

TESTIMONY

TO THE UNITED STATES
SENATE

COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS

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

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I would like to thank Chairman Christopher Dodd, Ranking Member Richard Shelby and the members of the Senate Committee on Banking, Housing and Urban Affairs for inviting me to testify today at this hearing on “American International Group: Examining what went wrong, government intervention, and implications for future regulation”.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

One, when you permit companies to pick their regulator, you create the opportunity for regulatory arbitrage. The whole purpose of financial services regulation is to appropriately control risk. But when you allow regulatory arbitrage, you increase risk.

Because you create the opportunity for a financial institution to select its regulator based on who might be more lenient, who might have less strict rules, who might demand less capital.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

But that is an academic analysis. Whatever the problems at securities lending, they would not have caused the crisis that brought down AIG. And without Financial Products and

the systemic risk its transactions created, there would have been no reason for the federal government to get involved. State regulators would have worked with the company to deal with the problem and protect policyholders.

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

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

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

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

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

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

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

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