the other way to where it doesn't reflect the reality. And I think one of the things a lot of people were interested in those mortgage-backed securities because they always knew that there was real estate involved, but the accounting process doesn't reflect that reality.

Mr. SULLIVAN. Well, I think, obviously, as I said, it wasn't a criticism of FAS 157. I think there was an unintended consequence that I am pleased that Congress and the SEC have agreed to at least take a look at.

Mr. BILBRAY. Thank you, Mr. Chairman.

Chairman WAXMAN [presiding]. The gentleman's time has expired.

Mr. Tierney.

Mr. TIERNEY. Thank you, Mr. Chairman.

Gentlemen, I think people are a little bit baffled here. We look at Mr. Greenberg's testimony, and it's not his fault; according to him, it all happened after his watch.

Mr. Sullivan, you say no mistakes were made as events unfolded.

Mr. Willumstad, you say AIG couldn't have done it any differently.

And yet I think that people really expected the management of the company, you as the leaders of the company, would have seen what risk you were taking and been able to just know what they were and assess them.

We took a look at the internal minutes from your audit committee meetings. They're not public, but we were able to get them. They seem to tell a different story on that. And let me just go down.

On January 15th, the audit committee minutes say this: Ongoing discussions revealed that PricewaterhouseCoopers believes to be an expectation gap among key parties, including the board, management and the internal control functions.

The next month, on February 7th, the audit committee meeting: PWC warns the role or reporting of risk management needs a higher profile at AIG.

At a February 26th meeting: PWC says, indicated that the process at AIG seemed to break down and that, unlike other companies where there was a good dialog and appropriate levels of management on the approach, alternatives considered and key decisions, at AIG, only AIG-FP, the Financial Products Division, was involved in a December valuation process.

And that may have something to do with the chairman's letter that he received from Mr. St. Denis that he brought it to people's attention, and he couldn't get by that office over there.

Then you have March 10, 2008, you get the Office of Thrift Supervision. They weigh in on this, and they say that your management of the company and your oversight of AIG subsidiaries, including in particular the Financial Products Division led by Mr. Cassano, should be criticized. And they also say that supervisory concerns regarding the corporate oversight of key AIG's subsidiaries exist, and they write that we are concerned that corporate oversight of AIG Financial Products lacks critical elements of independence, transparency and granularity.

And the next day, PricewaterhouseCoopers reports that there is a common control issue, the root cause for these problems, and that AIG does not have the appropriate access or clarity around the roles and responsibilities of critical control functions.

Gentlemen, that seems to stretch from January 15th all the way to March 11th, your own internal audits, your own PricewaterhouseCoopers group and the Office of Thrift Supervision repeatedly saying the serious lapses are there. They describe them, both the auditors and the regulators. Don't you think that management has some responsibility for what went on here?

Mr. Willumstad.

Mr. WILLUMSTAD. Yes, management has some responsibility.

Mr. TIERNEY. Mr. Sullivan, do you agree?

Mr. SULLIVAN. Yes, I would also say that, at the same time, we were putting compensating controls in place. You read the chronological list there, but we had put compensating controls in place that enabled us, obviously, to issue our financials for 2007 with a clean audit.

Mr. TIERNEY. I guess the problem is, people expect management to be ahead of the curve, not to wait for the regulators and PricewaterhouseCoopers to start blowing the whistle late. The salaries that you gentlemen pulled down, you and your team on that, means to us that you anticipate these things and that you start putting those things in place before the whistle is blown, before these people come in and point out the seriousness of the situation.

And I think that's what disturbs people on this and what continues to be a theme through here that it's not—and Mr. Chairman, I would like unanimous consent to put copies of the audit reports and the minutes, as well as the Office of Thrift Supervision letter of March 10, 2008, in the record, because I think it shows clearly that this is not something that external factors are responsible for solely on this; it's a fundamental failure here of management. And I'm glad that you both take responsibility for it. I hope your whole management team does, because certainly the price is extremely high on that.

Chairman WAXMAN. Without objection those documents will be made part of the record.

Mr. SULLIVAN. Can I just respond on one point?

One of the things that we set out to do in March 2005 was to make tremendous investments in a number of areas that previously had been underinvested. So we added a lot of staff in internal audit and legal compliance, risk management etc. So I wanted you to at least know there were compensating controls put in place.

Mr. TIERNEY. And I appreciate that, if I may, Mr. Chairman, except these are reports from January, February and March 2008. So, obviously, not enough had happened even remotely close to settling the qualms of the regulators and the auditors on that. So I think it shows some management issues there.

Chairman WAXMAN. And if the gentleman will yield to me. And Mr. St. Denis, who was working for you to alert you to these problems, tried to get through in November 2007, and neither of you remember him complaining or know anything about his concerns. So you did have an alarm, even in the previous year.

Mr. Turner, I think you're next.

Mr. TURNER OF OHIO. Thank you, Mr. Chairman.

Yesterday we had a hearing concerning Lehman Brothers, and there was a discussion that Lehman Brothers had it's own subprime lender, BNC Mortgage I believe it was, where they were issuing subprime loans. With AIG, my understanding is that you were an insurer and you also traded mortgage-backed securities. I'm not certain, though, did you also have a lending function of subprime mortgages? And also, then, did you package loans, issuing them, selling them as mortgage-backed securities. In the subprime crisis that we're seeing, what activity in the subprime market did AIG have?

Mr. SULLIVAN. We did have a—they do have—sorry. It is hard to differentiate when you've been there 37 years. AIG does have a consumer finance that's called AIG.

Mr. TURNER OF OHIO. Then you also packaged and sold those loans as mortgage-backed securities; you also traded in them.

Mr. SULLIVAN. What I was going to point out is that fortunately, AGF did not participate in, it is my understanding, any of the exotic mortgage products during that period of time and didn't participate in lending in what we're seeing to be the hot markets that we now discover. So whilst their results have not been at the level that we would normally expect them to be, they have not been as bad as others in their industry.

Mr. TURNER OF OHIO. Because the first panel indicated that you were invested heavily in subprime mortgages. So that's direct. That's not mortgage-backed securities. That's in the mortgages themselves?

Mr. SULLIVAN. I'm sorry, sir, I don't quite understand the question.

Mr. TURNER OF OHIO. The first panel indicated that part of AIG's problems were that your financial services institutions invested heavily in subprime mortgages. In what form was that investment held?

Mr. SULLIVAN. Again, I think that's the clarity that's required. These are super senior credit default swaps. These are the transactions that AIG-FP participated in, so there are—and we've made very, very fulsome disclosure on this. In fact, we've been complimented by the investment community and others about the fulsome disclosure that we've made. It's all on our Web site and has been for many quarters. Is that they were effectively insuring, and I'm no expert on this, but effectively insuring the super senior level of the transaction. So there are tranches of bonds, the CDOs below that, whether they are equity, triple B, double A minus, double A, triple A, and then there's another layer of protection before you get to the super senior. And what you're doing, and again, I'm no accountant, but you're valuing the assets that are underlying the super senior transaction. So that's, what FP wrote was a super senior credit default swap portfolio.

Mr. TURNER OF OHIO. My concern that I have mentioned in many of these hearings is—I'm from Ohio. We're one of the leaders in foreclosures. You can go drive through neighborhoods in my community, and you can see the abandoned houses that are there. Our experience has been that predominantly these are a result of refinances where the loan, ultimately where the consumer gets in trouble, the value of the loan exceeds the value of the house at origination; that there are terms many times capitalization of the fees. There are terms that ultimately caused the home owners to get into trouble. Sometimes it's financial circumstances of the consumer that causes that they can't keep up with the payments. But usually, it's something to do with the mortgage product itself that causes the initial stress and a realization by the consumer that the mortgage value is higher than the house value itself. So they don't even have the ability to sell the home, which you would find in normal then real estate transactions, to escape their liability. They are in effect trapped and have the only recourse, not having the financial resources themselves to make up the gap, of abandoning the property, causing therefore the foreclosure because they're not able to keep up.

In the county in which I reside, it's about 5,000 foreclosures a year now in a community of about half a million people. The State of Ohio is experiencing somewhere around 80,000 a year. Every 3 years, that's a geographic size of one full congressional district.

It's been interesting listening to you, Mr. Sullivan, about your discussion of mark to market because I was actually, until you began talking about it, kind of leaning toward perhaps maybe it was a policy that was a problem. But after hearing your statement on giving bonuses based upon excluding losses and your statement of these aren't really realized losses, that mark to markets, as you said, unintended consequences followed, I'm beginning to think that the advocates for significantly reducing mark-to-market applications are trying to say that we shouldn't look at value without looking at current value, which is kind of like your bonus description.

So my concern here, though, is that if mark to market is a process that people get concerned with when markets fluctuate, if we have a situation where the loans are originated at a higher than the value, the mark to market on day one would tell you that the underlying mortgage security is not properly collateralized. In your discussions on the subprime effect, mortgage-backed securities, as you were saying with the swaps, did you ever have any discussions in your company where you heard that in fact some of these mortgages perhaps exceeded the value at loan origination?

I would like you both to answer.

Mr. WILLUMSTAD. Not to my knowledge.

Mr. SULLIVAN. Not to my knowledge, sir.

Chairman WAXMAN. The gentleman's time is expired now.

We go to Mr. Yarmuth.

Mr. YARMUTH. Thank you, Mr. Chairman.

I think it was Mr. Bilbray earlier asked a question if you knew why AIG was bailed out and not Lehman. I'm going to ask a little bit more direct question.

Mr. Willumstad, did Goldman Sachs have anything to lose if AIG went under?

Mr. WILLUMSTAD. Goldman Sachs was a significant counterparty for AIG.

Mr. YARMUTH. To what extent are the relationships intertwined, and how much do you think Goldman Sachs would have suffered financially? What kind of stake was there for Goldman Sachs and AIG's survival?

Mr. WILLUMSTAD. I can't tell you what losses Goldman Sachs might have suffered because I don't know. The only thing I can tell you is that Goldman Sachs was a counterparty on approximately $20 billion worth of credit default swaps that AIG-FP had.

Mr. YARMUTH. So it's a significant interest in AIG's survival it sounds like.

Mr. WILLUMSTAD. Again, I don't want to jump to that conclusion. I don't know how those securities carried on Goldman Sachs' books, and I don't know whether they were hedged by Goldman Sachs, so it would be very difficult to draw that conclusion.

Mr. YARMUTH. It sounds like a question we need to ask, Mr. Chairman.

Several comments have been made about the fact that AIG was too big to fail. And we saw, I think you were in the room earlier, when the statement of Alan Greenspan about size and the question of whether we let companies get too big. Clearly, by your own admission, in this case the implications of AIG's failure on the financial markets would be substantial. Is this something that troubles you, that companies are able to reach the size where they can disrupt an entire economy? And I guess the corollary question or the followup question is, what benefits to society, our society, get by letting a company get so big that it puts the entire Nation's financial system at stake or at risk?

Mr. WILLUMSTAD. I'm sorry, I'm not sure I understand the question.

Mr. YARMUTH. Well, I mean, you're running a company now, albeit for just a few months—Mr. Sullivan ran the company for several years—that apparently was so big that its failure went—the implications of its failure, potential failure went far beyond its shareholders and its employees, and that's why our government decided that it needed to step in, because of that impact. Do you think that it is good that corporations can get to that size in our economy where their mistakes don't just affect them? And do you think there are benefits—you know, if we're going to allow companies to get that big, that their failures and their mistakes can affect all of us, then what does society get in return for allowing the company to get so large?

Mr. WILLUMSTAD. Well, again, I think the size of AIG and the interconnection between AIG and the rest of the capital markets are really the issue. I'm not sure purely size by itself is the determinant factor. I would say also that there have been plenty of benefits to AIG's size, its ability to serve broad markets, to provide a competitive marketplace so customers and policy holders can get a good deal if you will, that AIG was a strong well-capitalized insurance operation that provided many benefits to its customers and consumers that did business with it.

Mr. YARMUTH. And then that's the question I was asking, because we see this now in—we've seen it in many situations recently where companies that are so large that their failures just impact taxpayers throughout the system. And I think the question we have to ask as a society is, are the benefits of that size, whether it's a competitive—whether it's competitive pricing or whatever, adequate to justify the risk of a company disrupting, a company making a mistake and disrupting the entire economy. But that's something that's a little bit of a, I guess a 30,000-foot issue in this particular case. Just a quick question again. We've had some testimony about the fact that only $60 billion has been drawn down of the $85 billion. What specifically was the $85 billion needed for?

Mr. WILLUMSTAD. The $85 billion number was a number that was obviously determined by the Federal Reserve. The $85 billion, I believe, was intended to be a loan to cover liquidity needs inside the company. It's been characterized before as covering losses which I think is not an accurate representation. Again, the loan was taken down after I left the company, so I can't be specific about it. But what happens in a crisis of confidence like this and what was happening to AIG was not a question of losses. AIG has had a lot of money borrowed over the years. And when you go through one of these crises, people who have loaned you money in the past stop lending to you. People who give you money or put money on deposit with you want it back; that in another environment, without this crisis of confidence, AIG could have easily met all of those obligations. But when you have a series of counterparties who have decided for reasons of concern about the viability of the company stop doing business with you, the company can no longer meet its obligations.

It's not very much different that if all the consumers of a particular bank showed up 1 day and asked for all of their money back, there's no bank in America that could provide that. Those dollars of deposits that were given to that bank are loaned out in the communities to small businesses, consumers, credit cards. The whole system is driven around confidence and viability. And once that breaks down, there is no company, certainly in the United States and I think anywhere around the world, that can sustain a run on the institution.

Chairman WAXMAN. The gentleman's time has expired.

Ms. Watson has requested that she be recognized next. Does anybody object to that? If not, the gentlelady is recognized.

Ms. WATSON. Thank you so much, Mr. Chairman.

I think you just about answered my question, but it's about the $85 billion, Mr. Willumstad, that has been given to bail out. And as I understand, last Friday, AIG reported it had already drawn down $61 billion of the $85 billion loan. Does that align itself to what you were just describing, that people want their money now?

Mr. WILLUMSTAD. Again, I don't know what the use of the $61 billion was for because I wasn't there. I'm not there. But I would say, generally speaking, my assumption would be that's exactly what it was used for.

Ms. WATSON. In fact, AIG has drawn down the funds so quickly that credit rating agencies have now begun downgrading AIG again. And back on September 16th, AIG said that the bailout would prevent further rating downgrades. And we know that you're not at the company anymore, and I'm sure you're surprised by how quickly the $85 billion line of credit has been consumed. So one question that my constituents, and I'm sure that all American taxpayers, are asking, can you explain or try to how AIG could burn through $61 billion in just 3 weeks?

Mr. WILLUMSTAD. Well, again, I don't know what the source for the use of that money was. But I'm assuming that counterparties who would normally lend money to AIG are no longer lending money to AIG, and consequently that's where the money is going.

Ms. WATSON. The new CEO of AIG, Edward Liddy, publicly suggested that AIG might take a piece of the $700 billion bailout package that we just passed. So that would be in addition to the $85 billion that AIG already received. And my question would be to those who can look forward down the economic road, when is this going to end? Will it end? How much are we going to have to spend of the taxpayers' money to keep AIG afloat? Would you have any idea now that you're not actively with the company?

Mr. WILLUMSTAD. I'm sorry, but I do not.

Ms. WATSON. OK.

Well, I appreciate the going out of line, and I appreciate the gentleman coming here and being straightforward. A little honesty would help us very much.

Thank you so much, Mr. Chairman, for accommodating me.

Chairman WAXMAN. Thank you very much, Ms. Watson.

Mr. Braley.

Mr. BRALEY. Thank you, Mr. Chairman.

Mr. Sullivan and Mr. Willumstad, I would like to ask you about the compensation paid to one particular AIG employee Joseph Cassano. Mr. Cassano was president of AIG's Financial Product Division, the unit that sold the credit default swaps that helped bring down AIG. During his tenure at AIG, Mr. Cassano repeatedly denied that these swaps posed any risk to AIG or its shareholders.

And I'm going to quote to you from a September 28, 2008, article in the New York Times by Gretchen Morgenson which attributes this comment to Mr. Cassano in August 2007: "it is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing $1 in any of these transactions."

The committee has examined Mr. Cassano's pay, and we were shocked to find that AIG paid him more than it paid its CEOs. Over the last 8 years, he earned a total of $280 million in cash, and most of that money came from a bonus program. For every dollar that Mr. Cassano's unit made $0.30 came back to him and the other Financial Products executives.

On February 28, 2008, AIG posted losses of $5.3 billion. The main reason for these losses was the $11 billion lost by Mr. Cassano's division. The very next day, February 29th, Mr. Cassano was terminated from his position as president of the Financial Products Division. But when AIG terminated Mr. Cassano, it took two actions that, quite frankly, are hard for your new partners, the U.S. taxpayers, to comprehend. First, AIG let him keep up to $34 million in uninvested bonuses. And second, the company amazingly hired Mr. Cassano as a consultant for the sum of $1 million a month.

So, Mr. Willumstad, let me start with you. As CEO of AIG, you had authority until September 17, 2008, to cancel Mr. Cassano's consulting agreement for cause, but you never did that, did you?

Mr. WILLUMSTAD. No.

Mr. BILBRAY. Mr. Sullivan, as CEO for AIG during the period from March 11, 2008, when this severance agreement was signed between AIG and Mr. Cassano, through June 15, 2008, you had authority to cancel Mr. Cassano's consulting agreement for cause, but you never took that action, did you?

Mr. SULLIVAN. That is correct.

Mr. BILBRAY. Mr. Chairman, I'm going to offer as part of the record the consulting agreement of March 11, 2008, which provides the CEO of AIG to terminate the consulting agreement for cause.

And I certainly think that in light of what we've heard here today there was ample justification based upon the misrepresentations made by Mr. Cassano and based upon the financial peril he created for this longstanding company of great reputation and our entire financial marketplace, that option should have been exercised and something should have been done for the taxpayers of the United States.

Chairman WAXMAN. Without objection, the document will be made part of the record.

Mr. BRALEY. And Mr. Chairman, I agree that this is not a partisan issue. But there have certainly been some partisan comments made about the investigation by this committee of Fannie Mae and Freddie Mac.

And I would just like to read for the record a portion of a Financial Times article dated September 9, 2008, titled, "Oxley Hits Back at Ideologues." This is an article interviewing the former chair of the House Financial Services division, Mike Oxley, who, instead of blaming Fannie Mae and Freddie Mac, headed the Financial Services Committee and blames the mess on ideologues within the White House as well as Alan Greenspan, former chairman of the Federal Reserve. In fact, he talked about the GSE reform bill that passed the House overwhelmingly in 2005 and could have prevented the current crisis.

And here's what he says: "all the handwringing and bedwetting going on now without remembering how the House stepped up on this, he says, what did we get from the White House? We got a one finger salute."

And finally, he says, we missed a golden opportunity that would have avoided a lot of the problems we're facing now if we hadn't had such a firm ideological position at the White House and the Treasury and the Fed, Mr. Oxley says.

And I would offer that as part of the record as well.

Chairman WAXMAN. Without objection, that will be made part of the record.

[The information referred to follows:]

Oxley hits back at ideologues

Financial Times
By Greg Farrell in New York
Published: September 9 2008 19:25 | Last updated: September 9 2008 19:25

In the aftermath of the US Treasury's decision to seize control of Fannie Mae and Freddie Mac, critics have hit at lax oversight of the mortgage companies.

The dominant theme has been that Congress let the two government-sponsored enterprises morph into a creature that eventually threatened the US financial system. Mike Oxley will have none of it.

Instead, the Ohio Republican who headed the House financial services committee until his retirement after mid-term elections last year, blames the mess on ideologues within the White House as well as Alan Greenspan, former chairman of the Federal Reserve.

The critics have forgotten that the House passed a GSE reform bill in 2005 that could well have prevented the current crisis, says Mr Oxley, now vice-chairman of Nasdaq.

He fumes about the criticism of his House colleagues. "All the handwringing and bedwetting is going on without remembering how the House stepped up on this," he says. "What did we get from the White House? We got a one-finger salute."

The House bill, the 2005 Federal Housing Finance Reform Act, would have created a stronger regulator with new powers to increase capital at Fannie and Freddie, to limit their portfolios and to deal with the possibility of receivership.

Mr Oxley reached out to Barney Frank, then the ranking Democrat on the committee and now its chairman, to secure support on the other side of the aisle. But after winning bipartisan support in the House, where the bill passed by 331 to 90 votes, the legislation lacked a champion in the Senate and faced hostility from the Bush administration.

Adamant that the only solution to the problems posed by Fannie and Freddie was their privatisation, the White House attacked the bill. Mr Greenspan also weighed in, saying that the House legislation was worse than no bill at all.

"We missed a golden opportunity that would have avoided a lot of the problems we're facing now, if we hadn't had such a firm ideological position at the White House and the Treasury and the Fed," Mr Oxley says.

When Hank Paulson joined the administration as Treasury secretary in 2006 he sent emissaries to Capitol Hill to explore the possibility of reaching a compromise, but to no avail.

Chairman WAXMAN. Will the gentleman yield?

Mr. BRALEY. Yes I would.

Chairman WAXMAN. Why didn't you fire Mr. Cassano? You had the ability under the rules under which your corporation operated to fire him. And he's been kept on at a million-dollars-a-month retainer. He was discharged. Why didn't you fire him?

Mr. Willumstad.

Mr. WILLUMSTAD. Well, again, I was not the CEO at the time. Mr. Sullivan had recommended to the board and the compensation committee that Mr. Cassano's assistance in helping unwind, if you will, or work down the exposure in FP would be valuable to the company and that, as part of his agreement, he would have a noncompete, nonsolicitation agreement. It was important to keep the existing employees in FP to help work through the sizable exposure.

Chairman WAXMAN. You were the chairman of the board.

Mr. WILLUMSTAD. I was.

Chairman WAXMAN. And you could have insisted that he be fired, but Mr. Sullivan told you not to fire him so he wouldn't go out and compete with you. I would have thought you would want him to go to some other corporation the way he had put yours so deeply in the hole.

Mr. Sullivan, why didn't you fire him?

Mr. SULLIVAN. I recommended that course of action to the board, and Mr. Willumstad articulated the reasons very well.

One of the things that I wanted to ensure is that we retained the 20-year knowledge that Mr. Cassano had about the businesses. These are long-term transactions. These are not transactions that go on the books and expire 12 months later. They're very long term, and you want to make sure that the key players and the key employees within AIG-FP, that we retain that intellectual knowledge.

Chairman WAXMAN. What would he have to have done for you to feel that you should fire him? He put you in a situation where you had to come up with $60 billion immediately, and you couldn't do it. Isn't that enough reason to feel that the guy shouldn't be kept on at a million-dollars-a-month salary just to be available?

Mr. SULLIVAN. Well, at the time, you know, obviously, we made that decision. Mr. Casanno decided to retire, and I believed—and I made the recommendation, as Mr. Willumstad articulated, that his services be retained and——

Chairman WAXMAN. When I retire, I want to come to work for you at $1 million a month. What a good deal that is. And what a good signal that is. The man goes out on his own in these derivative deals that bring down AIG, and he gets $1 million a month retainer in case you need his advice. Is that what you're telling us?

Mr. SULLIVAN. Well—and, in addition, Mr. Willumstad articulated all the reasons there, that he had a noncompete nonsolicitation so that we could retain the key employees in AIGFP, bearing in mind these are multi-year contracts. This wasn't the entirety of FP's businesses. There were other sectors that they were in as well.

Chairman WAXMAN. Ms. Norton, I think you're next on the list.

Ms. NORTON. Thank you, Mr. Chairman.

I'd like to ask both of you questions about your statements as the company was collapsing. Because it didn't suddenly fall, suddenly collapse. Mr. Sullivan, let me ask you first.

In December 2007, you said the following: We believe we have a remarkable business platform with great prospects that represent tremendous value. How many superlatives in that sentence? And then you posted $5.3 billion in losses for the quarter. That was December.

Move just a few months to February 2008, and then you said, based upon our most current analysis, we believe that any credit impairment losses realized over time by AIGFP would not be material to AIG's consolidated financial condition. Then you went on to post $7.8 billion or more in losses for the quarter.

A few months later, May 2008, you said, "sir—the underlying fundamentals of our core business remain solid." The next month the board voted to replace you.

Let me ask you, Mr. Sullivan, what was the source of those glowing statements as you were posting loss after loss, quarter after quarter?

Mr. SULLIVAN. Well, I think, because you made a reference to a number of statements there, I need to break down my answer, if I may.

First of all, my reference to the corporation is talking about AIG's global franchise. Because, obviously, AIG is in a number of businesses, not just the super senior credit default swap arena. Obviously, we have leading market positions in many other businesses. I'm talking current. I keep on saying "we." I'm no longer there, but for 37 years I was there. They have market leading positions.

Ms. NORTON. Of course, there were the credit default swaps that were collapsing your fundamental business. Go ahead, sir.

Mr. SULLIVAN. That's correct. But I'm just trying to clarify some of my remarks, because you've taken—there's different topics being covered there.

So one is referring to the core franchise and the market leading positions that AIG holds in a number of businesses around the world. The other comment is trying to differentiate between the realized loss potential of that portfolio as against the unrealized loss potential.

As I mentioned earlier, at the time I left the company, to the very best of my knowledge, certainly to the best of my knowledge at the end of the first quarter, I don't believe AIG had suffered any realized losses. That's not to say they wouldn't suffer realized losses as the market continued to deteriorate; and, in fact, we made very fulsome disclosure. As I mentioned earlier, we had a tremendous amount of information on our exposures to the U.S. residential housing market on our investor Web site.

Ms. NORTON. Would not be material—credit losses realized over time would not be material to AIG's consolidated financial condition.

Mr. SULLIVAN. Based on what I knew——

Ms. NORTON. That is a pretty blanket, across-the-board statement. That's a pretty across-the-board, blanket statement.

Mr. SULLIVAN. But I was trying to differentiate there, to the very best of my knowledge, the difference between the realized loss situation or the potential realized loss situation against the amount of unrealized loss——

Ms. NORTON. It didn't occur to you, Mr. Sullivan, that in parsing your words this way that you might be misleading your shareholders?

Mr. SULLIVAN. Absolutely not.

Ms. NORTON. Do you think any of them were misled?

Mr. SULLIVAN. No. I would refer you—and I'm sure you've been supplied with this information—very, very fulsome disclosures of our exposures not only in the CDS portfolio but in our mortgage insurance company which was clearly causing me some concerns in the early part of this situation when the issue was——

Ms. NORTON. Well, you had departed very substantially from your core business. Are you saying to me that you believe your shareholders expected to be bailed out by the Federal Government at some point?

Mr. SULLIVAN. Certainly not. As I testified earlier, when I left the company I believed the company was in a position where it would certainly not need intervention from the government. But when—if I may go back to the disclosures that we made, one of the things that I set out to do in March 2005, given the challenges that we had with all of our regulators, we had——

Ms. NORTON. You mean disclosures of the losses?

Mr. SULLIVAN. No, no. When I took office, AIG was facing, as I mentioned, a crisis very different from the financial crisis. But I made it clear at day one that we were going to have an open and transparent relationship not only with our regulators but with our investors as well. We put very fulsome—I would encourage you to look at that information—we have put very fulsome disclosure on our Web site.

Ms. NORTON. So you believed these were fair and honest characterizations and that your shareholders were not misled by any of the three statements even after they saw the losses posted?

Mr. SULLIVAN. Absolutely. I believe what I said at the time to be truthful, very truthful based on all the information I was receiving and clarifying, you know, the difference between realized and unrealized losses.

Ms. NORTON. Mr. Chairman, I'm going to yield back the balance of my time.

But my question went to misleading; and I must say, in concluding, that it's difficult for me to believe that shareholders were not misled at least by the way in which you parsed your words and framed the condition—phrased the condition of the company.

Thank you, Mr. Chairman.

Chairman WAXMAN. The gentlelady yields back the balance of her time, and I now recognize Mr. Van Hollen.

Mr. VAN HOLLEN. Thank you, Mr. Chairman.

Gentlemen, I want to followup on some of the questions regarding executive compensation, including the bonus structure. And, Mr. Sullivan, let me start with you and ask about your actions at the meeting of the AIG compensation committee that took place on March 11, 2008.

According to the documents that this committee has received, AIG has two bonus programs to reward executive performance. The first is called the Partners Plan. It covers the top approximately 700 AIG executives. And the second is called the Senior Partners Plan, which applies to roughly the top 70 executives. Now, as CEO, you're paid under both those executive compensation plans, is that right?

Mr. SULLIVAN. That is part of my compensation.

Mr. VAN HOLLEN. Now as I understood it and looked at the rules that AIG had set, they tried to align pay with good performance. Rewards were supposed to be based on the company's performance. If performance went down and the company lost money, bonuses would be reduced or cut entirely. That was what was supposed to happen in 2007. And as a result of the disastrous fourth quarter results in 2007, bonuses under both those plans would have been cut under the normal rules.

But according to the minutes of the meeting that took place on March 11th, the meeting of the compensation committee, you personally urged the board to rewrite the rules. And according to the minutes—and I don't know if we're going to post them on the board. We had them earlier. But let me just read from the minutes of that meeting.

It said, Mr. Sullivan next presented management's recommendation with respect to the earnout for the senior partners for the 2005–2007 performance period, suggesting that the AIGFP unrealized market valuation losses should be excluded from the calculation.

I think it's important to point out that just weeks earlier, on February 28th, AIG just posted a record fourth quarter loss, as we've heard about, of $5.3 billion as a result of the AIGFP division. My question is very simple. You have referred to the unintended consequences. The question is, why did you change the rules, the compensation rules that were supposed to pay for good performance? Why did you change them to give yourself and other executives a bigger bonus?

Mr. SULLIVAN. If I may, just for clarity, this was not the bonus structure for AIG. These were long-term compensation programs for AIG executives. So just to clarify that for you, sir.

And, second, I was not asking the compensation committee to rewrite the rules. I was asking them to use their discretion, which I believe existed under both programs.

Coming back to—I testified earlier or responded earlier that my concern was that these 700 people that participated in the Partners Plan and the 70 in the senior Partners Plan, none of them were in AIGFP. They had their—as others have mentioned—their own compensation plan. And my concern was that, you know, other parts of the business that were not being impacted by the events in the credit markets, you know we would lose key individuals if we didn't at least acknowledge in their remuneration, which was a long-term remuneration. They didn't get their money until some time later——

Mr. VAN HOLLEN. If I could ask, you, I understand, despite the fact that you left approximately June of this year, you received the $5.4 million bonus, isn't that right? Is that not correct?

Mr. SULLIVAN. The reference to a bonus—if that was a number under the Senior Partner Plan, I don't have the numbers in front of me. That may be the number, but it's not referred to as a bonus.

Mr. VAN HOLLEN. But you received this payment under the Senior Partners Plan, did you not?

Mr. SULLIVAN. It's paid out over a number of years.

Mr. VAN HOLLEN. The question's pretty clear. Your company had just taken a record loss. Pay for performance is supposed to be based on how the company performed. And yet you went before the board of directors and specifically asked them to ignore those losses for the purpose of a compensation plan which had the direct result of giving you about $5.3, $5.4 million extra compensation.

If I could just ask you, Mr. Willumstad, because the minutes say you were present——

Mr. WILLUMSTAD. That's correct.

Mr. VAN HOLLEN [continuing]. At this particular compensation meeting. I have to ask you, in your role as a fiduciary to the stockholders, how does that payment, including the payments to Mr. Sullivan and the other executives, ignoring the losses that had just taken place, how does that conform to the rules for pay for good performance? And how does that benefit any stockholder?

Mr. WILLUMSTAD. If I could clarify some of the things you said. There are actually three components to the incentive compensation plan for Mr. Sullivan. It was the Partners Plan, it was the Senior Partners Plan and there was a discretionary bonus. Mr. Sullivan received a $9 million discretionary bonus in 2006 when the company had an exceptional year. Mr. Sullivan's bonus was reduced to in 2007 from $9 million to $2.5 million. So to put——

Mr. VAN HOLLEN. I understand that, Mr. Willumstad. I'm referring to a particular request that was made at the board meeting with respect to the senior partners program. And the request was made and complied with by the board, accepted by the board at a time of record loss. And my question is very simple. How did that decision help the shareholders at this particular point in time, which is the responsibility of the board, is it not?

Mr. WILLUMSTAD. The Senior Partners Plan was a plan that recognized the performance over a 3-year time period. 2007 was one of those 3 years. Mr. Sullivan's recommendation was to postpone the recognition of those losses because they were deemed to be unrealized losses. The understanding that the committee had and the board had is that, as Mr. Sullivan mentioned, there were 70 employees who were part of the Senior Partners Plan, none of which had anything to do with the FP operations. It was only Mr. Sullivan who had any direct responsibility for that. So his intention and I think the board's response was not to penalize the other 68 or 69 employees for the result of one business unit.

Mr. VAN HOLLEN. Well, Mr. Chairman, just to conclude, I mean, it seems that pay for performance means you get paid whether it's bad performance or good performance and you change the rules when it doesn't work out the way you intended. If that's what part of the unintended consequences of this have been, I've got to say a lot of people are scratching their heads when they look at how in good times you stick with the general scheme for pay for performance but in bad times it gets reinterpreted in a way that benefits executives. Anyway——

Chairman WAXMAN. Would the gentleman yield to me?

Mr. VAN HOLLEN. I would be happy to yield.

Chairman WAXMAN. Just so we can get this straight, Mr. Sullivan, you were the CEO of the whole company, which included the FP in London, right?

Mr. SULLIVAN. That is correct.

Chairman WAXMAN. OK. And when it came to the question of the bonuses for the 70 employees, which included you, you asked the board, upon which Mr. Willumstad sat as the Chair, to disregard the losses so that 3-year bonus wouldn't be reduced. Is that right?

Mr. SULLIVAN. What I recommended to the compensation committee was that for the purposes of the Senior Partners Plan and the Partners Plan that they use their discretion in the calculation of the 2007 year, particularly——

Chairman WAXMAN. Not to count the losses. Just to count the earnings but not the losses.

Mr. SULLIVAN. The unrealized losses.

Chairman WAXMAN. The unrealized losses. Now isn't it also the case that AIGFP changed the rules as well so that the bonuses there did not calculate the losses, unrealized as they might have been?

Mr. SULLIVAN. Um——

Mr. WILLUMSTAD. I don't think that's correct.

Chairman WAXMAN. Well, I have a document that says so. This is the minutes of the meeting of the Compensation Management and Resources Committee of the board of directors. And it says—explained that AIG's Mr. Dooley presented management's recommendation and explained that AIG management believes it is critical to provide a special incentive to assure retention of the AIGFP team, while recognizing the serious effects of the valuation losses and described the proposed terms of the alternative arrangements.

Then it goes on to say, no individual received compensation exceeding $1.25 million and employees affected by the reduced compensation would be eligible for the deferred compensation.

It just—that's the way we read this document. I'll put it into the record, and we'll be able to look at it.

But you've got this FP—you've got the bonus. You've got the 3-year partners compensation. Did you get an ordinary salary as well?

Mr. SULLIVAN. Yes, sir.

Chairman WAXMAN. And how much was that?

Mr. SULLIVAN. $1 million a year.

Chairman WAXMAN. So you got $1 million a year. Then you got a bonus that was reduced from $9 million to $2.5 million, is that right?

Mr. SULLIVAN. That's correct, sir.

Chairman WAXMAN. Then what else did you get?

Mr. SULLIVAN. My participation in the Senior Partners and the Partners Plan.

Chairman WAXMAN. And how much money was that for that period of time?

Mr. SULLIVAN. I can't recall.

Chairman WAXMAN. Take a guess. More than $1 million? More than $2 million?

Mr. SULLIVAN. I think my colleague here mentioned $5 million. Yeah. I don't have the schedule in front of me.

Chairman WAXMAN. We'd like to get it for the record.

Let me tell you one person that didn't get a bonus while everybody else was getting bonuses. That was St. Dennis—Mr. St. Dennis, who tried to alert the two of you to the fact that you were running into big problems. He was blocked by the people in London from even understanding what was going on so he could report to you. He quit in frustration, and he didn't get a bonus.

So the one guy that was really trying to do his job—and there may have been others as well—lost out on his bonus completely and was frustrated and felt he couldn't do his job, so he left.

I thank the gentleman for yielding.

Mr. SULLIVAN. May I suggest, Chairman, with respect that the company clarify the content of the compensation committee's reports so that you have an understanding? My view, obviously, and I think Mr. Willumstad may concur, was that was actually penalizing the FP folks at the time and trying to put a compensation structure in place that they would get rewarded as and when the marks came back.

Chairman WAXMAN. That's not our understanding from the document.

Mr. SULLIVAN. That's why I suggest, sir, for the subject of clarity it may help if the company explained it.

Chairman WAXMAN. Whatever penalties you imposed upon them, it's hard to see how difficult it is when you have Mr. Casanno not doing any work but getting $1 million a month in case you need him in addition to whatever else he got by way of bonuses and salaries and other money sharing agreements. This is really quite a good deal.

Mr. VAN HOLLEN. Mr. Chairman, I would just say—I mean, obviously, as CEO, you oversaw the whole FP division as well; and yet you received a bonus despite the fact that they had these huge losses. And so, again, it's just people have to scratch their heads and wonder what pay for performance means when you have that kind of compensation structure and going before the board.

Anyway, my time is up. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you.

Mr. Sarbanes.

Mr. SARBANES. Thank you, Mr. Chairman.

I'm just fascinated by this guy Joseph Casanno, because it appears to me that he single-handedly brought AIG to its knees and was the reason that taxpayers have had to step in with an $85 billion loan. So——

Mr. SHAYS. Mr. Sarbanes, could you speak a little louder?

Mr. SARBANES. Yeah. I was just talking about Joseph Casanno. Is your office in New York?

Mr. SULLIVAN. When I was with AIG, yes, sir.

Mr. SARBANES. Was in New York?

And your office was in New York?

Mr. WILLUMSTAD. Yes.

Mr. SARBANES. And Casanno's office was in London?

Mr. SULLIVAN. He spent his time between London and the Wilton offices, Wilton, Connecticut.

Mr. SARBANES. So how often would you see him?

Mr. SULLIVAN. Certainly at the FP board meetings and, obviously, occasionally when he was in town. He was not a direct report to me. He reported to Mr. Dooley, who was referenced earlier.

Mr. SARBANES. And how did—I mean, you weren't there, I guess, when the FP thing got started, right?

Mr. SULLIVAN. Well, I was certainly with AIG but in a completely different division, sir.

Mr. SARBANES. OK. You weren't heading the company up.

Mr. SULLIVAN. No. This is 20-odd years ago.

Mr. SARBANES. What's the company lore on how that happened? Did Mr. Casanno come to the powers that be and say, I have this really neat idea of what we can do over in London. We can get into this new product line. And off he went? What's the story there?

Mr. SULLIVAN. Oh, no, no. I think from what I know—you say folklore, but from what I know is that a number of executives came out of Drexel and were recruited by AIG at that time to form the capital markets division that became known as AIGFP. I don't believe Mr. Casanno was leading that at the time. He was one of the team that came in, and there were some management changes thereafter where ultimately Mr. Casanno became the head of capital markets. But I think there were two other executives prior to Mr. Casanno who ran that division.

Mr. SARBANES. Well, you've probably heard me refer to that office in this hearing before as the London casino, because I think that terminology captures as well as anything what was happening over there.

What I can't understand is why you were allowing these huge losses to buildup with apparently no consequence for Mr. Casanno. So I'm just curious, in December 2007, Mr. Casanno is telling the investors, with the data that you have in front of you, you can play this power game. And then, within weeks, AIG posts a loss of $5.3 billion. I assume most of that related to the activities of FP, right?

Mr. SULLIVAN. The unrealized loss, yes.

Mr. SARBANES. So when that happened—and this term "unrealized losses" which you are very careful to keep restating——

Mr. SULLIVAN. It's a loss.

Mr. SARBANES. Yeah. They turned out to be realized in a big way, it seems. Certainly the taxpayers are realizing these——

Mr. SULLIVAN. Just to clarify, at the time I left, as I said earlier, none of it realized. What has happened since, I don't know. But just for clarity.

Mr. SARBANES. I understand. So $5.3 billion. So then, obviously, you immediately get on the phone to Mr. Casanno and you say, what's going on over there at FP? Right?

Mr. SULLIVAN. Well, in the December——

Mr. SARBANES. I'm just assuming somebody calls him up or catches him the next time he's in town for a meeting and says, $5.3 billion of unrealized losses for the last quarter. What's happening over there, Mr. Casanno?

And what does he say that gives you comfort? Does he tell you the same thing he was telling the investors? Well, we've got all this data, and we can play this power game. So then you say, OK, fine, we'll keep you in there.

And then the next quarter he posts losses at $7.8 billion. And apparently that's still not enough for him to be put on the hot seat. So off he goes to the quarter after that and posts $5.5 billion of losses.

I just don't understand, in terms of the company and your stewardship of the company, how you can let this guy run up these huge losses, apparently with no consequence to himself in terms of the compensation. So just internally what was going on during that period? What was the discussion with Mr. Casanno?

Mr. SULLIVAN. Well, clearly, at the time of December 2007, there was a lot of discussion taking place within the organization on the whole issue of the CDS super senior portfolio. There's no question about that.

Don't forget—and I just want to point out that this business, that's been stopped writing in 2005. So effectively this portfolio was in run-off. These contracts were mature over a period of time. And as I said earlier, as they mature, if there's no loss, you know, on those contracts, that unrealized loss will then come back into the income statement of AIG. So I mean that's the point I wanted to make here. This business was stopped in 2005. I think that's an important thing.

And, clearly, in December 2007 a lot of dialog is taking place between FP. There's additional resources going in there to make sure that we're—you know, we obviously have the compensating controls in there that I referenced to one of your colleagues earlier. So in December 2005, there's a lot of interaction taking place between FP and the corporation.

Mr. SARBANES. So what you're saying is by that time—by December 2007, when the losses first started appearing, it was too late. You were already on a downward slide. And yet Mr. Casanno, having set off that situation, is still getting paid $1 million a month?

Mr. SULLIVAN. What I'm saying is the portfolio stopped writing in 2005. And, obviously, as the credit market is starting to freeze and the subprime issues are coming through, then the losses started to emerge.

Chairman WAXMAN. The gentleman's time has expired.

Ms. Speier.

Ms. SPEIER. Thank you, Mr. Chairman.

To both of you gentlemen, I want to applaud you for the stiff upper lip that you have shown today under intense questioning. But I've got to tell you that you make a shameful profile of corporate America. To you, Mr. Willumstad, I will say thank you for foregoing your golden parachute. And to you, Mr. Sullivan, shame on you. The shareholders of that company have nothing, and you walked away with $50 million.

Now I'd like to ask a question of you, Mr. Willumstad. In the final days, evidently Goldman Sachs' CEO was in on meetings. Is that correct?

Mr. WILLUMSTAD. That's my understanding.

Ms. SPEIER. You were not in those meetings?

Mr. WILLUMSTAD. I was only at one meeting when the CEO of Goldman Sachs was there.

Ms. SPEIER. And he was there. And what was he saying?

Mr. WILLUMSTAD. This was a meeting that took place on September 15th at the Federal Reserve. The Federal Reserve had gotten Goldman Sachs and JPMorgan together to try and find a private solution to AIG's liquidity issues. That meeting was to discuss how much capital the company might need. That meeting lasted for about an hour and a half and then the meeting was adjourned.

Ms. SPEIER. So they weren't interested in a private solution?

Mr. WILLUMSTAD. I'm sorry?

Ms. SPEIER. The CEO of Goldman Sachs was not interested in purchasing AIG——

Mr. WILLUMSTAD. No. He was there to participate in looking for a private solution.

Ms. SPEIER. Now you said that Goldman Sachs was one of the counterparties——

Mr. WILLUMSTAD. Yes.

Ms. SPEIER [continuing]. Of AIG and that they are owed about $20 billion, is that——

Mr. WILLUMSTAD. No. No. As a counterparty, if the securities defaulted, AIG would have to pay that counterparty, Goldman Sachs, the amount of the insurance premium or the credit default swap.

Ms. SPEIER. So they would receive about $20 billion, though. I used that term earlier. You actually referenced that amount of money.

Mr. WILLUMSTAD. I did. That's the correct number.

Ms. SPEIER. Now AIG has since taken up the taxpayers on $61 billion. Has $20 billion of that $61 billion gone back to Goldman Sachs?

Mr. WILLUMSTAD. I don't know.

Ms. SPEIER. Mr. Chairman, I think that's a question we may want to ask subsequently.

Mr. Willumstad, do you believe that naked short selling was part of the problem?

Mr. WILLUMSTAD. Well, AIG stock was down to about $26 in June. Up until September 12th, AIG stock was at $23. So during the course of—from late June to early September, there was not much movement on AIG stock. In the last week from September 8th to September 15th, AIG stock went from $23 to $4. I actually don't know that it was necessarily driven by short sellers, although I would assume there's been some short selling in there.

Ms. SPEIER. The rating was AA on Friday, and 2 days later you needed a total bailout. How did you go from being AA on Friday to needing a total bailout 2 days later?

Mr. WILLUMSTAD. Well, the AA minus rating that was provided by S&P and Moody's was the ratings. I had met with the rating agencies actually the prior week and reviewed what our plan was. They were considering a downgrade at that time. And on Friday after 4 S&P put out a negative watch that indicated they might reduce their ratings anywhere from one to three notches. And then I believe it was the following Monday or Tuesday—I'm not sure exactly which—both rating agencies downgraded the company.

I'm not sure I've answered your question. But I'm not sure what your question is.

Ms. SPEIER. I was trying to understand how you can be rated as AA on Friday and the following week you need a $85 billion bailout. I don't know how you go from being—that kind of rating doesn't make sense to me.

Mr. WILLUMSTAD. You'd have to talk to the rating agencies about that.

Ms. SPEIER. All right. One last question, Mr. Chairman; and this gets back to Joseph Casanno. In August 2007, he says, it's hard for us with—and without being flippant to even see a scenario within any kind of realm of reason that would see us losing $1 in any of these transactions. It's a lot of bravado.

In December 2007, he said, we have from time to time gotten collateral calls from people, and then we say to them, well, we don't agree with your numbers. And they go, oh, and they go away; and you say, well, what was that? It's like a drive-by in a way.

Also in December—and this is a real difficult one to believe—he says, there are some morbid questions we get about what happens if the world rolls off its axis and the world goes to hell in a hand basket? But with the data that you now have in front of you, you can play this power game.

Mr. Sullivan, you were on that same call. You knew that the company was in trouble. You allowed Mr. Casanno to make these statements, and you didn't stop him. You didn't suggest that he was overstating the case.

Mr. SULLIVAN. Well——

Ms. SPEIER. Is that transparent? Is that what you should be doing on behalf of the shareholders of the company?

Mr. SULLIVAN. The December 5th meeting which you refer to there I think laterally we made a very fulsome presentation to the investor community on AIG's full exposure to the U.S. residential housing market and made reference to not only to AIGFP but our mortgage insurance company, our consumer finance company and our investments.

And I don't want to take any of Joe's comments out of context, but we've put a lot of information into—you know, made available a lot of information to the investor community at that time. And I don't want to take the comments he's making out of context without seeing the slides that he was referring to at that moment in time.

You know, obviously, what we told the market—what I truly believed was accurate at the time, based on all the information I had available.

Ms. SPEIER. I yield back.

Chairman WAXMAN. Thank you, Ms. Speier.

Mr. Shays, I want to recognize you to close out the questioning. But before I do, I ask unanimous consent that we can put in the record a letter that was sent today to Secretary Paulson.

This is a letter telling Mr. Paulson that we're concerned about the profligate spending at AIG, including the $1 million a month that's being paid to Mr. Casanno. Mr. Casanno received up to $34 million, and even today he's getting paid as a consultant for $1 million a month, and we think this is unfair to the taxpayers of this country. AIG received $85 billion of taxpayers' money, and it's lavishing these kinds of perks on Mr. Casanno and the event that was taking place shortly after the government took over.

Without objection, the letter will be entered into the record.

[The information referred to follows:]

ONE HUNDRED TENTH CONGRESS

Congress of the United States

House of Representatives

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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October 7, 2008

The Honorable Henry M. Paulson, Jr.
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Secretary:

Today the Oversight Committee held a hearing examining the $85 billion government bailout of AIG. The hearing showed that even after the bailout, AIG has spent freely on executive compensation and perquisites. U.S. taxpayers are paying for AIG's profligate spending.

Today's hearing revealed that shortly after the bailout was signed, executives from AIG's major U.S. life insurance subsidiary, AIG American General, held a week-long conference at an exclusive resort in California. The company spent nearly half a million dollars in a single week at this resort, including thousands of dollars on catered banquets, golf outings, and visits to the resort's spa and salon.

The hearing also revealed that AIG continues to pay one million dollars a month to an official who helped bring about the company's downfall. This official, Joseph Cassano, is the former president of AIG's Financial Products division, the unit that sold the credit default swaps that caused billions in losses for AIG. Mr. Cassano resigned from his position in March 2008. Yet AIG has inexplicably decided to pay Mr. Cassano up to $34 million in unvested bonuses. Even today, it is continuing to employ him as a "consultant" for one million dollars a month.

The Honorable Henry M. Paulson, Jr.
October 7, 2008
Page 2

Secretary Paulson, this situation is unfair to taxpayers. AIG received $85 billion in taxpayer money, yet it continues to lavish its executives with undeserved payments and perquisites. We urge you to protect the taxpayers' money and end this profligate spending.

Sincerely,

Henry A. Waxman
Chairman

Elijah E. Cummings
Member of Congress

Bruce Braley
Member of Congress

Jackie Speier
Member of Congress

cc: Tom Davis
Ranking Minority Member

Mr. KUCINICH. Mr. Chairman, could I ask who signed the letter?

Chairman WAXMAN. The letter has been signed by Mr. Braley, Mr. Cummings, Ms. Speier and myself.

Mr. KUCINICH. I would like to be associated with that letter.

Chairman WAXMAN. OK.

Mr. KUCINICH. Thank you.

Chairman WAXMAN. Mr. Shays, you are now recognized.

Mr. SHAYS. Could we make it bipartisan and add my name to it?

Chairman WAXMAN. We certainly will.

Mr. Bilbray, do you want to join us?

Mr. BILBRAY. Yes, Mr. Chairman.

Mr. SHAYS. Mr. Willumstad and Mr. Sullivan, thank you for being here.

There's one thing I think there is unanimity on on the part of Members from both sides of the aisle, that we're deeply troubled by the compensation that has been paid to executives who, frankly, were not experiencing success and we don't think it was truly the executives' money to take.

Ripples from defaults on subprime loans underwritten by the toxic twins, Fannie and Freddie, grew to a tsunami that helped swamp Lehman Brothers and others, including AIG; and Fannie and Freddie were able to launch more than $1 trillion of bad paper into the private market because regulators and Congress let them do it. Now what I want to do is ask you——

And Mr. Chairman, I have a question for you as it relates to the testimony of Mr. Greenberg. Mr. Greenberg—my reading of his comments and testimony—Mr. Chairman, my reading of the testimony from Mr. Greenberg that was submitted to the committee is basically accusing the two individuals who are in front of us for all the problems of AIG. And I'm thinking how convenient we don't get to question him. And my question is, do we swear in the individual to make sure that their statement is under oath and that they are held accountable for what they say?

Chairman WAXMAN. Well, if the gentleman would yield, we invited to Mr. Greenberg to testify. He responded that he was not well enough to come. He did submit information, testimony to us, which will be part of the record.

[The prepared statement of Mr. Greenberg follows:]

Before the United States House of Representatives
Committee on Oversight and Government Reform

Statement of Maurice R. Greenberg

October 7, 2008

Chairman Waxman, Ranking Member Davis, and Members of the Committee, good morning. I am the Chairman and Chief Executive Officer of C.V. Starr & Co., Inc. and the former Chairman and Chief Executive Officer of American International Group, Inc. Thank you for the opportunity to appear today before the Committee.

Before I began my career in business, I enlisted in the United States Army at age 17 in 1942. During the Second World War, I landed on Omaha Beach on D-Day and helped to liberate the Dachau concentration camp. When I returned to the United States, I completed my education under the G.I. Bill. I graduated from law school and was recalled during the Korean War. When I separated from the service, I held the rank of Captain in the United States Army. I received the Bronze Star in Korea.

In 1960, I joined C.V. Starr & Company. The firm's founder, Cornelius Vander Starr, became my friend and mentor. Since 1981, I have served as the Chairman of the private charitable foundation to which Mr. Starr gave virtually all of his assets upon his death in 1968. The Starr Foundation, which had $15 million when Mr. Starr died, became one of the largest charitable foundations in the United States. Over time, it has provided more than $2 billion in grants to charities and non-profit organizations in the United States and around the world.

In the late 1960s, I became the first CEO of AIG, which at the time was a brand new company. I led AIG for more than 35 years until my retirement in March 2005. During that time, AIG grew from a modest enterprise into the largest and most successful insurance company in the world. Its market capitalization increased 40,000 percent between 1969, when AIG went public, and 2004, my last full year as Chairman and CEO.

I devoted much of my adult life to building AIG. As a result of the hard work of tens of thousands of employees around the world, AIG became a national asset. During my tenure there, AIG opened markets for U.S. businesses all over the world, and contributed significantly to U.S. gross domestic product. For more than three decades, it stood at the vanguard of the movement to liberalize the global trade in services.

AIG had a unique culture when I was its CEO, particularly in comparison with the way many large public companies operate today. Neither I nor other members of my senior management team had employment contracts. I received no severance package in connection with my retirement, and I never sold a single share of AIG stock during the more than 35 years that I served as CEO (although I did contribute tens of millions of dollars in stock I owned to a family foundation to be used for charitable purposes). When I left AIG, the company operated in 130 countries and employed approximately 92,000 people. AIG had a market capitalization of $170 billion and its stock traded at $64 a share in March 2005. AIG's net income per employee was over $100,000. It was a great place to work. AIG also became one of the most widely held stocks in the United

States. Today, the company we built up over almost four decades has been virtually destroyed. The enormous drop in AIG's share price in recent months has affected millions of Americans who own AIG stock directly or indirectly, including retirees and participants in public pension plans.

Today, AIG, a company with over $1 trillion in assets, has been effectively nationalized. How did this happen?

To the best of my knowledge, the problems that came to a head this year did not originate in AIG's insurance businesses, which remain fundamentally strong, but rather in a unit of AIG known as AIG Financial Products, or AIGFP. Among other things, AIGFP operated in the market for derivatives, which are financial instruments that transfer various types of risk from one party to another.

Our AAA rating was an asset that made it possible to create AIGFP in 1987 as part of AIG's philosophy that generating earnings from diverse business lines would add to earnings stability if any particular business unit encountered a downturn. In 1985, the fire and casualty business in the United States recovered sharply from the distressed conditions that prevailed in 1984 and before. AIG, in part due to disciplined underwriting, kept its capital base intact, which led to AIG becoming the leading commercial and industrial insurer in the U.S. AIG also recognized that the property casualty business, by its very nature, was cyclical. Therefore, to differentiate itself from other insurance companies, it needed to diversify its earnings base. It did so by expanding its life insurance operations and aggressively increasing its overseas insurance presence which ultimately led to doing business in 130 countries. It also created new lines of insurance to meet the constantly changing needs of industry and business. AIG was AAA rated in recognition of those results and the company's strong capital base.

Diversification of earnings will usually lead to greater stability when one part of the insurance business suffers from catastrophic events in a particular year and other parts make it up. AIG's strategy, accordingly, was to look for opportunities in businesses that benefitted from its AAA rating, strong capital base, risk management skills, as well as the intellectual capital needed to manage such diversification.

That led to the creation of AIGFP in 1987. At that time, the derivative market was small and growing. From the beginning, AIG's policy was that AIGFP conduct its business on a "hedged" basis - that is, its net profit should stem from the differences between the profit earned from the client and the cost of offsetting or hedging the risk in the market. AIGFP would therefore not be exposed to directional changes in the fixed income, foreign exchange or equity markets.

AIGFP, at that time, reported directly to me and Ed Matthews, Senior Vice Chairman, and later to William Dooley, Senior Vice President, supported by AIG's credit risk and market risk departments. When I was AIG's CEO, AIG management closely monitored AIGFP and its risk portfolio. AIGFP was subject to numerous internal risk controls, including credit risk monitoring by several independent units of AIG, review of AIGFP transactions by outside auditors and consultants, and scrutiny by AIGFP's and AIG's Boards of Directors. Every new type of transaction or any transaction of size, including most credit default swaps, had to pass review by AIG's Chief Credit Officer.

Our model worked. From 1987 to 2004, AIGFP contributed over $5 billion to AIG's pre-tax income. During that period, AIG's market capitalization increased from $11 billion to $181 billion, and its stock price increased from $4.50 per share to $62.34 per share.

AIGFP took pride in its ability to design custom products to meet the needs of its governmental, corporate and institutional clients. Early in this decade regulators imposed a capital charge on commercial banks for unused bank lines outstanding to clients. AIGFP created a product that would assume approximately 90% of the credit risk in these credit lines for a fee which would be less than the capital charge the commercial banks would otherwise incur. AIGFP retained for itself this "super senior" layer, reasoning that the risk of loss in this layer was exceedingly remote. This business has been highly successful for AIGFP and at June 30, 2008, there existed a mark-to-market loss of only $100 million on a total net notional amount of exposure of $306.9 billion. Due to changes in the new Basel II capital standards, AIG stated in its June 30, 2008 Conference Call Credit Presentation that this business is expected to run off in the next 9 to 21 months.

It was recently reported that AIGFP began selling credit default insurance in 1998 and that the volume of this business exploded after I left the company in March 2005. AIGFP reportedly wrote as many credit default swaps on collateralized debt obligations, or CDOs, in the nine months following my departure as it had written in the entire previous seven years combined. Moreover, unlike what had been true during my tenure, the majority of the credit default swaps that AIGFP wrote in the nine months after I retired were reportedly exposed to sub-prime mortgages. By contrast, only a handful of the credit default swaps written over the entire prior seven years had any sub-prime exposure at all. Based on published information from AIG, AIG net notional exposure to Multi-Sector CDOs at June 30, 2008 amounted to $80.3 billion, of which $57.8 billion contained sub-prime mortgage collateral. The mark-to-market loss on this portfolio at that date amounted to $24.8 billion, of which $21.0 billion related to securities containing sub-prime mortgage collateral. The total mark-to-market loss on the AIGFP portfolio as of June 30, 2008, is $25.9 billion.

How did this happen? I was not there, so I cannot answer that question with precision. But reports indicate that the risk controls my team and I put in place were weakened or eliminated after my retirement. For example, it is my understanding that the weekly meetings we used to conduct to review all AIG's investments and risks were eliminated. These meetings kept the CEO abreast of AIGFP's credit exposure. Earlier this year, AIG's independent auditors, PricewaterhouseCoopers, found AIG to have a material weakness in its internal controls relating to AIGFP's portfolio of credit default swaps. It also appears to be the case that the problem created by the additional risk AIG had taken on through these new credit default swaps may have been aggravated by the fact that the new exposure appears to have been entirely or substantially unhedged.

When it became increasingly clear that AIG faced an intensifying liquidity crisis, I offered to assist the company in any way I could, including by raising tens of billions of dollars in private capital. Unfortunately, I was not able to even arrange a meeting with the company to present my proposals.

As the AIG crisis reached its apex last month, the State of New York was prepared to permit AIG to use $20 billion of excess capital in its insurance subsidiaries, and I called on the federal government to extend a temporary and limited bridge loan to AIG. Those steps would have enabled AIG to address its temporary liquidity problem and would have preserved AIG as a going concern, while also preserving the ability of the private sector to help AIG to address its problems over the longer term.

Instead, AIG's Board of Directors entered into an agreement with the Federal Reserve Bank of New York for a two-year, $85 billion credit facility. The deal includes the issuance of preferred stock that is intended to deliver ownership of 79.9 percent of AIG to the United States Treasury, and it is now clear that AIG and the Federal Reserve intend to do so without shareholder approval.

This is a bad deal for AIG's tens of thousands of employees and millions of shareholders. First, the credit facility requires AIG to pay interest on undrawn capital. By requiring AIG to pay interest on money it does not borrow, the agreement encourages the company to draw down the full amount of the loan even if it does not need the capital. In order to service the principal and interest on this loan, AIG will have no choice but to engage in a fire-sale of profitable assets. Second, the equity component of the deal is not necessary. AIG has more than $1 trillion in assets, including key AIG assets that already act as security for the $85 billion loan facility. That security provides sufficient protection to American taxpayers. It was not necessary to wipe out virtually all of the shareholder value held by AIG's millions of shareholders, including tens of thousands of employees and many more pensioners and other Americans on fixed incomes. Those millions of Americans could have fared better if AIG had filed for bankruptcy protection, since they would at least have had the chance of recouping value on their investments in AIG over the longer term. Bankruptcy would not have had to affect AIG's sound operating companies because the bankruptcy could have been limited to the parent company and impaired subsidiaries.

Although AIG stockholders could have fared better if the company had filed for bankruptcy protection, other stakeholders – like AIG's Wall Street counterparties in swaps and other transactions – would have fared worse. Those transactions would have been frozen in a bankruptcy rather than gradually unwound. Although that result could have posed systemic risk absent a broader federal bailout, it's not clear that dismantling AIG was a better solution. Nor is it clear why, in designing a federal response to AIG's short-term liquidity problem, some AIG stakeholders were prioritized over others. Questions have been posed, but answers have not yet been provided. I hope that we will hear some soon.

There is no doubt that AIG's liquidity crisis required action, but the question is what kind of action. The role and functioning of the ratings agencies needs to be carefully re-examined, and earlier changes to mark-to-market accounting rules and short selling regulations now being amended would have mitigated AIG's liquidity problems and, I believe, would have resulted in different outcomes. AIG would not have been nationalized and would not be in the process of substantial liquidation. Thousands of jobs would have been saved, and America's premier global insurer would be intact.

It was not necessary to design a program that both wipes out millions of stockholders and effectively precludes private sector solutions to AIG's manageable problems. As a general matter, public policy solutions should protect ordinary Americans and encourage private sector solutions to private sector problems. I will continue to work toward that goal, and I hope that Congress will too.

Thank you.

Chairman WAXMAN. While he wasn't here to take the oath and no oath was administered to him, there are laws that say if a congressional committee is doing an investigation and someone knowingly misleads or gives misinformation, that would be tantamount to a crime in and of itself.

Mr. SHAYS. Thank you, Mr. Chairman.

Let me ask you to respond to his comments. He said, moreover—and this is his testimony to the committee. Have you read his testimony?

Mr. WILLUMSTAD. No, sir.

Mr. SULLIVAN. No, sir.

Mr. SHAYS. Moreover, unlike what had been true during my tenure, the majority of the credit default swaps that AIG wrote in the 9 months after I retired were reportedly exposed to subprime mortgages. By contrast, only a handful of the credit default swaps written over the entire prior 7 years had any subprime exposure.

So later on he says, how did this happen? I was not there, so I cannot answer the question with precision. But reports indicate that the risk controls my team and I put in place were weakened or eliminated after my retirement.

I would like to ask each of you, is this true? Were they weakened?

Mr. SULLIVAN. Well, I think there's two parts there. I don't know what constituted the subprime exposure on the contracts written when Mr. Greenberg was CEO and thereafter. So I can't comment on that. All I can tell from you a risk control standpoint——

Mr. SHAYS. I don't understand that statement. I mean, you run the company. You are not aware of the exposures you had earlier on?

Mr. SULLIVAN. What I said is, I haven't got an analysis at hand as to what the percentages were in response to Mr. Greenberg's statements. Sorry, sir. What I can tell you from a risk control standpoint, it was exactly the same risk control procedures that were in place when Mr. Greenberg was in office that continued thereafter, both at the subsidiary level and at the parent company that ultimately resulted, obviously, in the decision taken to stop writing that portfolio.

As I said, at that time I was focused on other issues that——

Mr. SHAYS. So he preceded you, correct?

Mr. SULLIVAN. Preceded me, yes, sir.

Mr. SHAYS. But he is basically blaming you primarily and he's blaming Mr. Willumstad as well for the short time that you were on the board and so on and so on. So he's blaming both of you. Your testimony is that you did not change any of the controls that existed before him.

Mr. SULLIVAN. In fact, what I would say from when I took office, as I mentioned earlier in response to one other question, I set out with the support of AIG's board to actually put in additional resource and enhance systems not only in our risk area but in our legal, compliance, finance and accounting areas.

Mr. SHAYS. So the point is, you take issue with the statement?

Mr. SULLIVAN. Yes, sir.

Mr. SHAYS. Mr. Dinallo who testified—and I thought it was very interesting there, about four paragraphs, but he says, that brings us to the issue of what happened at AIG. The history has been well reported in the press. Using its noninsurance operations, AIG, just like many financial service institutions, invested heavily in subprime mortgages; AIG's financial products unit and noninsurance companies sold hundreds of billions of dollars of credit default swaps and other financial products. As with other financial service companies, AIG was forced to mark to market and so on.

But your credit default swaps were basically—how did they relate to the subprime mortgage? Weren't you—you didn't buy subprime mortgages but you basically—my understanding is you insured them in a sense, correct?

Mr. SULLIVAN. Correct. What I tried to explain to the previous question that I had is that what we were underwriting was the super senior portion of the CDS.

Mr. SHAYS. I know you're trying to tell me you were trying to secure the best ones.

Mr. SULLIVAN. We actually wrote the super senior——

Mr. SHAYS. I understand. But you know what? They all were terrible.

Mr. SULLIVAN. The bonds—the way the structures flow—and it's not easy to explain in a few minutes—is that you're writing a swap on lots of bonds that sit below you. And they can be—it can be an equity tranche. It can be a triple B tranche. And the way these were structured was that AIG swaps sat over and above the triple A and a little bit more additional protection. That is why, with respect, I've been trying to differentiate between the unintended consequences and the realized losses when you've had to mark to market in a liquid market.

Mr. SHAYS. Let me just—we're going to deal with this in the Financial Services Committee, and it's probably going to scare the hell out of you. Because this committee, I'm sure, is going to look at how we dice and slice all these mortgages so it's very hard for people to have any sense of what their values truly are. And I don't know what that will do to the marketplace. But, clearly, we are going to be looking at that.

And what I want to establish on the record, though, is that you were involved in the subprime market and you did have credit swaps relating to the subprime market. And you can give me the refinement of that. And I don't want to listen to a long dialog. But isn't that true?

Mr. SULLIVAN. To the best of my ability——

Mr. SHAYS. You can say no or yes, if you want.

Mr. SULLIVAN. Some of the bonds below the tranche that we were writing could have been in the subprime area.

Mr. SHAYS. Thank you.

Let me just ask you, as it relates to the compensation committee, I am absolutely convinced that it's one person scratching someone else's back. You're on the board of one company. You serve as a CEO of another. Do either of you serve on the boards of any other companies?

Mr. SULLIVAN. Public companies, no, sir. No public companies.

Mr. SHAYS. You are the exception, not the rule. But the question I want to ask you is, describe to me the compensation committee.

Mr. SULLIVAN. The compensation committee, the structure of it, sir?

Mr. SHAYS. Yes.

Mr. SULLIVAN. As I mentioned earlier, there was a base salary.

Mr. SHAYS. I want to know who appoints the compensation committee. Are they employees of the committee?

Mr. SULLIVAN. No, sir. The compensation committee consists of independent directors of the board.

Mr. SHAYS. They are members on the board, correct?

Mr. SULLIVAN. Independent members, yes.

Mr. SHAYS. Not employees of the company.

Mr. SULLIVAN. That's correct.

Mr. SHAYS. How are they appointed?

Mr. SULLIVAN. From what I can recall—and you can defer to my chairman at the time—the recommendation of the committee membership is made by the nominating governance committee to the board at large, I believe is the process.

Mr. WILLUMSTAD. That's correct.

Mr. SHAYS. My sense is is that it's a club, and the club basically rewards their friends.

Chairman WAXMAN. Would the gentleman yield to me?

Mr. SHAYS. Yes.

Chairman WAXMAN. We've held a couple hearings in this committee about these compensation committees that are appointed or consultants that are selected by the boards, and oftentimes the people that are selected are doing other consulting work for the corporation that's much more profitable for them. And, of course, they receive that from the management of the corporation. So they're then deciding what the compensation will be for the management of the corporation with clear understanding that they may well have a conflict of interest.

I think it's an issue that we need to continue to explore on this committee, and I thank you for raising it.

Mr. SHAYS. Thank you. Would you allow me one more minute to close?

Chairman WAXMAN. Yes, sir.

Mr. SHAYS. We all have our constituents. I have a friend who just wrote me, sent me an e-mail, and he said, my wife and I are among those investors who got badly burned with Lehman bonds. I am sure many in your district have a similar experience. We are prudent investors who must rely on the store of capital we have accumulated over the years to live decently. We always save more than we earn. Unlike the country and most citizens, we are completely debt free. We invested very significant amounts in what the so-called rating agencies called triple A, double A Lehman Brothers bonds. It now turns out that our trust in the rating agency was sadly misplaced. Either through incompetence or criminal fraud they led honest investors astray. Bonds that we bought are at par and now worth 10 or 12 cents on the dollar.

This is why we're having these hearings. Because you may see your shareholders hurt, but there were far more than your shareholders that are hurt. And I won't read the rest of it, but you should see what it says about what it means to him to see CEOs of companies getting huge sums when they are working on 10 cents on a dollar on money they saved for most of their life.

Chairman WAXMAN. Thank you, Mr. Shays.

I want to thank the two of you for being here. You came here voluntarily. You've been here for many, many hours. You have been very generous. I know it hasn't been easy for you. But we very much appreciate it.

That concludes our business, and we stand adjourned.

[Whereupon, at 3:05 p.m., the committee was adjourned.]

[Additional information submitted for the hearing record follows:]

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
Hearing on AIG
October 7, 2008

Testimony from Nell Minow
Editor, The Corporate Library

Mr. Chairman and members of the committee, I thank you very much for inviting me to submit a statement for this very important hearing. I appreciate your exploration of this very important topic as both example and symptom of the greater instability in the financial services sector and our capital markets.

As with Lehman, however, "We told you so."

The Corporate Library is an independent research firm specializing in corporate governance. Our clients include director and officer liability insurers, executive search firms, law firms, investors, consultants, and scholars. And one of our most popular products is our rating of board effectiveness. We rate boards like bonds – A through F. And unique in this field, our ratings are not based on structural indicators like "independence," director training, or whether the governance principles are posted on the company's website but on the decisions made by the board. As we used to say when I was at EPA and OMB, The Corporate Library relies on performance standards rather than design standards. If the board handles certain crucial defining issues well, they are an effective board. If not, it really does not matter how many directors attended training classes. You can lead a director to a classroom, but you can't make him think. Of course "independence" is important. But you can tell far more about the independence of a director from the board's approval of a good compensation plan (or a poor one) than from what we call "resume independence," the kinds of employment-related disclosures required by the SEC.

With that in mind, I would like to go over the ratings our firm has given the AIG board since we first began issuing letter grades in 2002:

6/30/2002 – Overall D rating assigned
1/2/2005 – Downgrade to overall F
12/5/2005 – Upgrade to overall D
2/13/2006 – Upgrade to overall C
11/2/2007 – Downgrade to overall D

Here are excerpts from our analyst notes on the company. When we upgraded them in 2006 we wrote:

> The AIG board continues to impress us as it reinvents both itself and, presumably, the entire company. While clearly still struggling with certain issues related to internal controls and accounting, and not yet quite as forward-looking as we'd like to see with regard to compensation policies and practices, we are increasingly confident in the new board's willingness and ability to move the company forward in the best interests of ALL its shareholders, and we're pleased to raise AIG's rating accordingly, from an overall D to an overall C - the company's first movement into low risk territory in several years.

After all, they had engaged Arthur Leavitt as an advisory member of the board, and had already gotten rid of about half of the former Greenberg era directors, so we gave them the benefit of the doubt. By the time of our November 2007 downgrade, however, it had become clear that this was all more talk than walk, and the board continued to reflect Greenberg's influence. They could not seem to solve or prevent accounting problems. We wrote:

> We are downgrading our rating on insurance company American International Group to D from C to reflect very high concerns over executive compensation and a continued violation of Section 404 of Sarbanes-Oxley. Total actual compensation for Chief Executive Officer Martin J. Sullivan is more than 20% greater than median total actual compensation at similarly sized firms and raises concerns over the alignment of executive interests with shareholder interests. Meanwhile, a continued Section 404 violation raises concerns over the accuracy and reliability of the financial statements and raises the specter of an earnings restatement.

Our most recent analyst note on the company addresses continued concerns over CEO pay and internal controls:

> Total actual compensation for Chief Executive Officer Martin J. Sullivan was \$43.9M in 2007 (2006: \$17.7M), of which \$1M was salary, \$36.5M was annual bonus, \$5.6M was non-equity incentive compensation, \$30,021 was change in pension and deferred compensation earnings, \$697,910 was all other compensation and \$4,219 was value realized from the vesting of shares. Mr. Sullivan's bonus compensation of \$42.1M (annual bonus plus non-equity incentive compensation bonus) was 42X his annual salary and his all other compensation was near the 90th percentile for S&P 500 firms. Consequently, Mr. Sullivan's total annual compensation and total actual compensation in 2007 each were above the 90th percentile for S&P 500 firms and raise concerns about the alignment of executive interests with shareholder interests. Mr. Sullivan's other compensation is related to personal use of corporate aircraft (\$322,534), housing, home security and other living expenses (\$160,488), personal use of car service, car allowance and parking (\$153,023) and financial tax

> planning ($41,345). The components and amounts comprising this emolument raise concerns about the link between executive compensation and company performance and in some cases are difficult to justify given the size of the other elements of the compensation package. Elsewhere, the company announced in February 2008 that the company's internal control over financial reporting was not effective as of December 2007 as a result of a material weakness related to the fair value valuation of a credit default swap portfolio. This indicates increased risk of errors, restatements and even fraud related to the company's financial reports.

Neither of the CEOs that followed Greenberg sought to implement significant change at AIG, nor did the reconstituted board apply any real pressure on them to do so. One interpretation might be that they simply weren't up to it; a more cynical, but probably more accurate, interpretation would be that the house of cards constructed by Greenberg in the first place was already too fragile and too far gone for such efforts to work. Certainly it is no accident that AIG was among the first of the giants to be toppled by the mounting credit crisis – the seeds of its destruction had been sown by Mr. Greenberg, and endorsed by the AIG board, several years before.

As I have mentioned in previous testimony before this committee, there is no more reliable indicator of litigation, liability, and investment risk than pay that is not linked to performance. I think it is fair to say by any standard of measurement that this pay plan is as uncorrelated to performance as it is possible to be.

Pay that is out of alignment is one of the causes of poor performance but it is also an important symptom – of an ineffective board. In March of this year, extraordinarily, AIG filed suit against its own former executives for pay abuse. The company alleges that former CEO Greenberg, former Chief Financial Officer Howard Smith and five others breached their fiduciary duty through "misappropriation of a special block of AIG shares worth approximately $20 billion in 2005." Those shares were placed in a separate organization to give those executives more control of the company – and disguised additional compensation amounting to hundreds of millions of dollars. Just a few weeks ago, the company and its former executives settled a shareholder lawsuit on the same charges.

The settlement included a $29.5 million payment by Greenberg and three former AIG officers. The remaining $85.5 million was covered by AIG's directors and officers liability insurance. In other words, most of the money that was returned to the shareholders came from insurance they paid for and not from the executives who were overpaid.

The suit is separate from an earlier action under which the current executives are seeking to have all shares held by Starr International that were allocated for future compensation of AIG employees placed in a trust controlled by current AIG executives.

AIG is a serial offender in the category of outrageous CEO compensation. We encourage this committee to ask how the package awarded to new CEO Edward Liddy will be any better designed to tie pay to performance.

AIG shows us that even the most diligent efforts to improve corporate governance structures are ineffective in preventing compensation so devastatingly abusive that it can bring a company – and all of its employees and shareholders – to the brink of disaster.

How can this be prevented?

Sarbanes-Oxley did not create this problem but it did not prevent it, either. Corporate governance is a matter of state law, so the governance-related reforms of the post-Enron era focused mostly on disclosure. For example, under Sarbanes-Oxley boards are not required to have a financial expert, but they must disclose whether they have one.

There will always be bad decisions. But we can do a better job of stopping them before they get out of hand. Clearly, from the case of Lehman and the other failing financial services firms, we must have clawbacks for the return of bonuses paid based on financial reports that are later corrected. That is a matter of fundamental fairness and economic necessity. And that is something that can be addressed by Congress.

Furthermore, we must remove obstacles that currently prevent shareholders from exercising the independent oversight and providing the market response that is an essential element of economic sustainability. The House has already passed the "say on pay" legislation with an overwhelming majority and we hope it will move forward. Shareholders should be able to remove conflicted, over-boarded, or just plain ineffective directors by voting against them. Institutional investors, including pension funds, should have to disclose their votes so that their customers, the beneficial holders of the securities, can see who is voting to enable dysfunctional board behavior.

Shareholders want executives to earn a lot of money. They just don't want them to get paid a lot of money without earning it. Addressing the issue of board effectiveness in linking pay to performance and managing risk is a key element of restoring the credibility of our capital markets.

Thank you very much and I welcome your questions.