TESTIMONY

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CONGRESSIONAL OVERSIGHT PANEL

HEARING ON

AMERICAN INTERNATIONAL GROUP

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NEW YORK STATE INSURANCE DEPARTMENT

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I would like to thank Chair Elizabeth Warren and the other members of the Congressional Oversight Panel for providing the New York Insurance Department the opportunity to testify today at the hearing on the assistance provided to the American International Group.

My name is Michael Moriarty and I am Deputy Superintendent for Property Insurance and Capital Markets. I have been asked by New York Insurance Superintendent James Wrynn to testify on behalf of the Department because the events you are reviewing occurred well before he took office in August 2009.

You have asked me to discuss our regulatory role with AIG's insurance subsidiaries both before and after the rescue of the company in September 2008 and our participation in the rescue and in events since then.

Before I address those questions, I would like to make a couple of broad points that I think are essential context for understanding what happened at AIG. Please note that when I speak of AIG, I am referring to the parent company, which was an international financial services company not regulated by the state insurance departments. I am only discussing AIG's insurance companies when I state that explicitly.

First, 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. 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 were the main source of AIG's problems.

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.

Second, just as AIG was overly aggressive in seeking profits from credit default swaps in its Financial Products unit, it was also overly aggressive in its securities lending program, which was operated centrally by the parent company for its insurance companies. Many insurance companies and other financial institutions use securities lending, but none had the severe problems that AIG had.

State regulators identified the problems in the securities lending program well before the crisis and were working with the company to unwind it in an orderly fashion. It was the crisis caused by collateral calls on the credit default swaps that made a continuation of an orderly reduction impossible. While there is no question that the insurance subsidiaries would have had losses from the program, the losses were manageable and would not have made the insurance subsidiaries as a group insolvent.

Third, the federal rescue of AIG was possible because there were strong operating insurance companies that would enable the federal government and taxpayers to be paid back. The reason why those insurance companies were 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 for policyholders' claims backed by investments that cannot be used for any other purpose. That is why policyholders were and continued to be protected.

Now, let me turn to your specific questions. The first is the nature of the role of the New York Insurance Department regarding AIG prior to September 18, 2008.

Before the crisis, AIG was a huge, global financial services holding company that did business in 130 countries. At that time, AIG had 71 U.S.-based insurance companies. In addition to those US based insurance entities, AIG had 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 the insurance companies domiciled in their state. So the New York Department is primary regulator for only those AIG insurance companies domiciled in New York. At the time of the crisis, the New York Insurance Department was 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.

On the whole, prior to September 2008, we were regulating AIG's insurance subsidiaries as we normally regulate insurance companies under New York law, including regular reviews of financial information, on-site examinations and discussions with management.

However, starting in 2006 and 2007, New York and other state regulators began to more closely supervise the securities lending program.

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 or securities worth generally about 102 percent of the value of the security it is borrowing. (In the case of AIG the collateral was cash which AIG then invested in other securities.) 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 many of the borrowers return the securities and demand cash at the same time, 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, securities lending 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 and other state regulators were 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, at the insistence of state regulators, 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, the U.S. security lending pool 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 sudden increase in demands by borrowers to return securities and retrieve their cash. Instead, we would have continued to work with AIG to unwind its program and believe that any losses would have been manageable.

Second, even with no federal rescue of the securities lending program, 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.

Our involvement with AIG changed substantially on Friday, September 12, 2008. 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 Department received a call from AIG's then general counsel and chief financial officer informing us of the company's serious and immediate liquidity problem, and asking for assistance. 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 the consideration of any regulatory actions that might be needed to get through the crisis.

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 excess surplus assets in its property/casualty insurance companies while fully protecting policyholders.

There are some key points that are important to understand. The proposal was just that, a proposal that we agreed to consider. It was never finalized. Agreement was dependent on conditions that would guarantee the protection of policyholders, including a substantial investment from capital providers and a restructuring of the US operations that would essentially make the life insurers subsidiaries of the property/casualty operations. Thus the $20 billion liquidity provided would be one part of a total solution of the company's problems. At the point at which we were discussing this proposal, everyone thought that AIG only had a temporary cash flow problem. When it became clear after a few days that the problem was much bigger, our proposal was dropped and replaced by the government rescue.

I can provide more detail if you like, but the basis of the proposal was that AIG had plenty of assets, but could not turn them into cash quickly enough to meet the demands for collateral. Also, AIG's property insurance companies had excess surplus, that is, surplus above what was legally required to protect policyholders. We were willing to consider allowing the parent company to temporarily borrow more liquid assets such as municipal bonds from its property insurance subsidiaries in exchange for less liquid assets, but only if the less liquid assets were worth more than the municipal bonds.

We were very carefully vetting the assets being purchased by the property insurance companies to ensure they were of high quality. We were also being careful to make sure 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.

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, the 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 our proposal was no longer needed.

Staff of the Department participated in meetings at AIG over the weekend of September 12 through 14 and then in the meetings at the Federal Reserve that eventually resulted in the rescue. We were involved in meetings and informal discussions about different ideas and provided expertise on insurance issues.

Following the rescue, New York's involvement with the parent company has been substantially reduced. Those issues have been handled by the Federal Reserve. However, the New York Insurance Department co-chaired a 50-state task force created by the National Association of Insurance Commissioners to monitor the financial condition of the insurers, oversee and facilitate the sale of any insurance operations and coordinate state regulatory responses. One of the main purposes of the task force is to protect policyholders by ensuring 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.

Did AIG present systemic risk and was a rescue necessary? Yes, but the source of the problem was the risky and unregulated activities engaged in by AIG Financial Products. AIG's insurance companies, even with the problem from securities lending, did not pose systemic risk.

Credit default swaps, which were at the core of AIG's problems, were specifically exempted from federal or state regulation. That meant AIG Financial Products could sell a promise to pay without holding appropriate reserves to guarantee its ability to deliver on that promise. AIG Financial Products sold the swaps to banks and other financial institutions around the world. And some of those financial institutions used the swaps to evade their own capital reserve requirements. Thus, when Financial Products was unable to pay on its promises, that created the risk of substantial losses and other pressures on a broad range of financial institutions and thus, created a potential systemic spread of its problems.

AIG's insurance subsidiaries, however, were required by state regulation to hold reserves to guarantee they would deliver on their promises to policyholders. Thanks to that state regulation, AIG could not touch those insurance subsidiary assets when the bill came due on Financial Products' bad bets. Whatever the AIG insurance companies' losses on securities lending, those losses should not have created serious problems for other financial institutions, which were protected by the fact that they held and could keep the securities they borrowed if AIG could not return the collateral they provided.

Thank you for your time and I am happy to answer any of your questions.