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Official Transcript

Hearing on "The Role of Derivatives in the Financial Crisis."

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COMMMISSIONERS

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Session 1: American International Group, Inc. and Goldman Sachs Group, Inc.:

STEPHEN J. BENSINGER, Former Executive Vice President and Chief Financial Officer, American International Group, Inc.

ANDREW FORSTER, Former Executive Vice President
American International Group, Inc.

ELIAS F. HABAYEB, Former Senior Vice President and
Chief Financial Officer, AIGFP

DAVID LEHMAN, Managing Director, Goldman Sachs Group, Inc.

DAVID VINIAR, Executive Vice President and Chief
Financial Officer, Goldman Sachs Group, Inc.

Session 2: Derivatives: Supervisors and Regulators

ERIC R. DINALLO, Former Superintendent,
New York State Insurance Department

GARY GENSLER, Chairman,
Commodities Futures Trading Commission

CLARENCE K. LEE, Former Managing Director for
Complex and International Organizations,
Office of Thrift Supervision

P R O C E E D I N G S

(9:04 a.m.)

CHAIRMAN ANGELIDES: Good morning. I would like to now call the meeting of the Financial Crisis Inquiry Commission to order.

We have two sessions today as part of our public hearing on derivatives and their role in the financial crisis. This morning we will have folks from both AIG and Goldman before us.

This morning we will be examining, as part of our larger look at derivatives, how these instruments were used in the marketplace and the interrelationships between the companies that utilized these instruments.

So today, following up on yesterday's hearing, we have asked representatives of these two companies to come before us. It is a chance for us to explore how derivatives, and particularly perhaps in this instance credit derivatives, worked in the marketplace, particularly during the 2007-2008 time period.

This afternoon we will have a panel with regulators, which will include Mr. Gary Gensler from the Commodities Future Trading Commission, as well as Eric Dinallo who was the Superintendent of Insurance, the insurance regulator in the State of New York, as well as a representative from the Office of Thrift Supervision that oversaw AIG.

With no further ado, we will begin the proceedings. But I would like to ask first if Vice Chairman Thomas has some comments?

VICE CHAIRMAN THOMAS: No, thank you, Mr. Chairman. I am looking forward to today's panels.

CHAIRMAN ANGELIDES: Terrific. With that, welcome panelists to this first session of our hearing today. I would like to ask you to all rise and do what is customary for all witnesses in public session, which is to be sworn in. And so if you would please stand and raise your right hand, and I will read the oath and you will affirm.

Do you solemnly swear or affirm under penalty of perjury that the testimony you are about to provide the Commission will be the truth, the whole truth, and nothing but the truth, to the best of your knowledge?

MR. BENSINGER: Yes.

MR. FORSTER: Yes.

MR. HABAYEB: Yes.

MR. LEHMAN: Yes.

MR. VINIAR: Yes.

(Witnesses duly sworn.)

CHAIRMAN ANGELIDES: Thank you very much.

Gentlemen, we have received your written testimony and appreciate getting that. And knowing this Commission, everyone on this Commission has had an opportunity to read that and review it.

This morning we would like to ask if each of you would provide us with an oral statement. We would ask that it be no more than five minutes. There is a device in front of you that has a timer on it. When the light moves to yellow, that means there is one minute left. And when it goes to red, that means time is up.

So what we are going to do this morning is go from my left to right, starting with Mr. Bensinger of AIG, then to Mr. Forster, then to Mr. Habayeb, then Mr. Lehman, and then Mr. Viniar.

So, Mr. Bensinger, if you would please start. Terrific.

WITNESS BENSINGER: [Off microphone.]

CHAIRMAN ANGELIDES: And the other thing I would ask you to do is to please turn your microphones on. As the Vice Chair would say, they are very directional. So have that mike facing your lips. Thank you.

WITNESS BENSINGER: Good morning. Chairman Angelides, Vice Chairman Thomas, and distinguished Members of the Commission:

My name is Stephen J. Bensinger. I appreciate the opportunity to testify before the Commission today.

I would like to begin briefly discussing my background. I will then discuss my tenure as Chief Financial Officer of AIG.

I graduated from New York University with a double major in accounting and computer application systems in 1976. I then joined Coopers & Lybrand, becoming a partner in 1985. While at Coopers & Lybrand, I focused on the property and casualty insurance industry.

It was through my work at Coopers & Lybrand that I became involved with AIG, which was a client. After about 11 years at Coopers & Lybrand, I left that firm to become the Chief Financial Officer of a property and casualty reinsurance company which had also been a client.

After five years with that firm, I left and held senior positions at several other insurers and reinsurers until I joined AIG in the fall of 2002. Upon joining in 2002, I became the Treasurer of AIG. In that role, my primary responsibilities were overseeing the rating agency relationships, monitoring cash flows, and becoming involved in the company's financings as necessary.

I had no financial reporting responsibilities in that position. I remained in that role until 2005. Beginning in 2004, AIG became the subject of investigations by various authorities in connection with certain reinsurance transactions.

In addition, AIG and other insurance companies were subject to an investigation into, among other things, bid rigging and contingent commission claims by New York's then-Attorney General Eliot Spitzer.

In late 2004, in the midst of these investigations, Howard Smith, AIG's CFO at the time, and Hank Greenberg, AIG's then-CEO, discussed with me the possibility of my becoming Controller of AIG. Unlike the Treasurer position, the role of the Controller included responsibility as the company's chief accounting officer, and particularly included responsibility for overseeing the preparation of AIG's SEC filings.

In January of 2005, I became Controller of AIG, while also continuing as Treasurer. As the investigations developed, a decision was made by the AIG Board to replace Mr. Smith as CFO. Thus, in March of 2005, before AIG's 2004 10K was filed, I was asked by the Board to take over Mr. Smith's job as CFO of AIG.

Martin Sullivan was also asked at that time to replace Mr. Greenberg as CEO of AIG. Although I knew that I was stepping into an extremely complex and highly pressured environment in light of the challenges and investigations that AIG was then facing, I accepted the job as CFO.

Thereafter, I helped lead a thorough investigation of the company's financial accounting and control environment which resulted in a restatement of AIG's prior year's financial statements in May of 2005.

During the course of the closing of the September 30th, 2007, quarterly financial statements, I became aware of certain collateral calls that had been made by counterparties.

Along with company management expert in these areas, and also including the company's outside auditors, I attempted to ensure that the valuation and disclosure around AIG Financial Products super senior CDS portfolio was appropriate given the information available to the company at the time.

We continued to update our valuations and disclosures in ensuing periods as market conditions continued to deteriorate. I continued to serve as AIG's CFO until October 2008 when I left the company.

With that background, I stand ready to answer any questions the Commission may have concerning my tenure at AIG. Thank you.

CHAIRMAN ANGELIDES: Thank you, Mr. Bensinger. Mr. Forster?

WITNESS FORSTER: Thank you.

Chairman Angelides, Vice Chairman Thomas, and distinguished Members of the Commission:

Good morning. My name is Andrew Forster. I appreciate being given the opportunity to testify before this Commission and provide my perspective regarding AIG and its use of complex financial products, particularly the transactions that made up our multi-sector super senior credit default swap portfolio.

By way of background, I am an Executive Vice President of Banque AIG London, part of AIG Financial Products. Since 2003, I have been in charge of the Asset Desk, which manages AIGFP's cash investment book and undertakes trading and investment activities on behalf of AIGFP, including credit default swaps.

From 2003 until 2008 I was one of roughly 13 executive vice presidents at FP who reported directly to Mr. Cassano. In my current position, I am responsible for helping to reduce AIGFP's credit risk by winding down its remaining credit portfolios and maximizing the returns for AIG and its shareholders.

In an effort to conserve the Commission's valuable time, I will refrain from reading the written testimony that I submitted. I hope to be able to answer the Commission's questions on the topics that I understand you would like me to focus on today--those including the increase in the size of FP's multi-sector super senior credit default swap portfolio transactions during 2005; the process for approving the transactions that made up the multi-sector super senior default swap portfolio; the decision in early '06 by FP to exit the multi-sector CDS market that deals with subprime exposure; and the disputes that FP had with various counterparties, including Goldman Sachs, concerning collateral calls that were made in 2007 and early 2008.

From my years working at AIG, I have a fair amount of experience with credit default swaps and the markets in which they are traded. Being based in London, my work in this sector was focused primarily on what we called our regulatory capital credit default swap portfolio. And prior to 2005, I had limited involvement in our then-much smaller multi-sector super senior CDS portfolio. And I was not typically directly involved in originating or negotiating the credit default swap transactions that formed the multi-sector book.

However, as the multi-sector portfolio grew during 2005, after discussions with Mr. Cassano, I became more actively involved in the multi-sector book. From that point forward, I began to play a more active role in evaluating the risks that portfolio created for FP's overall credit exposure across all of the markets in which we traded.

After the dislocation of the credit markets began in the summer of 2007, I was one of a number of individuals at FP who were tasked by Mr. Cassano with helping to deal with various aspects of the collateral calls that started coming in from our counterparties.

My involvement continued through the first quarter of '08 until senior management at AIG took over direct responsibility for the collateral call process.

I recognize the important work of this Commission, and I sincerely hope that my testimony will help the Commission better understand the events. Thank you.

CHAIRMAN ANGELIDES: Thank you, Mr. Forster. Mr. Habayeb? Am I pronouncing that correctly?

WITNESS HABAYEB: Yes.

CHAIRMAN ANGELIDES: Kind of like "An-ge-leedes" or "An-ge-lidis". All right, thank you.

WITNESS HABAYEB: Chairman Angelides, Vice Chairman Thomas, and Members of the Commission:

Thank you for the invitation to appear before you today. From September 2005 until May of last year I was Senior Vice President and Chief Financial Officer of the Financial Services Division of AIG.

AIG's subsidiaries within the Financial Services Division engaged in a diverse range of activities. One of the subsidiaries is AIG Financial Products Corp., or FP. As you know, FP is the unit that wrote credit default swaps on multi-sector CDO bonds that had exposure to the U.S.

subprime market.

I understand that today's panel has been assembled to address Goldman Sachs' calls for the posting of collateral under the swap contracts with FP during 2007 and 2008. My position as CFO of the Financial Services Division of AIG gave me some insight into the collateral calls.

Beginning in 2008, I also participated in discussions with certain counterparties, including Goldman Sachs, about the collateral call disputes.

Because the bonds underlying the FP swaps were not trading, it was difficult to determine the appropriate value of the bonds and thus the amount of collateral required to be posted.

FP and its counterparties, including Goldman, engaged in ongoing discussions in an effort to come to some agreement as to the amount of collateral to be posted. By August 31, 2008, FP had posted about $19 billion in collateral to FP swap counterparties, including $6.8 billion to Goldman Sachs.

And by the beginning of September 2008, FP's collateral payment obligations and cash requirements in certain of AIG's other businesses were placing increasing stress on AIG's liquidity.

On September 15th, 2008, the rating agencies downgraded AIG's credit rating, triggering an onslaught of new collateral calls. Unable to access the capital markets or meet its liquidity needs, it was at this point that AIG received emergency government assistance.

I am happy to answer any questions the Members of the Commission may have. Thank you.

CHAIRMAN ANGELIDES: Thank you. Mister "Lay-man" or "Lee-man"?

WITNESS LEHMAN: "Lay-man."

CHAIRMAN ANGELIDES: Mr. Lehman.

WITNESS LEHMAN: Thank you. Chairman Angelides, Vice Chairman Thomas, and Members of the Commission:

Good morning. My name is David Lehman. I am a Managing Director at Goldman Sachs and the Co-Head of the Structured Products Group Trading Desk, a position I have held since 2006.

I understand that the Commission is interested in my role in connection with the collateral dispute between Goldman Sachs and AIG. As the Commission is aware, Goldman and AIG were counterparties in a number of credit default swap transactions referencing collateralized debt obligation, or CDO, securities.

The value of these transactions began to decline as a result of a significant dislocation in mortgage markets that occurred starting in the summer of 2007.

Beginning in late July 2007, a dispute arose between Goldman Sachs and AIG concerning the amount of collateral that AIG needed to post as a result of a decline in the market value in these transactions.

I became involved in the collateral dispute with AIG in late July 2007. My role focused on providing Goldman internally, and ultimately AIG, with pricing for these transactions and the rationale for such pricing, as well as to try to gain an understanding from AIG of their pricing and the rationale for that pricing.

Goldman made a collateral call to AIG in late July 2007 that demanded that AIG post approximately $1.8 billion in collateral. In connection with the collateral calls issued to AIG in late July and thereafter, I and others from my trading desk were involved in Goldman's pricing of the CDO positions.

Goldman's prices were formed by diligently observing and reviewing the best available information from the market through its role as market maker.

Shortly after the initial collateral call, I participated in a telephone conference with AIG in which both sides discussed the dispute. Despite a very volatile July, AIG questioned our lower prices, not believing their securities had lost much value.

We were firmly of the belief that the marks should represent as accurately as possible the market prices of these transactions based on our experience, expertise, and the market information that was available to us.

A market price is simply the price at which a security could be bought or sold in the market. But unlike the stock market where there are frequent transactions in stocks for the various companies that trade on an exchange, certain mortgage instruments trade infrequently even when the market is considered liquid.

Because there were infrequent or no trades in the particular credit default swaps between AIG and Goldman, we based prices for these positions on two main sources.

First, the prices of comparable transactions that were trading in the market.

And second, pricing information we could obtain from market participants through bid or offer requests for similar securities or credit derivatives to the extent that those bid or offers constituted real actionable prices at which market participants were willing to trade.

As an example of a comparable transaction, Goldman Sachs might observe a trade in a security with a similar risk profile, similar structure, and containing similar but not exactly the same mortgages. Or we might executive a transaction in otherwise similar derivatives but backed by mortgage loans from a different time period--for example, loans from 2006 versus 2005.

We would collect the information generated by these comparable transactions. Then we would perform a variety of analyses on the collected comparables in order to gain a sense of the market value of the Goldman-AIG swaps from the pricing reflected in actual market transactions in similar derivatives.

Crucial to the pricing process is having accurate market information. Non-actionable prices, prices at which the quoting participant is not willing to trade, are not indicative of the market.

Our marks were based on actionable prices informed by market information from comparable transactions. At various times during the dispute, Goldman was willing to, and did, receive less than it was entitled to from AIG as a partial payment of its collateral demand.

The firm did not, however, reduce its collateral demands to levels AIG posted, but instead kept its demand at the levels established by pricing determinations.

Indeed, for most of the AIG transactions, Goldman entered into swaps with other parties that offset the risk that the firm had taken through its transactions with AIG. These offsetting trades meant that Goldman was itself required to post collateral to counterparties to whom it sold credit protection, just as Goldman expected AIG to post collateral to it.

Throughout the collateral dispute, we continued the process of pricing our positions and demanding collateral from AIG consistent with that pricing.

AIG continued to dispute our marks, but for almost six months AIG refused to provide Goldman Sachs with its marks on these same positions. In addition, during this same time period our dialogue with AIG often focused on third-party marks that were neither actionable nor indicative of the market.

The collateral call dispute between Goldman Sachs and AIG continued throughout most of 2008. We offered at various time to transact with AIG or other interested market participants that AIG was aware of at prices consistent with those that we were using to calculate the collateral amounts.

AIG never took us up on the offer. Personally, I remain very confident that the prices we used represented accurate market prices for those transactions at that time.

Mr. Chairman, thank you again for the opportunity to appear before you and the Commission today, and I will gladly answer any questions that you have.

CHAIRMAN ANGELIDES: Mr. Viniar.

WITNESS VINIAR: Chairman Angelides, Vice Chairman Thomas, and Members of the Commission:

I appreciate the opportunity to appear before you and contribute to the Commission's work on understanding some of the causes of the financial crisis.

I will focus my comments on our risk management practices, including the use of derivatives, and how we managed our exposure to AIG.

As a global investment bank and financial intermediary, Goldman Sachs integrates advice, financing, market-making, co-investing, and asset management with its risk management capabilities to serve a broad range of largely institutional clients.

When we commit capital to buy or sell financial instruments or extend credit, we accumulate both long and short positions that have implications for our liquidity, credit, and market risks.

Derivatives are a very important part of managing those risks. We use derivatives to manage the interest rate and currency exposures on our long-term borrowings and certain short-term borrowings, and to manage currency exposure on a net investment in non-U.S. operations.

We also enter derivatives contracts to help clients manage their interest rate, currency, equity, commodity, or credit exposures, and then to manage our own positions as we take the other side of contracts on our clients' behalf.

It is important to underscore that we generally do not have a derivatives business. Rather, derivatives are risk-management instruments integrated into many businesses.

As a result, we do not divide revenue or profit between derivative and non-derivative products, or track or report our financial results that way. And we manage the risk exposures we take on through derivatives as part of an integrated set of trading businesses. We carry all derivatives positions at fair market value net of collateral paid or received.

I know the Commission is interested in the role of derivatives in causing or amplifying the effects of the financial crisis. We believe the vast majority of the losses that financial institutions sustained over the course of the financial crisis can be traced back to bad credit decisions in general, and most of those can be traced back to bad real estate loans.

Securities like CDOs and associated derivatives, including synthetics, embedded what were essentially concentrated credit risk emanating from bad lending decisions.

More broadly, whether in derivatives or in the most basic activities such as bank loans or mortgages, there also appear to have been failures of risk management across the industry.

With respect to AIG, our relationship was governed by the same client service and risk management focus described above.

To put our relationship with AIG in context, our clients first came to us to help them manage credit exposure to super senior CDO positions on their books. We entered into credit derivative swap contracts, or sold positions, to them to help hedge against a fall in the value of their super senior CDOs.

We then entered into offsetting contracts, or bought protections, from AIG to manage the resulting exposure on our books. We established credit terms with AIG consistent with those extended to other major counterparts, including collateral arrangements that we tightly managed.

In particular, we established a predetermined hedging program which provided that if the aggregate exposures moved above a certain threshold, CDS and other credit hedges would be obtained.

In July 2007 we began to significantly mark down our super senior CDO risk. Rigorous fair-value accounting prompted us to mark our positions down on a real-time basis. This resulted in collateral disputes with AIG.

We believe our marks reflected the realistic value markets were placing on these securities, and events eventually proved those marks to be correct.

Over subsequent weeks and months, we continued to make collateral calls consistent with the deterioration in the housing market. We made those calls based on prices that were consistent with the prices we had on similar securities in our inventory on which we posted collaterals to clients on the other side of the AIG transactions.

We also offered to buy from and sell to AIG at our marks. We collected significant amounts of collateral and hedged any gaps between what we were paid and what we believed we were owed primarily through the purchase of collateralized CDS such that we had no material residual risk.

In mid-September, prior to the government's investment in AIG, our total exposure was roughly $10 billion. Against this, we held roughly $7.5 billion in collateral. The remainder was fully covered through hedges.

I believe the way we managed our exposure to AIG demonstrates the importance of systematically marking positions to market, paying attention to what the market tells us, and maintaining a disciplined approached to risk management.

During the course of the financial crisis we made our fair share of mistakes. We lost a considerable amount of money through our exposure to leveraged loans and mortgages. We learned once again that financial institutions that focus on the fundamentals of measuring, monitoring, and dynamically managing their risks make themselves much more resilient to uncertain and unpredictable market behavior.

Thank you very much, and I am happy to answer any of your questions.

CHAIRMAN ANGELIDES: Thank you, Mr. Viniar. We will now begin the questioning. As is our custom, I will begin the questioning, and followed by the Vice Chair, and then we will move to the Commissioners who led this portion of our inquiry.

So let me start with you, Mr. Forster. What I am going to try to do in my time this morning is try to get a better understanding of how this marketplace worked.

And just an observation, obviously unlike the publicly traded markets, this was not a marketplace that was visible to view, and so I am trying to get my best understanding of how transactions occurred, and how pricing occurred particularly during the 2007-2008 time period.

I want to talk to you a little, Mr. Forster, just about kind of pricing. As you may know--and I think you may have been in transit yesterday so if you don't--yesterday we had entered into the record a chronology of events as between Goldman and AIG with respect to this pricing dispute, the collateral call disputes.

That chronology included the calls, the postings, as well as communications with participants at this table. And clearly, Mr. Forster, you were involved in this back and forth.

In the wake of Goldman's first collateral call on July 27th, there's a phone call between you and a guy named, I guess, John Leivergal (phonetic) in which you talk about how Goldman's margin call hit out of the blue. It's a blank number that is well bigger than we ever planned for. Goldman's prices were ridiculous.

On August 1st you indicate that Goldman's, quote, "not budging and are acting irrational." On August 2nd, you do indicate that Goldman realized they needed to use mids not bids, which I assume refers to the fact that their collateral calls had used bid prices not the midway between bid and ask. Is that a fair assumption?

WITNESS FORSTER: Yes.

CHAIRMAN ANGELIDES: And they later revised their collateral call down significantly. On August 8th--I'm just trying to set the plate here--there's an e-mail I believe from you, which I'll enter into the record, yes, it's from you to Mr. Frost, I believe, where you talk about the pricing. You talk about that Goldman, quote, "can do a lot of things in the market to generate price discovery and can influence how a dealer decides to determine a mid price going forward."

You also wrote that that was, quote, "a very credible threat" and that, quote, "you'd never seen"--no, I'm sorry, the e-mail is to you. I apologize. This is from Mr. Frost. He had never seen Mr. Dableman more discouraged and despondent about amicably resolving any debate or conflict between our firms.

You responded, quote, "What do they expect us to do? Just give them a whole lot of cash because they are Goldman Sachs?"

And then on August 16th, you wrote in an e-mail: I have heard several rumors now that GS is aggressively marking down asset types that they don't own so as to cause maximum pain to their competitors. It may be rubbish, but it's the sort of thing that GS would do.

So clearly you are at the front end of this dispute. Here's what I wanted to ask you: Could you comment on Mr. Lehman's observations about how they priced these products? What you thought was deficient about that pricing, and how you were looking at pricing at the same time?

WITNESS FORSTER: Sure. My understanding was that there were sort of two processes in terms of Goldman coming up with their pricing.

One part of it was talking about "other observable transactions," which I have to say I thought really wasn't discussed in any great detail until later on in the process, until we got into I think sometime in November where they talked about other observable transactions.

Our discussions with other investment banks at the time, however, suggested that there was very little if any trading going on. And when we discussed with Goldman Sachs the different transactions that they said had been transacted in the markets, they did seem to be very sporadic, very few, and it was debatable how closely aligned or linked they were with our transactions.

CHAIRMAN ANGELIDES: Well let me probe that. So when you say they were sporadic, very few? In terms of market volume? Are we talking about a market now that's trading at maybe half the volume it was before? Or are we talking about a market that's essentially frozen up by this time period in which there's only anecdotal information?

WITNESS FORSTER: Well our view clearly was that it was pretty much essentially completely frozen up, and that it was anecdotal information. And I think we got information about three or four different transactions, all in fairly small size, and as I said, questionable how closely aligned and related they were to our transactions.

CHAIRMAN ANGELIDES: All right. Did you have other pricing information? Or was it your view that you just couldn't price this market at this point?

WITNESS FORSTER: We did have some other pricing information. We had pricing information from some of the other dealers, and that pricing information again was at odds with what Goldman Sachs had told us. It was significantly higher.

CHAIRMAN ANGELIDES: And was that based on real trades? Quote/unquote, "actionable trades"? Or were they estimates by those other counterparties?

WITNESS FORSTER: At the time the counterparties that were providing us with these valuations told us it was their best-efforts valuation. I mean, how they actually came up with their individual prices, I couldn't speak to that I’m afraid.

CHAIRMAN ANGELIDES: Did you provide any valuations?

WITNESS FORSTER: To Goldman Sachs?

CHAIRMAN ANGELIDES: Yes. Basically was it just, no, we don't accept these? Or here's where we think they are, and here's the basis on why we think they're here?

WITNESS FORSTER: Well we explained, pretty much as I've just explained. We explained to them in terms of why we didn't think their pricing was accurate at the time. At the very outset I don't think we provided them with absolute levels for them in terms of our positions.

We didn't have an internal pricing system at that time, and that is something obviously that we then decided to construct, and that's what we start in September and then takes us through till December till we have what we think is a particularly accurate methodology.

So we didn't have that to go back with specific prices. But clearly we went back and articulated that we thought the prices, given what we could see from other counterparties, were at least above the thresholds and hence wouldn't require a collateral call.

CHAIRMAN ANGELIDES: All right. At a number of points along the way there's discussions about doing dealer surveys, or dealer polls.

WITNESS FORSTER: That's correct.

CHAIRMAN ANGELIDES: Did that ultimately happen at any point?

WITNESS FORSTER: No, it did not.

CHAIRMAN ANGELIDES: Tell me why not. I mean, I'm just curious why it never got to that point. Was it because neither party wanted this to emerge into the public? Was it that both parties had firm positions and they didn't want to move off them? What's your perception? Or what's the fact around why, or why not, you both didn't just go to the market and do your best survey as to what was happening out there from third parties?

WITNESS FORSTER: As I said, our view--and corroborated by talking to the different investment banks--was there was very little going on in the market. Very few trades, transactions occurring. And so we thought that whilst it was in the contract that we could go and try and resolve the situation by doing a dealer poll, we at AIG didn't think that that dealer poll would ultimately be successful because we didn't think we would get prices from that.

Our assumption was that Goldman Sachs also agreed with that, and hence the reason why neither party really pushed to get a dealer poll. There were discussions about having a dealer poll, but ultimately a dealer poll never occurred.

CHAIRMAN ANGELIDES: So you thought it really wouldn't be much added value beyond what you already knew in the marketplace from talking to the participants of a market that wasn't active in any respect?

WITNESS FORSTER: That's correct.

CHAIRMAN ANGELIDES: I do want to press you on a couple things. I mean, obviously in a couple of your e-mails here you in a sense to go motivation of Goldman Sachs, and I just want to ask: Having been in the private sector a lot of my life, I mean sometimes negotiations are just tough and hard. But what do you mean exactly by "Goldman can do a lot of things in the market to generate price discovery," and "they can influence how a dealer decides to determine a mid-price going forward"?

I mean, are you saying that--explain that to me.

WITNESS FORSTER: I'm not sure I can explain it to you, I'm afraid, because I think that--

CHAIRMAN ANGELIDES: That was from Mr. Frost.

WITNESS FORSTER: That's from Mr. Frost, and I must admit I'm not quite sure what he meant at that time.

CHAIRMAN ANGELIDES: And I guess I know what you meant, but when you said: What do they expect us to do, just give them a whole bunch of money?

At another point you do talk about how they're aggressively making down asset types they don't own so as to cause maximum pain to the competitors. Was it your view they were trying to deliberately move prices down?

WITNESS FORSTER: Well I mean we had heard, you know, nothing more than rumors from different--I mean, I don't remember the specific instances why we said that in the e-mail, but I think general we had heard from other dealers that Goldman Sachs' pricing was very aggressively marked down in many different products.

CHAIRMAN ANGELIDES: All right. I'm going to ask you, Mr. Lehman, a couple of questions here.

WITNESS LEHMAN: Can--Mr. Chairman?

CHAIRMAN ANGELIDES: Yes.

WITNESS LEHMAN: If possible, I'd just like to respond--

CHAIRMAN ANGELIDES: Sure. Wait one second. Hold that thought. I do want you to come back. But I want to ask Mr. Forster one other question. And again, having been in real estate and having been in both good times and bad times, a lot of transactions I've been in have buy/sell provisions.

Now the fact is, they sound great but when you are in a market with very little liquidity, when no one is anxious to buy, I'm going to ask you from your perspective, when Goldman is saying to you, well, these are actual prices and you could transact at those prices, did you think that was kind of a credible offer in the sense that here's a market where people don't have a lot of liquidity, so you're not really looking to buy into the market?

Give me your response to their contention: Well, we gave you actionable prices at which we were willing to trade?

WITNESS FORSTER: I guess our general view was that, whilst it was a kind offer, we were clearly not going to be selling the transactions at that point; so the actionable bid really wasn't that helpful to us. And it was fairly clear by the time that I recall them talking about actionable prices, that no one really wanted to add risk at this point, especially not in these sorts of products, and it was fairly clear to us that we were never going to be adding more risk.

So, again, the offer to be able to trade was kind but not one we were ever going to take up.

CHAIRMAN ANGELIDES: All right, Mr. Lehman, why don't you make a comment that you were going to make, and then I want to follow up on that line.

WITNESS LEHMAN: Sure. Just briefly, I think it is important to remember a few things when we're talking about the summer of 2007.

First and foremost, July was an incredibly volatile month for mortgage, in particular subprime related, but mortgage and CDO products. You saw a rapid price decline as a result, in my view, of rating agency downgrades shortly after July 4th, and increased loss estimates for the product.

In addition to that, fundamentals were deteriorating. Home prices, and ultimately delinquencies on this product. So prices for the most observable RMBS, or subprime products, in addition to certain CDO products, were going down very fast in July.

The second point that I would make is, we're talking about Goldman and AIG. This was a very big market, a market that is much bigger than Goldman Sachs and AIG. So there are a lot of other participants in the market.

And here I am talking about more than just the specific CDOs that AIG transacted on, but the mortgage market or the subprime market in the United States. So I think that’s important when we are talking about Goldman impacting prices. There were a lot of other participants that had views that were transacting in the market at this point in time.

The third point that I would like to make is: In large part--and I mentioned this in my testimony--the trades we had on with AIG, when we reduced our prices we were posting collateral on the other side. There was not a motivation--

CHAIRMAN ANGELIDES: Can I ask--finish that thought quickly.

WITNESS LEHMAN: No, I'm just--

CHAIRMAN ANGELIDES: Were they parallel transactions? In the sense, did your terms of your contracts with your counterparties mirror the AIG?

WITNESS LEHMAN: So I'm not personally familiar with all of the specific transactions, but what I do know is that the--

CHAIRMAN ANGELIDES: If they mirrored them, it makes sense. But if they don't mirror them, the collateral call analogy doesn't wash.

WITNESS LEHMAN: No, but by and large the posting that we were doing did mirror and was consistent with the prices that we had with AIG.

CHAIRMAN ANGELIDES: Well perhaps you could provide us that information, would you, please?

WITNESS LEHMAN: Sure.

CHAIRMAN ANGELIDES: Because I think it depends on, you know, what the terms of the collateral posting were, not just the prices themselves.

Let me ask you a couple of questions.

WITNESS LEHMAN: Sure.

CHAIRMAN ANGELIDES: So I want to pick up on one of the things you just said, which is that there were other participants in the market. From looking at least at the information we have, you were consistently low versus other folks who were providing pricing to AIG.

So why was that?

WITNESS LEHMAN: I can't speak for other dealers. I guess the pricing that we were providing to AIG and other clients around this time was, as I mentioned in my opening testimony, consistent with where we viewed the market given the transactions that we were doing, what we were observing in other products, risk premium around this period of time.

So the other thing that I mentioned in my testimony was--

WITNESS LEHMAN: What was the volume in trading at this time? I mean, if 100 was a robust market, what kind of level of trading are we looking at during this time period?

WITNESS LEHMAN: In the particular products, the specific products--

CHAIRMAN ANGELIDES: Yes.

WITNESS LEHMAN: --we had with AIG? I don't know that offhand.

CHAIRMAN ANGELIDES: Okay.

WITNESS LEHMAN: I think it's important in this market, the mortgage market, while it's big you have a lot of discrete securitization. So the exact securitization might not trade on any given day, but a lot of very comparable securitizations certainly in RMBS were trading.

CHAIRMAN ANGELIDES: And you probably heard my request yesterday to try to get us--

WITNESS LEHMAN: Yes.

CHAIRMAN ANGELIDES: --more granular information so we could take a look at how you priced these things?

WITNESS LEHMAN: Yes. And I'm happy to work with the Commission to that end and explain our pricing.

CHAIRMAN ANGELIDES: I would just make an observation, which is the whole notion of the buy/sell, the actionable, again from my own experience in an illiquid market telling someone you've got the right to buy this, you know, I mean I've been in land and housing transactions. The ability to buy more even at a really low price in an illiquid market ain't much of an offer, because you're not looking to add to your risk position. And, often you're not, you know, willing to sell during that illiquid time period. But I want to ask about a couple of things.

As I know, or you know, Goldman Sachs right now is subject to litigation by, you know, the Basis Yield Alpha Fund who contends that they were one of the purchasers of Timberwolf; that they bought in June. I guess they bought at about 80. Part of their contention is that you had warranted prices would be stable.

Do you know if the marks you're giving AIG aligned with what you were selling securities at to folks in the marketplace like at Timberwolf? In other words, you're selling to people in the marketplace securities like the BYAFM Fund.

WITNESS LEHMAN: Yes.

CHAIRMAN ANGELIDES: Would your prices at which you're selling to folks have aligned with the marks you're giving them?

WITNESS LEHMAN: Yes. So the trade we did with Basis and Timberwolf was a very different instrument than what we had on with AIG. But to the best of my recollection, the trades that we were executing with Basis or other counterparties, or trades we were doing throughout this time period, were consistent with both our marks as well as the prices we were providing to all clients, not just AIG.

CHAIRMAN ANGELIDES: Were you involved in providing the marks to Bear Stearns for the BSAM Funds in May?

WITNESS LEHMAN: Do you know on what specific products?

CHAIRMAN ANGELIDES: Let me return to you when I return to my question. Were you involved in providing any marks to Bear, the BSAM Funds in May?

WITNESS LEHMAN: So the desk that I co-head was responsible for the trading of ABS, CMBS, as well as CDOs. So if it's the prices on those products, then they would come off the desk. But the pricing process itself is not driven by the desk. There's a separate group at Goldman that provides pricing. But the prices themselves would come from us.

CHAIRMAN ANGELIDES: And I'm going to ask Mr. Viniar this, and then I'm going to defer the balance of my questions to the end.

Of course in December of '06 it is well known that the decision is made to get closer to home. The instructions down the line are to begin to mark things down, adjust positions.

Is there a view that--tell me a little about, just bluntly, if you are net short during this period--and, you know, Mr. Blankfein says I think in 12/06, I think sometime in--well, he doesn't say it then, but Mr. Blankfein says at one point: Of course we didn't dodge the mortgage mess. We lost money. And then made more than we lost because we were short.

How do you answer this? Look, you guys are net short and you're driving down prices. Are you in fact creating a self-fulfilling prophesy? I mean, you just made the observation that the market--you were eventually proved right, but of course what really matters is not what prices turned out to be, but were you in fact pushing the market down at the time?

WITNESS VINIAR: Let me just clarify one of the things you said. You said that the instructions came to mark things down.

We never instruct people to mark things down. We mark things where the market is. And we're--as you probably know, you've heard us talk about this a lot--we're pretty passionate about fair value accounting.

We believe that we're not smarter than the market, and that the market tells us a lot of things, and that should pay attention. If something was worth 100 and now it's worth 90, all we know is that today it is worth 90. It might be worth 100 someday, and it might be worth 80 some day. We don't know. And we don't ignore that.

And we spend a lot of time trying to figure out what the market prices are, and to mark our books exactly where--

CHAIRMAN ANGELIDES: But sometimes when markets are illiquid, they're illiquid.

WITNESS VINIAR: They are illiquid. And on probably 90 or 95 percent of our positions, it's easy to mark them. And on 5 to 10 percent, it's hard. But that doesn't mean you can't do it. If you can't mark your positions, then it's very hard to manage your risk. We don't know how you manage your risk if you don't know the value of your positions.

We have 1000 people in our Controller's Department. Probably half of them are responsible for verifying the prices of marks. Most of them spend their time on the less liquid positions because those are the hard ones, and you use comparable positions, you deconstruct positions into their different risks and look at other positions that trade. But we don't believe that you can't mark things to market.

If you can't mark them to market, you can't manage your risk.

CHAIRMAN ANGELIDES: So but here's my basic question. It's an illiquid market and you're at the low end. I mean, there's a bunch of other participants in the market. I mean, you guys may be smart, but it's not necessarily that everyone else is so stupid.

I mean, it's an illiquid market and you're at the low end consistently on all these marks. So what is--

WITNESS VINIAR: Chairman Angelides, I can't respond to why other people did not mark their positions where the market was.

CHAIRMAN ANGELIDES: Did you go out and look at all their other marks and their methodology to say maybe we are wrong here?

WITNESS VINIAR: We talked with other people periodically throughout, especially when we had disputes, and we fundamentally believed that our marks were right. As Mr. Lehman said, we're willing to trade at our marks. And although I know you say that may be hollow and--

CHAIRMAN ANGELIDES: Yes, I think it's--

WITNESS VINIAR: --we were--

CHAIRMAN ANGELIDES: -- personal experience in that kind of market, people just, I don't care what you price some of this stuff at unless it's extraordinary--

WITNESS VINIAR: And we also, again as Mr. Lehman said, we had positions on both sides. On the AIG transactions, for example, we did have many of the transactions, not all, were exactly the same as we had on the other side.

When we asked them for collateral, we posted collateral. So in our collateral disputes, we were actually out cash because we were posting the amount of collateral we were asking for.

But we think that the--

CHAIRMAN ANGELIDES: Is it likely that it was parallel?

WITNESS VINIAR: Yes.

CHAIRMAN ANGELIDES: In amounts? I mean, you struck the same economic deal with your counterparties as you had with AIG?

WITNESS VINIAR: As far as posting collateral and getting collateral, many of them were parallel.

CHAIRMAN ANGELIDES: All right, we would like to get that information. And we'd particularly like to get more information, as I said, on this pricing.

Let's do this. I'm going to stop right now, and what I'm going to do is go to Mr. Thomas. Thank you.

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman. I would just ask all of you to verbally respond, and hopefully in the affirmative, that if as we go forward we have additional questions based upon this or any other information we have, that you would be willing to respond to written questions with written answers in a timely fashion?

WITNESS BENSINGER: Yes.

WITNESS FORSTER: Yes.

WITNESS HABAYEB: Yes.

WITNESS LEHMAN: Yes.

WITNESS VINIAR: Yes.

CHAIRMAN ANGELIDES: Say something so she can say you said something. Okay. Thanks.

One of the things that Goldman keeps telling me is that you're market makers. You create markets. Well obviously you create a product. There's no market value until you create it. So you've got to have some kind of modeling, or estimating structure to figure out where you start.

And if I ask questions to Goldman, I don't care who answers. You guys can figure out whichever one you want, and the same thing with AIG.

How do you start when you have a quote/unquote "new product" asked for? I know you folks don't market, you don't sell, you're not creative, you simply respond to your customers asking for something, and that you meet their request is what I got out of the testimony yesterday.

The way I just said it probably doesn't mean I'm a 100 percent believer in that, but let's start with that. So how do you price it initially?

WITNESS LEHMAN: Sir, I can speak to that, to the best of my knowledge.

VICE CHAIRMAN THOMAS: Sure.

WITNESS LEHMAN: In my specific seat at Goldman, but--

VICE CHAIRMAN THOMAS: Well, have you done it?

WITNESS LEHMAN: Well creating a new product like derivatives, for example--why don't we talk about derivatives—

VICE CHAIRMAN THOMAS: Alright.

WITNESS LEHMAN: that reference both RMBS and CMBS, so what we call first-order securitizations,--

VICE CHAIRMAN THOMAS: Sure.

WITNESS LEHMAN: and then CDOs are securitizations of--

VICE CHAIRMAN THOMAS: We don't need to go all the way down the trail to synthetics right now.

WITNESS LEHMAN: I say that because that's a good example of talking about a new product and how that's started to price. And this was probably around 2003-2004, to the best of my knowledge. You started a--there was client demand for synthetics referencing these products.

For example, the first inquiry that I had was I think the summer of 2004 by a money management firm that they wanted exposure to double-B rated CMBS or commercial real estate backed securities. And they couldn't buy it in the cash market. It just wasn't available.

So they asked if Goldman would provide that to them, effectively buy protection synthetically. It was a portfolio of $80 million across different vintages that were actually seasoned. So it was very hard to find.

So this was a trade that we ultimately ended up executing in August of 2004, providing a mutual fund with a product that they wanted, an exposure that they wanted.

VICE CHAIRMAN THOMAS: When you say "execute", was there discussion between you and the person who was interested in the product as to what the price would be?

WITNESS LEHMAN: There was.

VICE CHAIRMAN THOMAS: So you negotiate prices?

WITNESS LEHMAN: There was. We had a view, similar to--

VICE CHAIRMAN THOMAS: But there's no market basis for determining what the product was going to pay at?

WITNESS LEHMAN: Well I think we had a view as to where the securities, to the extent they would be available in cash form, could trade and what the value of that was on an unfunded basis. And that's how we came up with our price, extrapolating from what we see in--

VICE CHAIRMAN THOMAS: And was that based upon market data?

WITNESS LEHMAN: It was, but it was not the most observable market data, is my opinion.

VICE CHAIRMAN THOMAS: No, no. So what you basically did was extrapolate from, adjust for--you put in various metric factors to come up with what you thought was a fair price.

Your purchaser would look at it and say, well, we don't think it's necessarily--adjust here, adjust there. So you had a kind of a negotiated, or a mediated arrangement that you both finally came to an agreement on?

WITNESS LEHMAN: Correct. As a general rule, you are taking as much as you can from the observable market because that's where the market is. And then if there adjustments that need to be made--

VICE CHAIRMAN THOMAS: And from the person who wants to buy it. I understand all that.

WITNESS LEHMAN: That's right.

VICE CHAIRMAN THOMAS: It's pretty--

WITNESS LEHMAN: That's right. And we agreed on a price, and we executed the trade with them.

VICE CHAIRMAN THOMAS: You said you were on a desk that did certain things. Does Goldman observe how you do on the desk? Do you get paid if you do well on the desk? Or not well?

WITNESS LEHMAN: Well are you saying in terms of how I'm compensated, or--

VICE CHAIRMAN THOMAS: Yes.

WITNESS LEHMAN: So Goldman and Mr. Viniar can speak at more length about this, but--

VICE CHAIRMAN THOMAS: You don't know how you're paid?

WITNESS LEHMAN: I'm about to tell you.

VICE CHAIRMAN THOMAS: Oh.

WITNESS LEHMAN: But the--but certainly I have regular--

VICE CHAIRMAN THOMAS: There are a lot of folks who made millions of dollars in the panel yesterday who had no idea--not only no idea how much they made, but whether they made it or not. Oh, hundreds of--I've found out I have to ask my questions differently than I normally do with people.

WITNESS LEHMAN: No problem. We have regular performance reviews at Goldman--

VICE CHAIRMAN THOMAS: I don’t know if that’s a problem or not, so--go ahead.

WITNESS LEHMAN: We have regular performance reviews at the firm, and I've been there a little over six years now, so that's part of it. In addition, the firm's performance, the division's performance--

VICE CHAIRMAN THOMAS: So the performance review was over how you did at your desk?

WITNESS LEHMAN: There are several criteria that are part of the performance review, both quantitative and qualitative.

VICE CHAIRMAN THOMAS: Was part of it your performance at the desk?

WITNESS LEHMAN: Yes.

VICE CHAIRMAN THOMAS: Okay.

WITNESS LEHMAN: But as I was mentioning before, the firm's overall performance, the division's performance, the department's performance, as well as my individual performance are all part of the formula, if you will, in terms of compensation.

VICE CHAIRMAN THOMAS: But as soon as you were able to get some kind of a handle on a product that went in the market, notwithstanding the fact you had some degree of modeling to create it, you kept tabbing it back to the market because your goal is to make sure that whatever you have is what's viable and available?

How do you do that if you've got a product that you got started originally in which the market then changes? That's where you start swapping money? -- Collateral

WITNESS LEHMAN: I'm sorry? I'm not sure I understand the question, Vice Chairman.

VICE CHAIRMAN THOMAS: Okay, you started off with a product that was negotiated.

WITNESS LEHMAN: The first trade was negotiated. But then the product became more--

VICE CHAIRMAN THOMAS: And do you have in that a need to post collateral if there's an adjustment?

WITNESS LEHMAN: I'm not sure about that specific trade, but my guess would be, yes.

VICE CHAIRMAN THOMAS: But usually you would?

WITNESS LEHMAN: Yes.

VICE CHAIRMAN THOMAS: How else do you get it adjusted to the market?

WITNESS LEHMAN: By and large, lateral posting was part of all of the trades we were doing in derivatives.

VICE CHAIRMAN THOMAS: Right. Adjusted to the market. So then once you get it started, you have to inevitably use a model of some sort, or negotiated position, which may not be modeling.

WITNESS LEHMAN: No, I think what maybe I didn't articulate very well previously is, that was the first trade. The market then grew immensely--

VICE CHAIRMAN THOMAS: Sure.

WITNESS LEHMAN: and became more standardized, and there was observable pricing for these products.

VICE CHAIRMAN THOMAS: Oh, absolutely. And that's why you had the adjustments based upon marking to market. That is how you folks--that's the sine qua non of your operation, I'm told.

WITNESS LEHMAN: So at that point in time, we mark to market prices. There was not a specific model that we used for pricing.

VICE CHAIRMAN THOMAS: And negotiations after that are easier because you have a market price around which you can quibble, and there's a whole lot less quibbling when you've got reality every day than when you're trying to create reality.

WITNESS LEHMAN: That's correct. The market is what the market is.

VICE CHAIRMAN THOMAS: Okay. And so sometimes if you couldn't exactly mirror--and to me "mirror" is like isomorphic, it's exactly the same. And you can't always do that. So it's kind of like in real estate when you're trying to price something. There are comparables.

And of course what you do then is negotiate out the difference between a comparable and a mirror, or an isomorphic position, and that's just part of the adjusting as you go.

So you folks are constantly trying to adjust to what is the reality of the market, or at least an agreed-upon position of what the market is. And that's what you guys do basically all the time.

WITNESS LEHMAN: Correct. Listening to the market and what the market is telling us as it relates to risk is very, very important. Perhaps the most important tool we have.

VICE CHAIRMAN THOMAS: And you were up and running '04 to -05, and I guess part of the problem was that by '07 some of those interest rates that were part of the mortgage deals came up for readjustment, and that's when you started to have to start making all kinds of adjustments based upon what the real world was doing and the price on the market.

WITNESS LEHMAN: I'm sorry? Again I'm not familiar. You're saying in 2007?

VICE CHAIRMAN THOMAS: Well didn't you notice a lot of your products with higher defaults and other things happening--

WITNESS LEHMAN: Okay.

VICE CHAIRMAN THOMAS: --in large part because the mortgages that began to be folded in in '05, '06, '07, were mortgages that were going to deteriorate because more and more of them had no docs and they had short-term interest rate only, or adjustable ARM rates,

WITNESS LEHMAN: So--

VICE CHAIRMAN THOMAS: and they began changing, and that's when the degradation began showing up?

WITNESS LEHMAN: So while I'm not a residential mortgage market expert, certainly in 2007 you saw prices declining in the observable mortgage products because perhaps of the resets that you're talking about, underwriting standards--

VICE CHAIRMAN THOMAS: Well then tell me what was your belief--

WITNESS LEHMAN: --higher LTDs, and home prices going down.

VICE CHAIRMAN THOMAS: --as to the increased activity in your desk segment of the market? You said it was getting a lot of increased activity.

WITNESS LEHMAN: In and around--

VICE CHAIRMAN THOMAS: In building new products?

WITNESS LEHMAN: In and around 2007, specifically?

VICE CHAIRMAN THOMAS: Yes.

WITNESS LEHMAN: I don't recall, outside of more and more participants, both on the long side of the market and the short side of the market in derivatives were getting more involved in the market around that time period.

VICE CHAIRMAN THOMAS: So it's continuing--

WITNESS LEHMAN: Increased involvement for market participants, is my view.

VICE CHAIRMAN THOMAS: Okay. So really almost all your activity is kind of mono-e-mono. You never give it to a third party mediation? You try to bring in data from third parties or other sources to come to an agreement, but it's always kind of a one-on-one to come to an agreement?

WITNESS LEHMAN: Well these are generally bilateral trades, the derivatives trades.

VICE CHAIRMAN THOMAS: Yeah.

WITNESS LEHMAN: So--and there was in large part an observable market. So it wasn't a negotiation. The market again was what it was, and people posted there and we transacted there.

VICE CHAIRMAN THOMAS: Or to the best of your ability you were where you thought the market was, or should have been?

WITNESS LEHMAN: In the absence of a specific trade in that security or derivative, yes.

VICE CHAIRMAN THOMAS: So you came up with an amount of money, or the $1.8 billion, or whatever. And then the other party gets to say that's an outrageous amount, or whatever it is they're quoted, the Chairman has quoted as their saying.

What do you do then?

WITNESS LEHMAN: I think what we did, and we did this with AIG in this situation, we got on the phone and tried to share information, talk about what we're seeing and why we think the market price is what we suggested, and have a point/counterpoint and try to reach agreement.

VICE CHAIRMAN THOMAS: Whoever wants to speak here, I don't know if you're the designated spokesman, Mr.

Forster, but if the others want to defer to you.

So you get the call. And it's been described as an outrageous amount. You folks basically took one side of the bet repeatedly over and over, and you felt comfortable. And to a very great extent this is testimony based upon Mr. Cassano yesterday, and so you can add whatever you might want to add, but my guess is that if you're going to take one side, which is on the short side, you did quite a bit of modeling in looking at the product and getting some comfort level for exposing yourself as much as you were exposed if things went bad?

WITNESS FORSTER: Yes.

VICE CHAIRMAN THOMAS: Because you were in the market. So what were you looking at when Goldman would then say we need X amount of collateral based upon market position? You say "what market position?" based upon where we think we should be? Are you relying primarily on your models to be comfortable with where you are?

Or do you--I know that there wasn't a lot of market data, but what were you seeing in the market data?

WITNESS FORSTER: Perhaps I could take a quick step back and help.

VICE CHAIRMAN THOMAS: Oh, sure. I need all the help I can get.

WITNESS FORSTER: I think perhaps what someone like Mr. Cassano was talking about yesterday, there's the initial process when we entered into the transaction--

VICE CHAIRMAN THOMAS: Yeah.

WITNESS FORSTER: and the modeling that we did then--

VICE CHAIRMAN THOMAS: Well the same thing they have to do when they get started, to a certain extent, but I think you were a little heavier into it. Would that be a fair statement, --

WITNESS FORSTER: Sure.

VICE CHAIRMAN THOMAS: in terms of relying on models?

WITNESS FORSTER: True. I think the important thing to try to explain to you is that at the beginning what we were doing was using a model to evaluate the ultimate credit risk that we were taking in the transactions, making sure that the risk position that we took on for the firm was one that we felt was appropriate.

As we get into 2007, the issue was that what you then need if there were no observable market prices is some way to evaluate what the market price would be, as opposed to what the--the credit risk, you could still view the credit risk as being there is no credit risk here in terms of our ultimate losses, in terms of a credit model, but there may be a change in the market value.

And we at that time did not have an internal model to calculate a market value, or attempt to estimate some sort of market value. And that is of course what we tried to construct and put together in the fall of 2007.

So absent of that at that time, until we get to the stage probably something around December 2007 where we have something that we think is more robust and useful, then we are relying on--

VICE CHAIRMAN THOMAS: Which is more robust or useful? Based upon market data that you then eventually collected? Or adjusted modeling which you have a high confidence level in?

WITNESS FORSTER: Building the model and then using market data within the model, what available market data we can get, to try and come up with a valuation.

VICE CHAIRMAN THOMAS: Did you use any of the Goldman numbers that they provided to you, which they thought were the market, in your modeling?

WITNESS FORSTER: Not within the modeling itself. The modeling that we used, and the model that we built, tried to look at the underlying assets within the CDO and come up with price estimates for those.

And then the model would then try and calculate an overall CDO price, and we would look at that final output versus the outputs we had, or the information that we had from the likes of Goldman Sachs, and we would compare the two.

VICE CHAIRMAN THOMAS: I've bought and sold a lot of old cars, a lot of English cars, MG-TF, a TR2, a Austin Healey BJA, all of that stuff. I had to walk away from a lot of cars because, frankly, the people who owned them thought they were worth a whole lot more than what a buyer--me--was willing to pay for them.

So I'm trying to figure out how you model, without actually looking at what someone is willing to pay for it. And at some point don't you have the ability to turn back toward Goldman and talk about taking another position, or going out in the market and covering yourself?

What was the worst possible consequence of your accepting Goldman's statement as to what the market price was at the time that you, the quote, whatever it was, it was ridiculous, outrageous, or whatever?

WITNESS FORSTER: Well I guess there would be a few consequences. One, there would be a significant amount of cash that would go out the door from AIG to Goldman Sachs.

Two, I guess up to the point where we had an alternative source of valuation, I would imagine that people like the accounting folks, both at AIG and our external auditors, would use that as a data point.

And if we believed those prices to be inaccurate, then I think it would be wrong to have the company use that as a data point to mark its books.

VICE CHAIRMAN THOMAS: And your argument for believing that the stated required capital posting was that your model said that it wasn't worth what Goldman Sachs said it was?

WITNESS FORSTER: I think we can say that later on in the period, but not at the beginning. So as I said, right at the beginning we didn't have that. All we had was some other prices from, you know, we had anecdotal--

VICE CHAIRMAN THOMAS: And did you know that you had to make margin payments? There were some folks yesterday who said they weren't aware that that was part of the contract.

WITNESS FORSTER: Right. I mean, I realized that--

VICE CHAIRMAN THOMAS: Were you aware of it?

WITNESS FORSTER: I realized it was in the contract. I think it's a fairly standard feature of pretty much every derivative contract. So I didn't see it as a big issue. I knew it was there.

VICE CHAIRMAN THOMAS: Would it bother you that people who were above you in the structure seemed very surprised and didn't know that that was the kind of arrangement they had, that they were going to have to meet margin?

WITNESS FORSTER: I guess I'm not sure I can speak for them. It was clear to me. I thought it was clear to others.

VICE CHAIRMAN THOMAS: I'm asking you to speak for yourself, if you would be surprised that someone in your business above you stated yesterday under oath that they had not idea that that was part of the contract.

WITNESS FORSTER: As I said, I think it's a fairly standard feature of a derivative contract, so I guess to that extent I would be surprised.

VICE CHAIRMAN THOMAS: Okay. Did you want to say something?

CHAIRMAN ANGELIDES: Just on that point, Mr. Bensinger, in the interview with our staffs you apparently indicated that you weren't aware--you were the CFO of the company, correct?

WITNESS BENSINGER: I was.

CHAIRMAN ANGELIDES: You stated in interviews with our staff you were not aware of the collateral call provisions. Correct?

WITNESS BENSINGER: I was not aware of the collateral provisions as it--

CHAIRMAN ANGELIDES: As it pertained to mark to market?

WITNESS BENSINGER: --pertained to market pricing declines. I was aware of collateral provisions relating to rating triggers.

CHAIRMAN ANGELIDES: Right. So you weren't aware of the mark to market.

And, Mr. Habayeb, you were the CFO of the Financial Services Division, and you told our staff you weren't aware of them until third quarter of '07. Correct?

WITNESS HABAYEB: That's correct.

CHAIRMAN ANGELIDES: Okay. Which I found remarkable. But I just wanted to clarify your question.

VICE CHAIRMAN THOMAS: Mr. Chairman, we both find it remarkable.

CHAIRMAN ANGELIDES: Yes. All right.

VICE CHAIRMAN THOMAS: You'll get some time. All I'm trying to do is to try to understand the way in which, if you have a product which is determined by the market--because ultimately, don't you agree, Mr. Forster or anyone on AIG's side--is that no matter how good you think your modeling is, eventually what you have is worth what someone else is willing to pay for it? I mean, that's the market, isn't it?

WITNESS FORSTER: I mean ultimately that's the market. But that relies on actually having market prices at the time.

If you're in a liquidity gap and for a period of time where people just do not want to add risk, personally I don't think you should then mark all your positions to zero.

VICE CHAIRMAN THOMAS: No, I understand that.

But, you know, if I was going out looking for Austin Healey 1967 BJH, which was the last year that they imported them into the U.S., I'd love to have 100 to choose from. I wound up having one to choose from. And fortunately the price he was asking was the price of a lot on Flathead Lake in Montana. And so I could meet that price, and got a car that frankly appreciated significantly over a period of time.

So sometimes the market isn't what you want the market to be. The market is what the market is. And if you say you had very little ability to determine what the market is, that's the market. But you were not relying on what someone was buying or selling, or trying to--did you negotiate in terms of what a comparable would be in terms of saying there's limited options on the market, but we think there are the adjustments that should be made?

Because after all, they did come back with a lower collateral statement, didn't they?

WITNESS FORSTER: They did, yes and I think--

VICE CHAIRMAN THOMAS: Did you negotiate with them to reach that point? Or did they go back and negotiate with themselves and come back with the position that you accepted?

WITNESS FORSTER: Well I think, as I understand the chronology, the change from 1.8 to 1.2 was purely a--it was just in the contract that it needed to be reduced by that amount. There wasn't any real negotiation at that point.

And then, you know, we did enter into, you know, what I saw was fairly friendly negotiations with Goldman Sachs, and we came up with a compromise agreement in terms of posting that amount of money. I don't think either side thought that solved the situation; it didn't. Neither side accepted each other's prices, but as part of a business negotiation we came up with a compromise number for the short period of time.

VICE CHAIRMAN THOMAS: Last round for right now. Back to Goldman. What happened in terms of you going from 1.8 to 1.2?

WITNESS LEHMAN: So to the best of my recollection, what drove that change--one thing, I think it's important that we're mindful of this was a $15 or $20 billion portfolio. So it is a very big number.

VICE CHAIRMAN THOMAS: Yeah.

WITNESS LEHMAN: But what I recall we did, was we refined our pricing after we got more information--

VICE CHAIRMAN THOMAS: How do you refine it if you're using market? So you added adjustments to it--

WITNESS LEHMAN: No

VICE CHAIRMAN THOMAS: which weren't market based?

WITNESS LEHMAN: What we did is there were a few of the specific CDS contracts that we didn't have the offering docs to, so we needed to get increased information as relates to the structure and the performance of those deals.

And after a more thorough review of that, we put forth a new price.

VICE CHAIRMAN THOMAS: So you took a decent stab. You couldn't pull it off, so you sharpened your pencil, went back and decided that you would look at something.

If you went back and sharpened your pencil and redid it and it was a higher number, would you--do you think--I mean, let's just, I know I'm asking the question and you don't have to answer in any way you want--if you came back with a higher price, would you have gone back with a higher price?

WITNESS LEHMAN: Our prices always represented the best prices, our best view of market prices, given the information we had at that time. And that's what I believe changed the number from 1.8 to 1.--

VICE CHAIRMAN THOMAS: So when they rejected it, you went back and got a finer, or a better price of what you thought the market was?

WITNESS LEHMAN: I don't recall it being contingent upon their rejection. We needed more information to provide better pricing, and we asked for it.

VICE CHAIRMAN THOMAS: And had they rejected it, would you have gone back and looked for a different price, which probably would have been lower?

WITNESS LEHMAN: If we felt like there was more information out there that AIG had that could help us provide better pricing, we would always ask for it.

VICE CHAIRMAN THOMAS: Okay. Mr. Chairman, I will--

WITNESS LEHMAN: Higher or lower.

VICE CHAIRMAN THOMAS: --I will reserve my time.

CHAIRMAN ANGELIDES: I was going to defer the rest of my questions, but I've got to just follow up very quickly on this on two points.

Number one is, when you spoke you made this sound like a science. You know, we do all this quantitative analysis. But I just want to point out for the record, you make a capital call of $1.8 billion. Within a matter of days, you reduce it to $1.2 billion. You ask for 50 percent more initially than your quote/unquote "refined estimate."

It seems to me, I mean that's pretty much a stab in the dark. I mean, that's you guys--and, look, you're in business, and you're being aggressive. There may be many motivations. Maybe you're short. Maybe you guys have cash. You're just trying to protect your position. But just to put it in perspective, you're in a disrupted market.

You're saying you have this fine methodology, but one day you're saying it's $1.8 billion, and a few days later you're saying $1.2 billion. That's a $600 million spread. That's pretty damn big. Let's be frank about it. It's not like--and you're divergent with other people in the marketplace.

And by the way, it is 400 percent more than what you settle for. Now I know you had a standstill agreement, but just to put it in perspective, it seems to me like you guys are going in and being as aggressive as you can. It's not exactly, gee, here's where we see the market is. It's you're marking positions I assume for your benefit in the business environment. Isn't that fair to say?

WITNESS VINIAR: No, it's not fair to say.

CHAIRMAN ANGELIDES: So, so, okay, okay, I know I just barely--you say no, but if you really have good market data, how the heck is it $1.8 billion on day and $1.2 a few days later?

WITNESS VINIAR: I think one thing you said is fair, which is for illiquid assets like this it's not a science. And that there is judgment involved. And we continue to refine our judgment. And the market also continued to move, which is why the collateral calls changed constantly over time--

CHAIRMAN ANGELIDES: Yes, but it didn't move--it didn't move that much in a few days. Let's be blunt.

WITNESS VINIAR: I said it's not a--it's not an art, it's not a science. There is judgment involved. But we used our best estimate at all times of what the market was.

CHAIRMAN ANGELIDES: Okay, but just to put it in perspective, one day you thought it was $1.8 billion--and I want to just say. There's an e-mail here from Ram Sunderahm that goes to Lester Brafman, that comes to you, Mr. Lehman. And right at the same day the capital calls are made, he's saying the extent of the collateral calls being generated overnight is embarrassing for the firm, $1.9 billion for AIGFP alone. We need to focus on developing a--it's cut off. I have to get the full e-mail here. Sorry. I will get it. It's coming. Hang on a second. Mine is just cut off. Thank you.

"We need to focus on developing a process for ensuring accuracy of all marks, especially those which are being sent to clients, and those are the basis for margining open transactions."

So I just want to point out, your own folks are saying, hey, we'd better be accurate about this stuff. But the capital calls--the collateral calls are already gone.

Here's the other thing I want to just visit with you briefly, which is: You mentioned that you lay off your risks to other counterparties on parallel terms. But I've got to just ask you, I mean you're really not, you know, you're not just solely in the feed business. I mean, I assume you're making money on the spread here, correct?

WITNESS VINIAR: Yes.

CHAIRMAN ANGELIDES: I mean, it's just not credible to me--you know, you wouldn't be doing very well if it--okay, good.

WITNESS VINIAR: I'm sorry. I said, yes.

CHAIRMAN ANGELIDES: Good. Okay. And just to amplify the "yes," obviously if there were parallel terms, you guys wouldn't be doing very well?

WITNESS VINIAR: The parallel terms I was talking about were the collateral terms. Parallel collateral terms so we had--

CHAIRMAN ANGELIDES: Yes, but then collateral is a subset of the economic terms of the whole deal, too.

WITNESS VINIAR: No, Not necessarily. The parallel terms are the collateral terms, which mean that we had to post or receive if they declined. What we charge for writing protection, or got for getting protection, could be different. And that's where the spread--

CHAIRMAN ANGELIDES: We'll look at those when you provide them. And the last thing I want to do at this moment is enter into the record the e-mail I referred to earlier, which is an e-mail string, the last item of which is an e-mail from Mr. Athan to Mr. Frost dated August 8, 2007.

All right, Ms. Born.

COMMISSIONER BORN: Thank you very much, Mr. Chair, and thank you all for appearing before us.

Mr. Viniar, you state in your testimony, and I'm quoting, quote: "With regard to revenues and profits, it is important to underscore that we generally do not have a derivatives business." End quote.

You have also repeated under oath today that Goldman Sachs, quote, "generally does not have a derivatives business." Is that correct?

WITNESS VINIAR: Yes.

COMMISSIONER BORN: Didn't you tell the Commission staff that Goldman Sachs is one of the top five derivatives dealers in the world?

WITNESS VINIAR: I don't know if I said we were one of the top five. I might have. We're one of the bigger participants in derivatives markets in general.

COMMISSIONER BORN: Is the Office of the Comptroller of the Currency correct when it reports that Goldman Sachs held $48.9 trillion in notional amount of derivatives at the end of 2009?

WITNESS VINIAR: I don't know. I'd have to go look at our financial statements.

COMMISSIONER BORN: It also says that Goldman Sachs has the third largest derivatives position among any

of the U.S. bank holding companies. Does that surprise you?
WITNESS VINIAR: It could be.
COMMISSIONER BORN: We also have learned from our investigation of Goldman that Goldman currently holds more than a million contracts in derivatives.
WITNESS VINIAR: That's possible.
COMMISSIONER BORN: When you say that Goldman doesn't have a derivatives business, I would like to explore what you mean by that.
If a customer comes to Goldman and says it wants to buy an interest rate swap, do you say, no, we generally don't have a derivatives business?
WITNESS VINIAR: No.
COMMISSIONER BORN: Would you sell them an interest rate swap, or not?
WITNESS VINIAR: Yes, we would. Let me--can I clarify what I meant by we don't have a derivatives business?
COMMISSIONER BORN: Yes.
WITNESS VINIAR: We don't separate out derivatives and cash businesses. So we would have an interest rate business. We could have a credit business that would include both cash and derivatives. And we wouldn't separate them out. And so we might have someone on a desk if they wanted to buy a Treasury, or an interest rate

swap, it could be the same person.

If they wanted to buy a bond or a CDS contract, it would all be part of the same business. That's what I meant when I said we don't have the derivatives business, is that they're integrated into the cash businesses.

COMMISSIONER BORN: But it is an enormous portion of your business?

WITNESS VINIAR: Derivatives are a very big part. Derivatives and cash are both very big parts of what we do.

COMMISSIONER BORN: And in fact Mr. Lehman has said on the Structured Products Group Trading Desk you trade not only cash products but also derivatives products, correct?

WITNESS VINIAR: That's correct. We trade both cash and derivatives mortgage instruments.

COMMISSIONER BORN: Then, Mr. Viniar, in your testimony you go on to say, and I'm quoting: "We do not divide revenues or profits between derivative and non-derivative products, or track or report our financial results that way."

Is that your position?

WITNESS VINIAR: That's accurate. Yes.

COMMISSIONER BORN: Since early this year, the Commission has asked Goldman to provide to us its revenues and earnings from its enormous over-the-counter derivatives operation, and we have not yet received that information.

I would like to reiterate that request.

WITNESS VINIAR: I know this was discussed a lot yesterday, as well, and we're happy to sit down with your staff and go through what we have, what we don't have. We don't keep our books and records that way because the businesses are integrated.

Again, if we have a long cash position and a short derivatives position, we'd look at integrated. Even more complicated, you could have for example a commodities derivative that is settled physically. So you have a derivative and you end up with the physical asset at the end. So is that a derivative? Is it not a derivative? Where's the profit? So we don't keep your books and records that way. And we're happy to sit down with your staff and go through exactly what we have and what we don't have to show you that.

COMMISSIONER BORN: But you do keep financial data from which this could be derived, don't you?

WITNESS VINIAR: We keep financial data. I'm not sure that we actually could derive exactly what derivatives' profits or loss are. But we're happy to sit down with your staff and go through exactly what we have and what we don't have.

COMMISSIONER BORN: Well as I pointed out yesterday, the Office of the Comptroller of the Currency has reported that commercial banks' 2009 revenues from derivatives' trading were $22.6 billion. And it also reported that Goldman's commercial bank had $41.6 trillion in notional amount of derivatives.

Do you know whether you have reported to the Office of the Comptroller of the Currency?

WITNESS VINIAR: Notional amounts of derivatives--

COMMISSIONER BORN: No--

WITNESS VINIAR: --we have, and we can give you--

COMMISSIONER BORN: --revenues. They are reporting revenues of commercial banks.

WITNESS VINIAR: I don't believe we have reported to anybody revenues of derivatives, because we don't keep them. The report to the OCC that I've seen is combined derivatives and cash.

COMMISSIONER BORN: Well we would like copies of that, whatever reports you've given to OCC as well.

WITNESS VINIAR: Sure.

COMMISSIONER BORN: Aren't you aware of whether particular kinds of transactions are profitable or not profitable? I mean, if Lloyd Blankfein came to you and said: Are we really making money on our interest rate swaps transactions? Should we go out of the business of being a dealer in over-the-counter interest rate swaps? Would you say: Sorry, Lloyd, I can't tell you?

WITNESS VINIAR: I would have a hard time looking at just swaps, particularly. The interest rate business is a good business for us, but it's very combined with derivatives and cash. And so one of the reasons I wouldn't want to go out of the business is because it would be very hard to manage the cash risk, and it would be very hard to help our clients if we could only do one side, if we could only deal the cash and not handle derivatives.

COMMISSIONER BORN: If you're not aware of the profitability of that aspect of the business, how is it that you price the spread? I mean, let me ask Mr. Lehman.

How is it you decide what the prices are that you should bid and ask for CDS contracts, for example, if you don't know whether or not the business you're doing in that is profitable?

WITNESS LEHMAN: Well I think just to underscore the point that Mr. Viniar made, you know, the business--and I can speak to the mortgage trading business specifically--you know, ourselves, our competitors, our clients think about it holistically. So similar to how I price cash securities bid and offer, we're pricing derivatives in a similar manner. And in a lot of these securities, certainly in this day and age, there are liquid observable markets that we're looking at to, you know, assess risk and make trading decisions.

But we're looking at cash and derivatives holistically in these businesses, by and large.

COMMISSIONER BORN: Well I am asking you to try and look at them separately. So you don't know whether or not in a swaps transaction, say a CDS that you purchase or a CDS that you sell, whether that turns out to be profitable or a losing proposition for the company?

WITNESS LEHMAN: I think maybe a good example is if we have a CDS transaction where a client wants to be short risk, and they want to be long cash securities, you know, if we facilitate that transaction for the client, if we're just merely looking at one leg of the transaction that's not indicative of the whole picture in terms of that business for Goldman Sachs.

COMMISSIONER BORN: Well some of the business that you do is just the one leg, isn't it? You enter into a lot of over-the-counter derivatives contracts where you are not managing your counterparties' cash exposure. Isn't that correct?

WITNESS LEHMAN: You're suggesting if the client merely just wants to trade a derivative and not the cash security?

COMMISSIONER BORN: Yes.

WITNESS LEHMAN: The client might want to do that, but that trade is going to be in the holistic, integrated book that I mentioned by product, as opposed to meaning the sector itself, like commercial real estate, or residential mortgages, as opposed to derivatives versus cash.

COMMISSIONER BORN: So if you can't ascertain the profitability of particular kinds of instruments, I thought you marked them all to market, including, I assume, your derivatives book?

WITNESS LEHMAN: We do. Correct, we do.

COMMISSIONER BORN: But if you can't determine profitability of for example your interest rate swaps, how do you protect as a business against a rogue trader like Nick Leeson was at Barclays going in and losing a great deal of money on interest rate derivatives? Because that would kind of just be subsumed in your overall fixed income? Is that right?

WITNESS VINIAR: We would mark all of the traders positions to market, whether they had cash or derivatives, and we would see where they are.

COMMISSIONER BORN: So you would see that you were taking enormous losses on your derivatives?

WITNESS VINIAR: It--it, it would likely be a combined cash and derivatives. We'd look at both sides.

COMMISSIONER BORN: Well I don't think Nick Leeson's trading was. He was trading in derivatives only.

WITNESS VINIAR: I don't know what Nick Leeson was trading in.

COMMISSIONER BORN: He was at Barclays in the early '90s--

WITNESS VINIAR: No, I know where he was. No, I know that.

COMMISSIONER BORN: And so I wouldn't expect you to exactly notice. Well, I think it makes it appear very--a question has to arise as to whether or not Goldman would be capable, if it has no idea of its profits or revenues on its derivatives operation to manage that kind of enormous business properly.

Your Chief Risk Officer yesterday said that you can't manage something you can't measure. And I suggested--I am very skeptical that you really can't measure these revenues and profits. I think I urge you to provide us with the information we've been asking for. I think it's been about six months that we've been asking for it.

And it makes one wonder also why Goldman has the incentive, or impetus not to reveal this information. You're suggesting you don't reveal it to your regulators. You don't give it to OCC. You don't give it in your financial reports, so you don't give it to the market. You don't give it to any forum in which your customers over-the-counter derivatives counterparties can see what you're making on this aspect of the business, and you're refusing to give it to us.

I hope very much that we will see this very shortly.

WITNESS VINIAR: Commissioner, again, we are not refusing anything. We are happy to sit down with your staff and go through exactly what we have and try and accommodate as best we can. We don't have a separate derivatives business. It's integrated into the rest of our businesses. And I'm not aware of any other firm that in their financial statements has derivatives revenues broken out.

COMMISSIONER BORN: They don't, but some other firms have provided us with that data when we've asked for it. And Goldman Sachs hasn't.

Yes?

CHAIRMAN ANGELIDES: Just on my time for one minute, because you've made a couple of narrow statements. I noticed in your statement, your written testimony, and just there where you say "in our financial statements."

That's not what we're asking you. Look, I ran a very small business. I didn't have, let's put it this way, I didn't have the asset base Goldman Sachs had. But it's pretty simple when you run a business that if you have contracts, you know, the way it tends to work is you enter those contracts into your system.

You can track your contracts. So you have a 1.2 million contracts. Are you telling me you have no system at your company that tracks revenues or assets of contracts and liabilities and payments under contracts? So you don't track any--you have no management reports, no financial reports that track these contracts?

WITNESS VINIAR: I've never seen one that adds up our derivative revenues. And again, derivatives are somewhat complicated in that--

CHAIRMAN ANGELIDES: Well you may not have seen it, but you're telling me you don't have that kind of management system where you can--you get management reports to see, not just in these divisions but in other ways how information can be displayed horizontally, vertically, saying, hey, tell me how we're doing on those contracts?

WITNESS VINIAR: Where we would just break out the derivatives? No. We do not. Because it's not meaningful.

COMMISSIONER BORN: Back on my time? Thanks.

Mr. Lehman and Mr. Viniar, you said that Goldman marked to market the CDOs underlying the credit default swaps it bought from AIG in order to determine the collateral calls that you were making to AIG. Is that correct?

WITNESS LEHMAN: That's correct.

COMMISSIONER BORN: And were those marks an accurate measure of the value of those CDOs in your estimation?

WITNESS LEHMAN: In my estimation, yes, they were.

COMMISSIONER BORN: Was the value you arrived at below the par value of the CDOs?

WITNESS LEHMAN: Yes. These securities were trading at a discount at that period of time.

COMMISSIONER BORN: When the government bailed out AIG, it arranged to purchase a number of those CDOs from Goldman Sachs into the Maiden Lane III special purpose vehicle. Isn't that right?

WITNESS VINIAR: Yes.

COMMISSIONER BORN: Did the government pay your mark to market values of those CDOs? Or did it pay the full par value of the CDO?

WITNESS VINIAR: It paid the full par value to purchase the underlying securities from the CDOs.

COMMISSIONER BORN: It bought the CDOs from you at--

WITNESS VINIAR: It bought the securities underlying the CDOs.

COMMISSIONER BORN: Well those were CDOs, weren't they?

WITNESS LEHMAN: Yes, they were.

COMMISSIONER BORN: so--

WITNESS LEHMAN: And simultaneously tearing up the contract, the derivatives contract, as I understand it.

COMMISSIONER BORN: Right. In order to cancel the credit default swap, you sold in effect, or returned to Maiden Lane III the CDOs that the credit default swaps had been written on. And those were the same CDOs that you had been making to market, correct?

CHAIRMAN ANGELIDES: I will yield five minutes.

COMMISSIONER BORN: Thank you.

WITNESS LEHMAN: I believe it was a portion of them, yes.

COMMISSIONER BORN: So you got 100 cents on the dollar for those CDOs form the government through Maiden Lane III, even though you had valued them at a discount? Is that correct?

WITNESS LEHMAN: So, Commissioner, on the desk that I worked I was not privy to or involved in the Maiden Lane III conversations. But as I understand it, AIG was long this risk synthetically, and they were long it at par, and the prices went down to 50, 60 cents on the dollar. I'm not sure the exact price. And as opposed to maintaining that risk position synthetically, they decided to purchase the securities and have it in what we would term "funded format," in cash format, instead.

COMMISSIONER BORN: AIG didn't make that decision, did it?

WITNESS LEHMAN: I'm not familiar with--

COMMISSIONER BORN: Isn't that the Government of the United States making that decision?

WITNESS LEHMAN: I don't know who exactly made that decision.

COMMISSIONER BORN: Do you know, Mr. Viniar?

WITNESS VINIAR: No.

COMMISSIONER BORN: But there was no kind of compromise or negotiation for, between the full par value and the value that Goldman Sachs put on the CDO? You got the full value, not any discounted value? Isn't that correct?

WITNESS VINIAR: That's correct.

COMMISSIONER BORN: Do you know if anyone at Goldman did speak to the Government about the price that it would get for the CDOs?

WITNESS VINIAR: We had one conversation, either the day or two days before the Maiden Lane transaction.

COMMISSIONER BORN: Who was that—

WITNESS VINIAR: I’m Sorry?

COMMISSIONER BORN: with? Was that between you and--

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WITNESS VINIAR: Not me, personally no.

COMMISSIONER BORN: Who was it?

WITNESS VINIAR: It was a senior person in our Fixed Income area.

COMMISSIONER BORN: Who was it?

WITNESS VINIAR: The name is Harvey Schwartz, ran the division.

COMMISSIONER BORN: And was there any negotiation in that conversation about whether Goldman's valuation or the full par value is what you'd be paid for the CDOs?

WITNESS VINIAR: There was no negotiation. The representative of, I believe it was--I think it was New York Fed, but I'm not sure, said we'd like you to think about a discount. Mr. Schwartz said that he had to talk to more senior people, and we never had another conversation. The next thing we got were the documents from Maiden Lane.

COMMISSIONER BORN: So he never got back to the Government?

WITNESS VINIAR: There were no other conversations.

COMMISSIONER BORN: Goldman had insured itself by purchasing CDS from third counterparties, third parties, against the losses that it might suffer on the CDOs that it had credit default swaps from AIG on, correct?

WITNESS VINIAR: We insure ourselves on the difference between the collateral we believed we were owed by AIG and the collateral they had posted.

COMMISSIONER BORN: Correct. And did you exercise or get payment on those CDSs?

WITNESS VINIAR: No. You can only exercise the CDS, actually deliver, if the counterparties--if the underlier, who is AIG, actually defaults. So, no, there was never a payment under the CDS because AIG did not actually default.

COMMISSIONER BORN: Because the Government had paid you 100 cents on the dollar.

WITNESS VINIAR: The Government basically came in and prevented AIG from defaulting on any of their obligations.

COMMISSIONER BORN: So you took none of the losses, just the American Taxpayer took the losses on your dealing with AIG. Isn't that correct?

WITNESS VINIAR: We had, as we've said, no exposure to AIG because of the collateral and the CDS contracts. So we were paid in full, and we had full protection.

COMMISSIONER BORN: You were paid in full by the Government.

WITNESS VINIAR: On those transactions.

COMMISSIONER BORN: On those transactions, and you didn't have to exercise--make a claim on the CDSs, on the insurance you had bought on losses

WITNESS VINIAR: Well we couldn’t.

COMMISSIONER BORN: because you suffered no loss, because the American Taxpayer paid your loss on those deals.

WITNESS VINIAR: All we were paid was what we were due under a contract. We had paid for insurance, which of course we never collected under, so we had whatever the cost was of buying the insurance.

COMMISSIONER BORN: So you were 100 percent recompensed on that dealing. You got 100 cents on the dollar--

WITNESS VINIAR: We were paid what we were owed.

COMMISSIONER BORN: --and the only people who were out money was the American public.

WITNESS VINIAR: All I can comment on is we were paid what we were owed under our contract.

COMMISSIONER BORN: Thank you.

WITNESS VINIAR: You're welcome.

CHAIRMAN ANGELIDES: Mr. Thomas.

VICE CHAIRMAN THOMAS: Okay, I'm second in line. I mean, the U.S. talked about what they were going to pay. What would I have had to pay for it if you're dealing with me on the mark to market basis for the same piece of paper that the U.S. paid 100 cents on the dollar for?

WITNESS VINIAR: I'm not sure I understand the question.

VICE CHAIRMAN THOMAS: If I wanted to buy what the U.S. bought, what would it have cost me? What was the market price?

WITNESS VINIAR: We--I'm sorry, I'm confused.

WITNESS LEHMAN: I think the--and maybe--

VICE CHAIRMAN THOMAS: If I wanted to buy the underlying security.

WITNESS LEHMAN: I don't know the specific price, Vice Chairman, but--

VICE CHAIRMAN THOMAS: Try 48 cents.

WITNESS LEHMAN: --it was at a discount.

VICE CHAIRMAN THOMAS: Try 48 cents on November, early November of '08.

WITNESS LEHMAN: Understood. I think the point that I was making before--

VICE CHAIRMAN THOMAS: No, I'm just asking the question. So if I was second in line, I could get that security for 48 cents on the dollar?

WITNESS LEHMAN: Correct, if you did not--if you were not already owning that risk synthetically, which is what I was trying to articulate.

VICE CHAIRMAN THOMAS: But did the U.S. already own that risk synthetically?

WITNESS LEHMAN: No. AIG did.

VICE CHAIRMAN THOMAS: Okay, so the U.S. paid 100 cents for a security that if I were second in line and I said I want what they just bought, it would cost me 48 cents on the dollar?

WITNESS LEHMAN: If you did not have any contractual arrangement and you just decided to purchase it in the market, that's correct.

VICE CHAIRMAN THOMAS: Did the U.S. have any contracts or arrangements when they purchased that security?

WITNESS LEHMAN: Not that I'm aware of.

VICE CHAIRMAN THOMAS: Okay, so they paid 100 cents--back to Ms. Born's point--they paid 100 cents on the dollar for something that the next person in line could by for 48 cents for.

WITNESS VINIAR: I'm a little confused. I'm sorry I'm slow, but what--

VICE CHAIRMAN THOMAS: You're not slow. You work for Goldman Sachs.

(Laughter.)

WITNESS VINIAR: What the Government did, the Government stepped--

VICE CHAIRMAN THOMAS: Your problem is not answering my question the only way it can be answered.

WITNESS VINIAR: No, the Government stepped into AIG's shoes to perform under their contract. And in order to perform under their contract, they owed 100 cents on the dollar.

VICE CHAIRMAN THOMAS: Yeah, but if it was not in that situation and you negotiated, just like you went at them initially on those earlier arguments for $1.8 billion, and you wound up settling at $1.2 [billion], so you're going to come at me as the U.S. Government saying you owe me 100 cents on the dollar. I'm going to come back at you and use your data and say what's it selling for in the marketplace today? Let's mark to market.

So I'd offer you 48 cents, and you'd take it because that's what the price was, wouldn't you? Or are you not now buying and selling at market price?

WITNESS VINIAR: No, I think you're mixing apples and oranges. If you came and said to me I want to--

VICE CHAIRMAN THOMAS: Have you ever tried it in a salad? It's really not bad.

WITNESS VINIAR: If you came up to me and said, I would like to sell you protection on a similar instrument, then we would have looked at what the market price was at the time. It might have been 48 cents on the dollar.

But what you were saying was, I want to settle a contract that I already have with you that was written at a different time. And in order to settle that contract, you had to pay 100 cents on the dollar. So I think they are different questions.

VICE CHAIRMAN THOMAS: You had to sell at 100 cents on the dollar?

WITNESS VINIAR: In order to settle that contract.

VICE CHAIRMAN THOMAS: All right. The Government paid 100 cents on the dollar for something that was going for 48 cents at the same time. Is that a totally inaccurate statement?

WITNESS VINIAR: As I said, I think it's, with all due respect to the salad, I think it is mixing apples and oranges. I think they tried to settle a contract that they had on which they had posted collateral, in which they owed 100 cents on the dollar.

VICE CHAIRMAN THOMAS: Who is "they"?

WITNESS VINIAR: AIG.

VICE CHAIRMAN THOMAS: No, but I'm buying it. I'm the Government.

WITNESS VINIAR: Right. What you did is, the Government was step into AIG's shoes.

VICE CHAIRMAN THOMAS: I don't want to step into AIG's shoes. I want to take on the obligation which is something that's bought and sold in the marketplace. Why wouldn't I pay the marketplace price?

WITNESS VINIAR: But then we would of still had a contract with AIG.

VICE CHAIRMAN THOMAS: Yeah?

WITNESS VINIAR: If the Government wanted to start a fresh con--

VICE CHAIRMAN THOMAS: Were you going to collect from AIG?

WITNESS VINIAR: We had collateral. Yes, we would have collected the 50 cents, because we had the collateral.

VICE CHAIRMAN THOMAS: Okay. So the U.S. Taxpayer paid more than the value.

WITNESS VINIAR: I'm sorry, I don't think so.

VICE CHAIRMAN THOMAS: You don't think so? Okay.

CHAIRMAN ANGELIDES: All right. I'm going to return to that at the end, but Mr. Wallison. Oh, I'm sorry, Mr. Hennessey.

COMMISSIONER HENNESSEY: That's okay. Not a problem.

Thank you, Mr. Chairman. I think we're--

[Having trouble with the microphone.)

CHAIRMAN ANGELIDES: It's a deal over there.

COMMISSIONER HENNESSEY: Doug did this yesterday. Okay, I think we're way off track here. Our job is to understand the causes of the financial crisis, and I think that we are suffering from two big cases of selection bias here.

One is that we have structured these two days of hearings around derivatives, which as I said yesterday I believe are an instrument rather than a causal factor themselves. And two is, and you have to do this when you pick particular firms, but we have chosen two particular firms which seem to represent, I don't remember Peter's word, outliers, I was going to say extremes. But outliers in terms of how they operate, and in particular how they used derivatives.

And so I see certain commonalities with respect to derivatives: the lack of capital requirements, and the lack of transparency in certain cases. I see it as a commonality that we heard from the experts, and I believe a common policy problem going throughout this whole other area.

But everything that I keep hearing reaffirms to me that different firms are using these instruments in different ways. And it feels like some of us are trying to repeatedly shove this square peg into this round hole saying why doesn't this particular firm look at derivatives the way that I do? And it may be the case that different firms are looking at these different ways.

To come back to my hammer analogy from yesterday, I am imagining us bringing K.B. Homes up here and saying tell us how much of your income you earn from hammers. And

I wouldn't be surprised if they said, you know, we don't know. We can tell you how many hammers we use. We can tell you how many nails we buy, and how much income we get from building homes with those hammers. But in the case of K.B. Homes, the hammers themselves may not be an important element of this.

Also, I think it is really dangerous, as Peter was saying, to draw conclusions about derivatives generally as a causal factor in the crisis from the two particular firms in the cases that we are seeing here.

And I find it is hard for me to really care that much about the negotiations between these two firms as one of them was in the process of failing. I do not see that as a cause of the crisis. I see this, I believe, as an effect of the crisis.

And so I have just one question with respect to sort of the negotiations, which is for the AIG team. Goldman was not your only counterparty with which you were having these kinds of negotiations. Can you give us a sense of, was Goldman 80 percent of your counterparty dealings during this time of stress? Or were there four, five, or six others? Give me a feel for that?

WITNESS FORSTER: Sure. Goldman was certainly the first, I believe, and they were certainly the largest. But we did, as time went on through the fall of '07, we did start to get collateral calls from other people. Typically, I think, I'm not perfect with my recollection, but I think you're probably talking more like November and December time till we had, you know, relatively significant calls from other people as well.

COMMISSIONER HENNESSEY: And obviously there are going to be specific differences in each one of these discussions with the different firms.

Qualitatively, were the discussions all of a similar nature? Which is, that AIGFP was sticking to their model in terms of how much they thought was appropriate, and then the other firms were saying, no, we want more collateral?

I mean, did they all have the same sort of feel to them?

WITNESS FORSTER: Broadly they had the same sort of feel to them. I think everyone we talked to, everyone certainly that I talked to understood the lack of transparency in the market, the difficulty in actually coming up with observable prices. And everyone, including Goldman Sachs, to be fair, was willing to sort of work together to try and come up with negotiations.

I think the negotiations with everyone were, you know, fairly friendly to that extent.

COMMISSIONER HENNESSEY: And in each case it sounds like what you've got here is a negotiation between parties. Each of you has your model, relying as best you can on market data, but there really isn't that much market data available.

And then you're just getting down to sort of the relative strength in the negotiations? Is that--

WITNESS FORSTER: I think that is a fair statement.

COMMISSIONER HENNESSEY: --a fair way to characterize it? Okay.

So let me zoom out here. And I understand that the question I am going to ask is broader than any of your particular portfolios, but I found myself even more disturbed by what I heard yesterday from the AIG senior folks panel yesterday after I went home.

Why do you think AIGFP failed? I'll ask each of you to comment on that. Maybe start with Mr. Bensinger.

WITNESS BENSINGER: I believe that the ultimate cause of its failure was the lack of anticipation that the market conditions could deteriorate so significantly to create a liquidity strain on the corporation that it could not handle. And I believe that was really the ultimate, the ultimate factor.

COMMISSIONER HENNESSEY: So it was a--

WITNESS BENSINGER: It was a liquidity issue that ultimately--

COMMISSIONER HENNESSEY: A failure to manage liquidity risk, triggered by a mis-estimation of some other kind of risk?

One of the senses I got was that Mr. Cassano was saying, look, if they had just left me in as the negotiator I would have been able to cut a better deal with Goldman and we wouldn't have had any of these problems. And by the way, my model was still right, and is still right.

Whether or not his model was right and is right, clearly someone missed the possibility that there might be more collateral calls that they'd be forced to do, or he might of just missed the possibility that he would have been replaced as the negotiator, which meant that AIGFP was dependent entirely upon him being in that position to do the negotiations.

So if we move one step back in the chain, what was the error in judgment, or the error in just probability assessment that led to the liquidity crisis happening?

WITNESS BENSINGER: Perhaps I can amplify. If you go back to the third and fourth quarter of 2007, once the collateral calls began coming in, there was a significant effort made by the corporation to model--to try to anticipate how much liquidity would be needed in stress scenarios in the event that the market continued to deteriorate.

Using what my--the experts that we had in the corporation, you know, explained were highly stressed scenarios, I think ultimately that once you got into, I have to estimate some timing here, but I think into the spring of 2008, we became concerned that the market was deteriorating more significantly than we had anticipated even in our liquidity stress scenarios.

And we were having consistent dialogue with our Board, and with the Finance Committee of the Board about the liquidity situation, and monitoring that with them.

We made a decision in the spring or so of 2008 that, given the continued deterioration in the marketplace, that we needed to shore up our balance sheet from a liquidity standpoint, and also try to replace some of the capital that had been eroded by the unrealized valuation losses that were being taken principally on these instruments.

And so in May of 2008 we completed a capital raising of approximately $20 billion. And at that point in time, our best estimate, based upon any reasonable set of stressed assumptions that we could make, was that that additional liquidity within the corporation would be able to carry us through whatever might happen in the market.

And if you fast forward, unfortunately, to the

September of '08 time frame, you saw conditions deteriorate to the extent that they were unfortunately well beyond what we had anticipated, and I think well beyond what many market participants had anticipated. And even with all of that cash flow addition and monitoring and trying to do everything we could to stem the cash outflows, market events overtook us.

COMMISSIONER HENNESSEY: Okay. I think I understand that, and I think I understand what you are saying that part of it was that there was a decrease in the available supply of liquidity in September of 2008.

WITNESS BENSINGER: There was.

COMMISSIONER HENNESSEY: Was there also an unexpected surge in the demand for liquidity from your counterparties in the fall of 2008, or any other point in time?

WITNESS BENSINGER: I'm not really the expert in the market in this particular area, but I think what you saw was sort of a vicious cycle of marks bringing down the value of those securities, calling for more collateral, generating losses--

COMMISSIONER HENNESSEY: Got it. I understand that as a general matter. My problem is that lots of financial firms experienced a similar decline in the supply of available liquidity, right? But they didn't all fail.

So what I am trying to figure out is, were you all just hypersensitive to that? Or was it also the case that people were looking at AIG or AIGFP and saying, you know what, I'm nervous about them because I don't trust their model. And because everybody else is on the other side of their model, and they fired Cassano, and PWC has given them a black mark, et cetera, et cetera, so I'm trying to figure out do you actually think that, for instance, the model that was used earlier was in fact being played out as wrong? Or that you were on the wrong side of that, and that that was encouraging your counterparties to show up and knock on your door and say give me money?

WITNESS BENSINGER: Well I think toward the September time frame there was certainly an element of what I'll call a run on the bank, where the market was getting more nervous about what was going on because of the market conditions and our well known exposures to the mortgage market.

So I think market forces certainly had a lot to do with it.

COMMISSIONER HENNESSEY: Let me ask you about that run. Sometimes a run is unjustified because there's a false rumor that the bank is unhealthy, and sometimes there's an element of truth that the bank really is out of money or has done something wrong. And I think that's the claim that's made often about AIG, is, you know what, their models were so wrong, these guys really are insolvent, or they may not be able to pay us back.

Do you believe that any of those arguments made by others--let me ask it the other way--Mr. Cassano seemed to be suggesting that he still stands by the model. Do you agree with that?

WITNESS BENSINGER: I think maybe if I could separate it into two places?

COMMISSIONER HENNESSEY: Please.

WITNESS BENSINGER: One is ultimate credit losses on this product. These products, as you've heard, were designed to be able to withstand very significant stressed economic scenarios. And again, I'm not the expert on how these were underwritten, but I've seen a number of presentations to show that the underlying collateral supporting the super senior positions that AIGFP insured contained significant elements of AAA protection, as well as protections below that.

So there was a lot of subordination. I don't want to put words into Mr. Cassano's mouth, but I think what he's saying is he believes that ultimately when this whole story plays out, that the actual credit losses in those instruments will be far lower than the actual market prices that caused the collateral calls and I think that--

COMMISSIONER HENNESSEY: That I got. And I remember similar conversations, which is, look, if we just hold this MBS for 30 years, the stream of mortgage payments are going to come in and we're going to get 98, 99, 100 cents on the dollar. And then someone is replying, yeah, but we're not going to hold it for 30 years. We need to sell it sometime within the next 6 to 12 months. How much can we get for it now, when others don't have that same confidence?

Do you believe that there was a failure at AIGFP to correctly anticipate what the sellable market value of those securities would be? Or I'm not sure if I'm describing the transaction right, but setting aside what the long-term value would be of this contract in reality based on the cash flows, do you think that there was an error in anticipating for instance the counterparty calls?

WITNESS BENSINGER: With hindsight,

COMMISSIONER HENNESSEY: Yeah

WITNESS BENSINGER: I believe that the ultimate cause of the issues was the liquidity issue that arose because the assumptions, even the stressed assumptions, that the experts were using around how significantly a market can deteriorate, how significantly an entire global market can effectively shut down, become completely illiquid and opaque and lack of transparency and inability to fund oneself in a multi-trillion dollar global market, I think the assumptions that were used simply were overtaken by the unbelievable deterioration that ultimately occurred in the market.

COMMISSIONER HENNESSEY: Okay, I am going to shift and ask similar questions over to one of your biggest counterparties.

Mr. Viniar, you had the broader portfolio of the two of you here. Understanding that you are not an expert in the finances of AIGFP, given that they were such a large counterparty to Goldman, I assume that ya'll were having some sorts of discussions about, you know, how healthy are they? Are they going to be there?

Can you give me your thoughts and observations as to what happened to cause AIGFP to collapse?

WITNESS VINIAR: Well that would be very hard. I am not inside AIGFP. I don't really--

COMMISSIONER HENNESSEY: I'm not asking you if you know. I'm asking what's your judgment. What do you think?

WITNESS VINIAR: I guess I would say, I'm going to maybe answer your question a little bit more in a generality. When I look at some of the issues that I saw as problems for various financial firms in the market--

COMMISSIONER HENNESSEY: No, I'm sorry. I am interrupting you because my time is limited. I am interested in--

VICE CHAIRMAN THOMAS: Mr. Chairman, I yield the gentleman an additional--

COMMISSIONER HENNESSEY: Three minutes?

VICE CHAIRMAN THOMAS: --three minutes.

COMMISSIONER HENNESSEY: I have to believe that you were at some point involved in sitting around with a bunch of people saying, we think AIGFP is going down, and someone said why? And of course you don't really know, but what did you think?

WITNESS VINIAR: So like I think--and you just talked about some of them--I think first and foremost, you start with any financial institution, liquidity, liquidity, liquidity.

You know, the only thing that ever causes a financial institution to truly go down is running of money. So liquidity--the first ten issues are liquidity.

I think the second--

COMMISSIONER HENNESSEY: And what I'm most interested in is, what triggered the liquidity crisis.

WITNESS VINIAR: I think the second thing is that all financial institutions, including AIGFP, need to be very cognizant of very large, concentrated positions. And one of the things we have learned, and we know, is that we are not smart enough to know what is going to happen. All models can be wrong.

Tail risk can happen even farther out on the spectrum than you ever thought it would. All of the models that showed how unlikely it was that, not just AIGFP but others would lose money on super senior CDOs, I think if everybody had looked at those models before 2007, everyone would have agreed with them and said really, really, really unlikely.

COMMISSIONER HENNESSEY: So they concentrated too much tail risk and bet the firm on that.

WITNESS VINIAR: Too much. And then the third thing I would say is, as I said before, we think it is very dangerous to ignore what the market says. And, that you have to pay attention to marking to market. If the market says something's worth 90, then all you know is that today it is worth 90. Maybe it will go back to 100, but maybe it won't.

COMMISSIONER HENNESSEY: Okay, but in this case there really wasn't a market price for them to use?

WITNESS VINIAR: There were enough indications of similar things in the market that you could mark things to market. We don't believe you ever can't mark things to market and come up with a fair value. Maybe not the exact thing you have, but markets will tell you what's going on with similar securities, with securities with similar risks, and you should pay attention to those and take actions based on those.

COMMISSIONER HENNESSEY: Okay, let me ask one more. So Mr. Cassano, as I heard him, was telling us that he still believes in his model. He still thinks that these securities in the long run will be good. And to the extent they're still there, that the cash flows will still flow.

Did he or AIGFP, did they underestimate the need for collateral?

WITNESS VINIAR: It appears that way.

COMMISSIONER HENNESSEY: And is that what triggered--in terms of the proximate cause of the liquidity run, they needed the cash to pay you and other counterparties, right?

WITNESS VINIAR: You get back to liquidity, liquidity, liquidity. What causes it maybe in the end, I don't know, maybe in the end they do pay off in 30 years, as you said. But in the interim you have to pay attention to the market.

COMMISSIONER HENNESSEY: The image that I am building in my mind of someone sitting there insisting my model is right, and then someone on a staff saying, well, the model may be right some day but we are never going to know, because we have got to pay these guys right now. And then the response is, no we don't, I'm a better negotiator than all of you. Let me go negotiate with them.

How am I don't on my story?

WITNESS VINIAR: I think--(Shrugs his shoulders.)

COMMISSIONER HENNESSEY: Okay, I'm done. Thank you.

CHAIRMAN ANGELIDES: Well, and I just actually want to point out, I do think this is a very central issue for our deliberations. Because what we are dealing with here in this panel is, there were the long-term economic value, or losses of these securities, and of course you've got to juxtapose that against the liquidity pressures that are developing in the market starting in July of 2007, and around other devices also--for example, the Bear Stearns asset management funds where, because of the mark to market, either redemption provisions in the Bear Stearns asset management, or the collateral call provisions tied to mark to market--it did begin, it seems to me, a set of liquidity pressures that began to build over a period of time.

COMMISSIONER HENNESSEY: Yeah. I am just having a difficult time drawing broader lessons from these two outliers. I think I've learned something about, I think, why I think AIGFP failed. I think I've learned something about how these two firms operated, and a little bit about the transaction.

It's very difficult for me to extract from this a broader lesson about derivatives and their role in the crisis, or even a broader reason why this particular interaction contributed to AIGFP failing, or more importantly, contributed to the crisis.

CHAIRMAN ANGELIDES: Well we will have a lot of time for deliberation. I think this is a central issue because this was one of the major flashpoints, potentially--these are all questions--this could have been one of the major flashpoints, and there may have been others, where liquidity pressures began to build in this market.

And that is why I think it is of interest. I think your line of questions was very interesting in this regard.

COMMISSIONER HENNESSEY: Thank you. If I could just, ten seconds, and ya'll are disadvantaged because we heard from Bear Stearns, I don't know, a couple of months ago, and I heard a response which I found similarly incredible, which was--not from you--but from what we heard from your CEO yesterday, where he said we didn't do anything wrong. We didn't make any mistakes. In hindsight, we didn't make any mistakes. It was just the liquidity market dried up and we got caught up in that.

We heard that from Bear Stearns. I didn't believe it then, and frankly I didn't believe it from Mr. Cassano yesterday. Thank you.

CHAIRMAN ANGELIDES: All right. Mr. Wallison?

COMMISSIONER WALLISON: Thank you, Mr. Chairman. Actually I want to follow a very similar line of questions that Mr. Hennessey, Commissioner Hennessey followed, but from a slightly different point of view.

He mentioned the idea of outlier, and I see a lot of the same things happening here. That is, we are talking about in the case of AIG a real outlier on which we are trying to develop some major conclusions based on one incident.

And it turns out now, as Commissioner Hennessey was drawing his questions, it turns out now that that was connected quite directly to a model. And the success and operation of a particular model.

So, Mr. Forster, if I can spend a little bit of time talking to you about the Gorton Model, because that does interest me quite a lot.

First of all I would like to clear up one thing. That is, did anyone else in your knowledge use the Gorton Model for what you used it for? Or was this proprietary to AIG?

WITNESS FORSTER: I think the Gorton Model itself is proprietary to AIG. I think the general building blocks that the Gorton Model used was used by other people, as well.

COMMISSIONER WALLISON: So the Gorton Model now evaluated the risk of loss on super senior portions of these CDOs. Did the Model evaluate the assets or the composition of the assets in the CDOs?

WITNESS FORSTER: No.

COMMISSIONER WALLISON: So it just--let me go on a little bit further then and ask: So in your testimony you said that in the summer of 2005 you began thinking more about the multi-sector CDOs, and you began to question whether the modeling that was needed, the additional analysis of deals, was sufficient. Or were they sufficiently taking account of interest-only loans. I think that's how you phrased it in your testimony.

Were you then beginning to ask whether the Model was actually looking at the underlying loans and how it was functioning at that point?

WITNESS FORSTER: I think, just to take step back if I may, through any business that we did it always made sense to take a step back at different times and question the assumptions that we were using in any of it, and I think that is what we did in July of 2005.

Some of the questions that I have posed at that time, we probably knew the answers to; others were just reinforcing the assumptions that we were making.

At the time what we wanted to do was--the Model is obviously only as good as the inputs that you put into it--we wanted to make sure that the underlying loans, underlying reference obligations, we were still comfortable with those, and we still felt the ratings and things like that reflected the risk that was inherent in them.

COMMISSIONER WALLISON: Let me see if I understand correctly. The model did look at the underlying loans, the kinds of loans that were being made? And when you were talking about interest-only loans, for example, those were taken account of in some way in the Model? So that if the Model was made up of 95 percent interest-only loans, the Model would have reflected the risk associated with that? Is that correct?

WITNESS FORSTER: It's not quite correct, I think.

COMMISSIONER WALLISON: Good. Please correct me.

WITNESS FORSTER: Sorry. The underlying ratings of the obligations, if you had the subprime obligation, if it was all interest-only, or heavily concentrated in certain areas, then the rating of that obligation would reflect back.

So if it was all interest-only, the rating agencies would see that as more risky. It would likely then get a lower rating. The Model would just take the rating of the instrument.

COMMISSIONER WALLISON: Oh, so the Model relied on the rating agencies?

WITNESS FORSTER: Yes. The Model--I mean, to a large extent. We made additional changes to it, and we stressed the rating agencies' assumptions, and we checked that we were comfortable with the rating agencies' ratings. But the Model basically uses the ratings of the underlying data.

COMMISSIONER WALLISON: Have you by any chance followed some of our questions to the rating agencies and what we learned from those questions?

WITNESS FORSTER: I haven't followed them in too much detail, but I understand the general issues, yes.

COMMISSIONER WALLISON: Now I understand the problem with the Model.

Okay, let me ask one more question that is related to this. At this point, based on your analysis of the Model and what you have done in the past, what is your conclusion about why this Model failed?

WITNESS FORSTER: The Model has failed to the extent that ultimately we take credit losses, which I suspect will occur to some extent. The Model has failed in that sense only in that, you know, the underlying reference obligations that we're putting in, the ratings that we're assuming, turned out to be, you know, not as robust as we expected. We were putting them through a very stressed scenario, and the world turned out to be--a combination of the world turning out to be more stressed than we had predicted, and that the ratings were less reliable than we had expected.

COMMISSIONER WALLISON: I guess the lesson here is whether it makes any sense for a business to place all its eggs in the basket of a model, rather than, as Goldman is suggesting, looking at what the market is doing.

WITNESS FORSTER: I don't think it's a question of looking at what the market was doing, because we were marking our positions to market. I don't think, actually my personal view is that that wasn't the issue.

I do totally agree with the view that, you know, too much reliance and too much notional was placed in one area due to reliance on a model.

COMMISSIONER WALLISON: Okay. Just based on your knowledge, and obviously you might not have much broader knowledge than simply what AIG was doing, are you aware of any other major firm that did its trading and entered into its obligations on the basis of a model?

WITNESS FORSTER: I mean I know of other institutions that entered into similar transactions. What they actually used to come up with their attachment points, I couldn't tell you I'm afraid.

COMMISSIONER WALLISON: Okay. Thanks very much.

Mr. Viniar, I would like to ask a few questions of you about how Goldman acted. And again I am trying to get away from what I think is a rather unproductive discussion of how you guys thought about collateral, but I am interested in how you dealt with the fair-value issue.

And you said that you tried to come to a value based on what you saw in the market. If you determine that there is a thin market, you still rely on the consequences of that. What if the market, as it did for a period of time in 2007, late 2007 early 2008, simply disappears? So that the only sales that are being made in one kind of market, and in this case this was the mortgage-backed securities market, there were hardly any sales at all? And when they occurred, they were, as everyone would have said, distress sales. People who were absolutely forced to sell in order to protect themselves against default.

Can you tell me what you do in a situation like that? Do you mark down to a distress sale?

WITNESS VINIAR: That's a very good question. And, frankly, about the only time I can remember where there really was virtually no market in a product since I've been looking at it was late 2007--late 2008, really, early 2009, in the real estate related areas. It was very difficult.

And we don't mark everything to zero in that case. But what we do is, we take whatever market comparables we see, and the other thing we do is we'll do all different types of analysis. So for example, we might look at what the cash flows coming off an asset were and say, okay, what return would someone require in this market to buy those cash flows?

And so the return requirements would have gone up dramatically, but we'll still take those into consideration. So we'll look at other transactions people are doing, the returns they're requiring to do those transactions, and say even though there are no transactions in this market, if they required those returns for the cash flows that they're getting, what would the pricing be? So that would cause in some cases a fairly dramatic markdown, but not to zero.

So we will use methodologies such as that where we will find market-observable data of some type and see how we can use that data to price the securities that we have.

COMMISSIONER WALLISON: Well you know what I'm going to ask now. That is, that for the super seniors the cash flows were fine. It was the market that was not fine. So what do you do in a case like that?

WITNESS VINIAR: Well in some cases the cash flows were fine; in some cases there were questions about whether the cash flows would be fine.

COMMISSIONER WALLISON: It would be fine, in the future?

WITNESS VINIAR: Or whether they would be--yeah, whether they would be fine, and therefore what return requirements people would have in order to buy that projected stream of cash flows, which could be a significantly higher return because the cash flows were significantly less certain, and therefore you would mark things down on that basis.

COMMISSIONER WALLISON: And so this was really a gut kind of thing?

WITNESS VINIAR: It was based on--again, we'd look at market observable transactions to see what returns people were requiring, but--and if there were no trades in that specific security, you would have to use all kinds of different methodologies that you sought in the market to decide what the value was.

COMMISSIONER WALLISON: Did you use a model for this?

WITNESS VINIAR: We--I actually--I'm not sure. We used models, but we used models as informed by what we see in the markets.

WITNESS LEHMAN: Yeah, I would say, you know, throughout--and it depends on the specific time frame--there were models that we had used. But they were helpful tools, one of many things that we used to help inform our decisions.

But really, it is very important that the model is calibrated to what we are actually seeing in the market because the big difference here is bifurcating between fundamental value or ultimate losses versus market value.

Risk premium is what we are looking to observe often, and the market was telling us that risk premium was going up in this time period. Even if one's opinion of fundamental value was unchanged, risk premium clearly was changing in what we saw in the market.

WITNESS VINIAR: And one of the things from a risk management point of view that we always are paying attention to is, at times when markets tell you something very different than what your models tell you, it is cause for concern and cause for pause, and cause to say should we be doing something differently? Because clearly whatever the models were telling you, it was breaking down in the market's view of what's going on.

So it is a very important factor that we'll look at.

COMMISSIONER WALLISON: When you wrote down the value of an asset because you looked at the market and you saw how it was functioning, did you--what did you do with the associated liability?--

WITNESS VINIAR: I'm not sure--

COMMISSIONER WALLISON: That is to say, if the asset declined in value because the market was declining, wasn't there an appreciable increase in the liability that was associated with that?

WITNESS VINIAR: If it was just funded for example by debt, the answer is we wouldn't mark that to market.

COMMISSIONER WALLISON: You wouldn't mark that--

WITNESS VINIAR: No.

COMMISSIONER WALLISON: That's what I was trying to get at. You wouldn't mark that to market?

WITNESS VINIAR: Not necessarily. It depends on what's on the other side of it.

COMMISSIONER WALLISON: Okay. In your testimony you said that Goldman Sachs arranged credit default swap coverage for clients. I'm trying to just get a sense of how this actually worked in practice.

Let's say that a client has come to you and wants protection on a super senior CDO. There's going to be a price you're going to ask for that. And you know that you're going--or in most cases, you're going to hedge that somewhere else. So you're going to protect that client, but you're going to hedge with say an AIG or some other counterparty in the market.

Do you test the market first to find out what's available, and what the prices would be to hedge the risk? Or is there a way that you can establish what you're going to charge without that?

WITNESS LEHMAN: I think it's imperative as a market maker to have continuous involvement in these markets, talking to various different clients, understanding what's happening.

So having a sense of the supply/demand dynamic is very, very important in that specific situation.

COMMISSIONER WALLISON: So in other words you would know for almost every kind of security that is presented to you for protection, you would have some view of what you were going to have to pay to lay off that risk if you took it? So you don't actually have to be requesting prices at the same time?

WITNESS LEHMAN: That's correct. You are market makers. Our traders on the desk are involved in these markets day in/day out, and they are going to have a view on what's happening in the market and the right price for that product.

Certainly at times for less liquid products it's, you know, it's more challenging than for more liquid products, but that is what we expect of the traders on the desk.

COMMISSIONER WALLISON: One more question. And that is, much of what you have talked about is what you do for clients when clients come in and ask for protection.

Do you have a portfolio of your own of CDOs, for example, that are your own investments, Goldman's own investments? And what kind of protection did you seek for the super senior levels of those CDOs, to the extent that you held them?

VICE CHAIRMAN THOMAS: I yield the gentleman an additional three minutes.

COMMISSIONER WALLISON: Thank you.

WITNESS LEHMAN: Commissioner, I think it is important--and I'll answer in one second--but the business that AIG and other longer term investors or insurance providers did was different than the business that I do at Goldman Sachs.

So specifically, the trading desk is a function of the over-the-counter nature of the fixed-income market. We do act as principal for clients in our trading. So we have positions and we manage our risk holistically, cash and derivatives, by product. And that is, so we will at times have positions of varying sizes as we carry an inventory to service clients.

COMMISSIONER WALLISON: So it's not--let me understand this. Goldman does not actually have assets that are for the purpose of simply investing? They are always "shows as an action" as we used to say in law school. That is to say, you are holding them temporarily in order to meet the needs of clients?

WITNESS LEHMAN: Well I can speak for my

business, and perhaps Mr. Viniar can talk more about the firm, but in my business that's correct. It's a trading business.

WITNESS VINIAR: I think it would be an overstatement to say "always." I think predominantly would be true. We do have some proprietary desks that would just buy and sell things for the account of Goldman Sachs. But it's a very small part.

COMMISSIONER WALLISON: I think I'm finished, Mr. Vice Chairman. Thank you.

VICE CHAIRMAN THOMAS (presiding): Thank you. I think I am the chairman right now.

COMMISSIONER WALLISON: You are. You have the gavel.

VICE CHAIRMAN THOMAS: I've taken the gavel away.

COMMISSIONER WALLISON: So I'm stepping out of your way.

(Laughter.)

VICE CHAIRMAN THOMAS: Senator?

COMMISSIONER GRAHAM: I am going to have to start by raising a little different perspective on what this Commission's responsibilities are that my friend Keith did a few moments ago.

I interpreted what Keith said that the financial crisis had an ending point, and our responsibility is up to that ending point but not subsequent to the ending point.

Our actual charter from the Congress reads that our responsibility is, quote:

> To examine the causes, domestic and global, of the current financial and economic crisis in the United States.

I interpret that as being an ongoing responsibility, because I believe clearly the millions of people who are out of work, and those who have lost their homes, and those who have lost their hope, don’t think the financial and economic crisis is over.

And in fact, I believe that, given the nature of what Congress did, a rather unusual step, that that underscores my reading of legislative intent.

We in many forums have been analogized to the CORA Commission, which was a commission really of the Senate Banking Committee, the committee that occupies this very room, back in the early 1930s to look into the causes of the Great Depression, and to prescribe solutions to those found causes.

Our Commission was established by Congress with the single purpose of diagnosing the causes. It would be like going to the doctor and having one doctor do the diagnosis, and then go next door and have another doctor decide what prescription you should receive against that diagnosis. We are only in the first office of diagnosis.

Why would the Congress have split the jurisdiction in that manner? My answer is that the most logical reason is because the Congress felt that it, itself, was part of the causes of the problem; that we are going to find areas such as areas of Jennie Mae, and Fannie Mae, and Freddie Mac, where the Congress played potentially a key, critical role in this; and that Congress felt that it, because of that, was not a credible diagnostician, but that it could be a credible prescriber against the diagnosis.

If that is a correct analysis, then I think since the Congress has been involved in this through today--in fact, the consideration of important legislation is before the Congress as we meet this morning--that our charter is a continuing charter to deal with the continuing financial crisis.

Therefore, issues such as how did the Federal Government deal with this issue of the AIG indebtedness to Goldman Sachs is a very relevant part of our diagnosis of the current financial and economic crisis.

Now I say that so that the questions I'm going to ask are not dismissed as being irrelevant to our inquiry.

And so going back to the role of the Federal Government, AIG, and Goldman Sachs, let me understand. If the hypothetical number of 48 cents on the dollar was accurate, that was what these securities were, that was their market mark, if you had been paid for--if you, Goldman Sachs, and I will direct this question to Mr. Lehman--if you had been paid the 48 cents that the market said they were worth, would you not have collected the other 52 cents from these various counterparties from whom you had hedged your AIG investment?

WITNESS LEHMAN: Sure and so I think, Commissioner--and maybe Vice Chairman Thomas's question earlier--the trades with AIG where they were long synthetically or in derivative form at 100 cents on the dollar, using your 48 or 50 cents on the dollar just to use round numbers, they had posted very close to 50 cents on the dollar by the point in time of November 2008.

So AIG or the Government, I'm not sure who exactly made the decision to want the exposure in cash format, but at that point in time they paid the balance, what AIG had not collateralized to us to, which was the market price to own the security outright.

By and large, you know, we were looking for the cash that we had from AIG, as well as the incremental monies to purchase those securities from our counterparties to deliver them to AIG or the Government.

COMMISSIONER GRAHAM: You've made my simple question more complicated.

WITNESS LEHMAN: I apologize.

COMMISSIONER GRAHAM: It seems to me that you had two ways to make yourself whole. One was whatever money the Federal Government was going to provide through AIG. And second, the hedged contracts that you had said you had purchased.

If that is correct, it seems to me by the Federal Government paying 100 cents on the dollar rather than the 48 cents that the market said they were really worth, the beneficiary party was not Goldman Sachs but was whoever held those contracts that would have paid you the difference between the Federal Government and what your real loss was.

Is that a correct statement?

WITNESS VINIAR: Those CDS contracts only paid off if AIG defaulted. So basically the Government either had to pay 100, or zero. If they paid zero and AIG defaulted, then we could collect under the contracts. Otherwise--

COMMISSIONER GRAHAM: So your contracts didn't cover for less than total default?

WITNESS VINIAR: That was the purpose of the collateral with AIG. And the difference between the collateral they paid and the collateral we felt we were owed was covered by the CDS contracts, which only paid--the CDS contracts in general only settle on the case of a default.

That's why they're credit default swaps.

COMMISSIONER GRAHAM: You said that there was one brief meeting at which there was some negotiation between Goldman Sachs and a representative probably of the New York Fed as to what this transaction would be. And then the New York Fed individual left the meeting, and the next thing you heard you were going to be paid 100 percent? Is that right?

WITNESS VINIAR: It was a phone call. It was one phone call, and it was a brief phone call, and that was it.

COMMISSIONER GRAHAM: Were there any--was that the totality of your relationships with the Federal Government vis-a-vis AIG? Were there any other subsequent transactions involving financial relationships that Goldman Sachs had with AIG?

WITNESS VINIAR: Other than Maiden Lane? I don't believe there are any others, but I'm not positive.

COMMISSIONER GRAHAM: Mr. Chairman, my time is up.

CHAIRMAN ANGELIDES (presiding): Would you like a couple of more minutes?

COMMISSIONER GRAHAM: I'm satisfied.

CHAIRMAN ANGELIDES: You're satisfied? All right, thank you. Mr. Georgiou.

COMMISSIONER GEORGIOU: Thank you very much, Mr. Chairman. I would like to ask the AIG gentlemen, if I could, how old is AIG? Do you know? Anybody?

WITNESS BENSINGER: I believe it is slightly under 100 years old.

COMMISSIONER GEORGIOU: Okay. And at the end of '07, the market capitalization was about $147 billion? Is that right?

WITNESS BENSINGER: That sounds right.

COMMISSIONER GEORGIOU: And is it fair to say that we all can agree now that the price which you charged at AIGFP for the essentially insurance protection you were providing in the credit default swaps against the failure of the underlying securities was insufficient to protect against the risk that you undertook? Does anybody agree to that proposition on the AIG side? Mr. Forster?

WITNESS FORSTER: Sure I think with hindsight clearly there turned out to be more risk embedded in the transactions than we thought. So, yes, the price didn't reflect that--

COMMISSIONER GEORGIOU: Right. So you should have charged more money to Goldman Sachs and any other counterparty who was buying credit default swaps protection against these super senior tranches of these securities in order to protect against their default--in order to insure them that you could pay against--pay if they defaulted? Correct?

WITNESS FORSTER: I mean looking back from here and seeing now what the likelihood was of ultimate defaults, the answer to that is, yes.

COMMISSIONER GEORGIOU: Because isn't it the case that the company, AIG, basically failed as a result of collateral calls and other obligations associated with these products that caused the company to collapse and require an infusion of some $80 billion to start with from the Government? Mr. Habayeb?

WITNESS HABAYEB: You know, looking in hindsight from a liquidity perspective within Financial Products and other parts of the company, there were significant liquidity exposures for AIG. Faced with being shut out of the capital markets, not being a bank with access to the Fed Window, and facing the perfect storm in the market, those were all things that led up to AIG's failure.

COMMISSIONER GEORGIOU: Okay, but I don't really buy this perfect storm argument, which has come before us a number of times, in which witnesses in the private and public sector have continually testified to this Commission that all of these things occurred which caused the financial crisis without anybody doing anything wrong in the private or the public sector; that it was simply a confluence of events, which the Chairman has called an immaculate calamity, and I call sort of a pathetic mythology.

So I frankly don’t buy the perfect storm. I mean, I think these events were caused by human decisions that were in many instances profoundly wrong. And I want to explore this a little bit, if I can, with the Goldman Sachs people.

Now, Mr. Viniar, you testified, and your opening statement says, that with respect to AIG our relationship was governed by the same client service and risk management focus described above. To put our relationship with AIG in context, our clients first came to us to help them manage credit exposure to super senior CDO positions on their books.

We entered into credit derivative swap contracts--that is, sold protection--to help them hedge against a fall in the value of their super senior CDOs. We then entered into offsetting contracts, bought protection with AIG to manage the resulting exposure in our books.

You with me?

WITNESS VINIAR: Yes.

COMMISSIONER GEORGIOU: Okay. You can keep your microphone on because we're going to talk for a little bit here.

WITNESS VINIAR: Okay.

COMMISSIONER GEORGIOU: What I would like to know is--and if I could take a look at that chart here, what we call chart number four--what I would like to know is--and I am going to give you some advice now, unsolicited and unpaid for, on how it is then you can evaluate whether your derivative contracts are profitable or loss making for Goldman Sachs.

Okay? Now in the big chart, the big piles of, you know, little silos on the left-hand side, it shows that you paid 12 basis points annually for protection from AIG on $1.76 billion worth of risk of default on a particular tranche of CDO Abacus 2004-1.

So you paid $2.1 million annually to be protected against 100 percent risk of loss of $1.76 billion. Do you follow me?

WITNESS VINIAR: Um-hmm.

COMMISSIONER GEORGIOU: Okay. Now I would like to know what you charged, since you only entered into this transaction with AIG, as I understand your testimony, to hedge yourself against the risk that was created when your clients asked you to provide them protection against the failure of this same tranche, so I would like to know what it is that you charged as compared to the 12 basis points you paid AIG for the protection, what you charged your clients for the same protection on the same tranche?

WITNESS VINIAR: I don't know.

COMMISSIONER GEORGIOU: Well I would like to ask you to provide that to the Commission in writing.

WITNESS VINIAR: Sure.

COMMISSIONER GEORGIOU: Okay. Now if as I believe is likely the case it was 10 times or more than you were paying to AIG for the same protection, I would suggest to you that that is a pretty good metric of how much money you made on that particular transaction. That is, you charged your clients X in terms of basis points of the risk undertaken per year for the protection you sold to them so that you would pay them in the event that that tranche failed. And you in turn laid off that risk to AIG and paid them 12 basis points. That is, a tenth of a, 12/100ths of a percent per year for that same protection.

So you no longer had a risk so long as AIG could honor their obligation. If the thing failed, you owed the full $1.76 billion to your clients, but you were going to get it from AIG. So you were neutral except for the spread on the charge that you made between what you charged your clients annually and what you paid them. Correct?

WITNESS VINIAR: So far everything you said sounds right, other than I have no idea if it was ten times as much, but I certainly hope--

COMMISSIONER GEORGIOU: Maybe it was 100 times as much. Maybe it was 5 times as much. We don't know. But I want to know. Okay? And our Commission wants to know. Because when you tell us that you don't know how much you make in your derivatives business, nobody here really believes it. And I will tell you why.

It's crazy. It doesn't make any sense. Goldman Sachs is, if not the most sophisticated investment bank, certainly one of the most sophisticated investment banks in the world. And nobody here believes that you don't know how much money you're making on your various aspects of your business. It doesn't make any sense.

And I will tell you another thing. I am continually flogged by the guys in your asset management business to try to entrust--to get me to entrust my family's--

CHAIRMAN ANGELIDES: Mr. Georgiou, would you like three minutes?

COMMISSIONER GEORGIOU: If I could, please. Actually, five, if I could.

CHAIRMAN ANGELIDES: Well I'm sure you'd like 10, but let's start with 3.

COMMISSIONER GEORGIOU: --to entrust my family's assets to Goldman Sachs to manage. And I can tell you that I will never--number one, I think it is inappropriate to even consider it while we are in the midst of this Commission proceeding and all these matters that are before us, but I certainly would not do it if I thought that Goldman didn't have a clue as to what aspects of its business it was making money on, and what it was losing money on.

So I don't really believe it. So what I would really like you to do is, as to all of the tranches that you purchased credit default swap protection from AIG on, I would like you to have a nice chart that shows us exactly what you paid in terms of percentages of those tranches for protection from AIG, and what you were charging to your clients who were buying the protection. Because that's the reason, you say, since you're not in the proprietary trading business primarily, you're just doing it to provide services to your clients, I want to know exactly what the differences were.

Then that will be one of the elements you can use when you come back to us to respond to Ms. Born and Commissioner Angelides' question about how you can evaluate whether you made money or didn't make money on your derivatives business.

Can you do that?

WITNESS VINIAR: We will provide you that information.

COMMISSIONER GEORGIOU: Okay Thank you.

Now let me move to one other area. You know, everybody has been talking here about the fact that the Taxpayers ended up paying you on the obligation which AIG owed you to pay on the failure of these particular tranches

100 percent.

Now when you write down--when you write down your position, that is when Mr. Lehman and others are trying to identify as best they can the marks of what's happened to the underlying securities when you're going back to AIG to call for collateral, do you recognize that loss on your books? Or the diminution in the value of the underlying security on your books as a loss netted out against the gain from some other activity that you're in?

WITNESS VINIAR: Yes.

COMMISSIONER GEORGIOU: Okay. So that means that you were continually writing it down and taking those losses against your profits for the purposes of reporting income that the firm made, correct?

WITNESS VINIAR: Correct.

COMMISSIONER GEORGIOU: Okay. That means that when the Government paid you 100 percent of your position, I take it you recognized that gain, the difference between the 48 cents that Commissioner Thomas was talking about that you'd written down this to, and the 100 percent that you received, you recognized that gain as profit and paid tax on it? Is that right?

WITNESS VINIAR: But we have a position on the other side, so it would go--they would equalize.

COMMISSIONER GEORGIOU: You had a position on the other side with your own clients?

WITNESS VINIAR: Um-hmm.

COMMISSIONER GEORGIOU: Okay. On which you--okay, on which you recognized, presumably--

WITNESS VINIAR: So they would offset.

COMMISSIONER GEORGIOU: I've got it. Okay. So they would offset when you wrote it down, and they would offset when you wrote it up?

WITNESS VINIAR: Yes.

COMMISSIONER GEORGIOU: Okay, I've got you.

CHAIRMAN ANGELIDES: Mr. Georgiou, would you like two minutes?

COMMISSIONER GEORGIOU: If I could, yeah. Thank you very much, Mr. Chairman.

CHAIRMAN ANGELIDES: You're indebted to me.

COMMISSIONER GEORGIOU: No, I mean--

VICE CHAIRMAN THOMAS: Excuse me? No, those were my two minutes, not his.

COMMISSIONER GEORGIOU: I've been indebted to both--

CHAIRMAN ANGELIDES: --on the other side of the minute trade.

COMMISSIONER GEORGIOU: I've been indebted to both of you in so many ways I can't even count.

Okay, have you gotten--has anybody gotten a chance, Mr. Viniar, I guess, to read this story by Greg Gordon of the McClatchy Newspapers that ran yesterday morning titled "Goldman Admits It Had Bigger Role In AIG Deals"?

WITNESS VINIAR: I saw it and I skimmed it. I did not read it.

COMMISSIONER GEORGIOU: Okay. Well if you skimmed it, then that's a good thing, because under this--What it says here is that a senior Goldman executive disclosed the bilateral wagers on subprime mortgages in an interview with McClatchy, making the first time that the Wall Street titan has conceded that its dealing with troubled insurer AIG went far beyond acting as a, quote, "intermediary" responding to its clients demands. The official who Goldman made available to McClatchy on the condition he remain anonymous declined to reveal how much money Goldman reaped from its trades with AIG. That is, its proprietary trades with AIG. Independent of countervailing protection that you were doing just to net out your position with regard to client commitments that you had made.

Can you tell us who that person was?

WITNESS VINIAR: I actually have no idea what the reporter was talking about.

COMMISSIONER GEORGIOU: Okay, but nobody--well you are the most senior person here today. Can you get back to us with who that person is, because I think we would like to talk to them.

WITNESS VINIAR: Sure.

COMMISSIONER GEORGIOU: Okay. Thank you.

And it says here: Goldman's proprietary trades with AIG in 2005 and '06 are among those that many Members of Congress sought unsuccessfully to ban during recent negotiations for tougher regulation of the financial industry.

But it says here that Goldman agreed recently to settle these wagers which had a face value of $3 billion with AIG for somewhere between $1.5 billion and $2 billion, which AIG lost and that Goldman supposedly paid less than $10 million for the credit default protection that you settled for $1.5 billion to $2 billion. Do you know about that result?

WITNESS VINIAR: I don't know what the author is referring to, no.

COMMISSIONER GEORGIOU: So you don't have any transaction that you recently settled with AIG--you're the Chief Financial Officer of Goldman--

WITNESS VINIAR: No, I--I don't know. We settle lots of transactions. We might of.

COMMISSIONER GEORGIOU: Well it's $1.5 to $2 billion. I know that even in Goldman Sachs' rarified world

I would think that that might be on your radar screen.

Mr. Lehman, could you tell us?

WITNESS LEHMAN: Yes commissioner perhaps I can be helpful here. That trade I believe was done in the summer of 2009, and it was done consistent with our pricing at the time. So it was not a revenue event at that point in time because it was done, again, in the context of our market.

CHAIRMAN ANGELIDES: Time, Mr. Georgiou, can you wrap up, please.

COMMISSIONER GEORGIOU: Okay, but you did settle it for $1.5 to $2 billion? Is that right?

WITNESS LEHMAN: No, I believe--well, I don't know the specifics of the trade. I believe Abacus 041, where you have 806 million for the 1.76 was part of it, but I believe there to be other parts of that trade.

COMMISSIONER GEORGIOU: Okay, but is it fair to say that you paid $10 million for the credit default protection and recovered between $1.5 billion and $2 billion on that particular trade?

WITNESS LEHMAN: Again I don't know the specific numbers right now. We can come back to you on that.

COMMISSIONER GEORGIOU: And that's from AIG, correct?

WITNESS LEHMAN: Correct.

COMMISSIONER GEORGIOU: Okay. And so that is effectively from the Taxpayers.

CHAIRMAN ANGELIDES: All right. Let's do this. Just to wrap up your questioning, can I offer something up, Mr. Georgiou? It seems to me that one of the things you asked for today was you asked for the information on all the transactions with AIG; the entity on the other side; and essentially the payment provisions on the other side. Correct?

COMMISSIONER GEORGIOU: The cost to the other party--

CHAIRMAN ANGELIDES: Correct.

COMMISSIONER GEORGIOU: --of precisely the same protection which Goldman Sachs was selling--was purchasing from AIG.

CHAIRMAN ANGELIDES: And can I just suggest, and maybe ask a quick question before we go to Mr. Holtz-Eakin, were there transactions with AIG where there was not an entity on the other side?

WITNESS VINIAR: I actually don't know. Do you know?

COMMISSIONER GEORGIOU: Mr. Lehman?

WITNESS LEHMAN: No. I think we should come back to you with specifics.

CHAIRMAN ANGELIDES: Yes. And I was going to say that, unless you can give me an answer now, part of this is we would like to see very specifically all those transactions with AIG, which would include people on the other side with the information that Mr. Georgiou said, as well as those transactions where there was not an entity on the other side, where it was purely bilateral. Correct?

COMMISSIONER GEORGIOU: Yes. And can I get one more minute before you go off?

CHAIRMAN ANGELIDES: Please--

COMMISSIONER HOLTZ-EAKIN: I will yield one minute.

CHAIRMAN ANGELIDES: Okay.

COMMISSIONER GEORGIOU: Okay, one minute. I apologize, but I want to just get to one other point which I think is important.

You know, Mr. Blankfein at his testimony, and you today, Mr. Viniar in your testimony, continue to assert that you were adequately hedged against AIG's failure with a number of other counterparties. That is, when you started to do collateral calls with AIG, and of course you knew that they were, AIGFP was, you know, close to $80 billion by that point on one side of a transaction, and they weren't capable of paying all those debts, you started--

WITNESS VINIAR: We only knew their transactions with us.

COMMISSIONER GEORGIOU: Well, okay, you only knew their transactions with you, but I'm sure anecdotally in the marketplace you knew that other people were buying similar protection from them.

In any event, you chose to protect yourself by doing two things. One, asking for collateral in a fairly aggressive manner. And two, purchasing default protection of AIG's default. Correct?

WITNESS VINIAR: Correct.

COMMISSIONER GEORGIOU: Okay, now--

WITNESS VINIAR: That was predetermined that if we were not getting the collateral that we were owed, that we would hedge down to zero.

COMMISSIONER GEORGIOU: Okay. Now it's been asserted here, and in other forums by Mr. Blankfein and yourself, that you never really needed the Government to pay you 100 percent of the obligations that AIG owed you on those credit default swaps because you were adequately hedged by other parties against the risk of an AIG default.

I would like you, if you know, to tell us today who provided those hedges to you. And whether they--whether in your judgment they were in a position to honor those hedges? And if you don't know, then I'd like you to provide in writing to us who they were and what they cost and whether in your judgment--or I guess we can make some evaluation ourselves--whether they were capable of honoring it.

Because I find it incredulous that if AIG, the largest insurer in the world, with $150 billion market cap, wasn't in a position to honor its obligations to you, that some other parties were in a better position to honor them in the event AIG defaulted.

And of course AIG did default, and the Government stepped in. And you're trying to tell us that there were other private parties who were prepared to honor that obligation to AIG instead of the Government. And I'm highly skeptical about the proposition.

CHAIRMAN ANGELIDES: Let’s go to the answer and then let’s move on to Mr. Holtz-Eakin and I have an observation, I’m sorry. Let's get the answer quickly, and then I will just remind Commissioners what we have already asked for and received to date on this, and what we are missing that I imparted to Mr. Cohn yesterday.

WITNESS VINIAR: Okay, just very quickly.

CHAIRMAN ANGELIDES: Yes, but if you know the names of the counterparties of the amount you had in CDS against AIG particularly around September, mid-September, that would be very helpful if you could tell us right now.

WITNESS VINIAR: Just very quickly, first of all AIG did not default. You mentioned AIG defaulted, but they didn't.

Second of all--

COMMISSIONER GEORGIOU: That's not true. They didn't default because the Government gave them $80 billion to honor their obligations.

WITNESS VINIAR: Right. Correct. But they--

COMMISSIONER GEORGIOU: So they did default--I mean, they would have defaulted but for the infusion of Taxpayer capital, correct?

WITNESS VINIAR: They would have--I believe would have defaulted, but they didn't default, therefore we couldn't collect under the CDS contracts. But I do not know the specific names of the parties, but I know we're going to get you those. But I think it's important to know they were predominantly with other major financial institutions. And what you will find is that, given the volume of trading, most of the financial--major financial institutions deal with each other, Goldman Sachs, JPMorgan, Morgan Stanley, Deutsche Bank, PIMCO, we basically collateralize all of our trades with each other. And so the contracts we had with those counterparties were collateralized as well. And so that's why I am confident that they would have paid off, because we had the cash.

COMMISSIONER GEORGIOU: Well, all right, but many of them wouldn't have been able to pay off unless they too were infused with exceptional Taxpayer assistance.

CHAIRMAN ANGELIDES: Let's move on.

WITNESS VINIAR: We had the cash.

CHAIRMAN ANGELIDES: Okay--well, you didn't have the full cash, but let me just do this. Let me just wrap this up.

You had collateral.

WITNESS VINIAR: Correct.

CHAIRMAN ANGELIDES: You also bought protection essentially for the collateral you did not have--

WITNESS VINIAR: Correct.

CHAIRMAN ANGELIDES: and we have the chronology of what you bought in CDS protection, and from whom you bought it. What is missing, and what we have asked for, is if you look at what we have been given it says, for example, in July of '07 you bought $100 million of credit protection against AIG. And then subsequently you bought another $50 million.

It ultimately gets to I think around $3 billion. And I think around the time period of AIG's near collapse and the loan by the Government, I think you have about $2.7 billion outstanding.

WITNESS VINIAR: Um-hmm.

CHAIRMAN ANGELIDES: What we have asked for, and what we have not gotten, is we have asked very specifically the counterparties with whom you had that $2.7 billion of protection so we could take a look at it.

Now we do know, looking at the list today, that for example when you look at the full list without knowing who that $2.7 is, people you've bought along the way, there are some names there like Lehman Brothers that clearly by September 16th wouldn't have been in a heck of a good position to pay. So I think the information Mr. Georgiou has asked for is important.

All right, so let's do this. Mr. Thomas, and then we will go to Mr. Holtz-Eakin. Mr. Thomas wanted to make a comment.

VICE CHAIRMAN THOMAS: And based upon the information that we got in part from the McClatchy Newspaper story, I am going to ask the staff to chart whatever information they are going to need. They're probably going to have to talk to you about the money that moved to AIG, which then went overseas to Deutsche Bank, and other banks, which then came back to Goldman in virtue of cash that was paid back.

So you've got to follow that circular, as well, and we will work that out. The point I wanted to make was that Commissioner Georgiou also requested the unnamed Goldman source to the McClatchy Newspaper article, and I want to assure you, I think you said we want to talk to him--I want to assure you, it's not for a panel. It's not for public disclosure. He has information that we now know we would like to take a look at.

And so in requesting up through whatever chain you report to about getting that individual to talk to us, we have our own ways if he isn't forthcoming, or your company isn't forthcoming, but we are not interested in outing the individual; we are interested in getting the information that he apparently has and has supplied to others.

CHAIRMAN ANGELIDES: Well, and if the article is accurate. It does say "whom Goldman made available." So that's I think why it’s of particular interest.

VICE CHAIRMAN THOMAS: Well understanding we're dealing with the press, so to the degree it's accurate.

CHAIRMAN ANGELIDES: Yes. And the most patient member of the Commission today, Mr. Holtz-Eakin.

COMMISSIONER HOLTZ-EAKIN: Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: And you can have as much time as you want.

COMMISSIONER HOLTZ-EAKIN: Right. I want to thank you for your time today, gentlemen, everyone. We really do appreciate you showing up and answering these questions.

I just want to clean up some details, and I apologize for repeating some things, but just to make sure I understand them.

I want to pick up where Mr. Georgiou left off with the Taxpayer money. This is what I don't understand, because I'm an economist and I'm trained to be stupid--

(Laughter.)

COMMISSIONER HOLTZ-EAKIN: --but you've said you're fully hedged against AIG in these transactions. So you just don't care what the price is that you get, because you're going to get par no matter what. You're going to get a dollar, regardless.

So when the Fed calls Mr. Schwartz and says, will you take a discount, why does he even have to think? You're going to get the same amount of money.

WITNESS VINIAR: No, again, the CDS contracts that we get, we only collect on those if AIG actually defaults. So if AIG does not default, we don't collect anything under the CDS contracts.

COMMISSIONER HOLTZ-EAKIN: And so you got a benefit from them paying you at par that was above and beyond what you would have gotten, even though you were fully hedged.

This is, in the end, I think what the panel is desperately trying to get you to acknowledge; that you received an economic value from the intervention of the Taxpayers and the U.S. Government. Is that not true?

WITNESS VINIAR: Vis-a-vis our direct transactions to AIG, it is not true. We got what we otherwise would have gotten. If AIG had defaulted, we would have collected--we had the collateral, and we would have collected under our hedges. We would have collected the same thing that we got from the Government.

COMMISSIONER HOLTZ-EAKIN: Okay. Yesterday Mr. Cassano testified that in his view there would have been no credit event with the CDSs; that the underlying CDOs--and even to the end stipulated that in the end there will be no credit event; that the modeling was correct and that if you would watch the Maiden Lane assets play out over the course of their lifetime, the contract will just expire and there would never have been a payment.

Is that Goldman Sachs' view today of those underlying CDOs that are in Maiden Lane? Or do you expect there to be a credit event?

WITNESS LEHMAN: Commissioner, I don't have an updated view on fundamental losses or, for that matter, market prices of the Maiden Lane III assets. But that is something I can--I can address with your staff.

COMMISSIONER HOLTZ-EAKIN: Well here's an update.

CHAIRMAN ANGELIDES: Those are provided by Black Stone, Mr. Holtz-Eakin--

VICE CHAIRMAN THOMAS: BlackRock—

COMMISSIONER HOLTZ-EAKIN: 43 cents on the dollar?

CHAIRMAN ANGELIDES: BlackRock, Black Stone--

WITNESS LEHMAN: Just to be clear, those are market prices, or the ultimate view of losses from BlackRock?

COMMISSIONER HOLTZ-EAKIN: These are current market prices? I don't know.

WITNESS LEHMAN: Because I think what Mr. Cassano--

CHAIRMAN ANGELIDES: No these are--

COMMISSIONER HOLTZ-EAKIN: My familiarity began when this Post-It arrived.

(Laughter.)

CHAIRMAN ANGELIDES: I'm sorry, are these projections of economic losses? No. You know what, go ahead. Ask your question.

COMMISSIONER HOLTZ-EAKIN: No, I'm just trying to understand the nature of this transaction at the end, and the significance of avoiding bankruptcy for AIG in terms of what transacted both in terms of cash, but also in terms of exposure to risk. You no longer--there's no exposure now to the risk of the underlying assets. That's now off your books entirely. And there's a value to avoiding risk.

And I'm just trying to tease through what Goldman got in this transaction. You lost some risk exposure. You got some cash. And I was just trying to do the math on that. And I can come back to the specific question, but I find it improbable that you can sit there and say we got the same thing no matter what if the Taxpayer had not intervened, because you lost an enormous amount of risk exposure up and down, and you got the same cash.

Usually when you get the same cash and have no risk, you are better off. So that's what I'm trying to figure out.

I want to talk about the risk thing in my remaining time, because I want to echo the comments that Commissioner Hennessey made about the nature of this hearing and what we have learned.

I think the one thing that we have drawn out of the series of hearings--and this one in particular--is the colossal failure of risk management in many of these institutions. And in AIG I find it just stunning that you would have such a deeply siloed risk management system, and that the CFO who is in charge of liquidity risk management would be unaware of contractual obligations to deliver collateral, the most fundamental liquidity event I can imagine.

And so, Mr. Forster, I know you are familiar with Mr. Cassano's testimony yesterday. Did you concur with his view that the modeling was right and that there would never be a credit event? And that ultimately these underlying securities should in fact have a market value which is equal to their par value?

WITNESS FORSTER: I think obviously the portfolio was transferred to Maiden Lane in 2008, so I don't have a huge amount of insight or surveillance over that portfolio.

COMMISSIONER HOLTZ-EAKIN: At the time did you agree with the modeling? Did you agree with, and would you have concurred with his statement that there will never be a credit event, and that ultimately these securities will trade in liquid markets when they come back at par value?

WITNESS FORSTER: I think if we were looking--and perhaps this isn't your exact question--if we were looking at the statement in sort of 2007, did I expect to see any material loss? No, I expected to see no material loss.

If I looked at it now--

COMMISSIONER HOLTZ-EAKIN: Um-hmm.

WITNESS FORSTER: --and decided what would I think? I don't have a huge amount of insight into it anymore, but having looked at what I’ve seen sort of BlackRock estimates and things like that, they clearly project quite significant losses. And I would see no reason why not to concur with their thoughts.

COMMISSIONER HOLTZ-EAKIN: So you didn't expect material losses. So Goldman comes to you with marks that are substantial discounts, offers to trade at those marks, why don't you buy?

WITNESS FORSTER: For, again this is a difference between what you ultimately expect and what the market price might be at that one time. And at that time there was clearly, you know, no appetite to add additional risk to the book.

COMMISSIONER HOLTZ-EAKIN: So there was risk. And did you report that risk to the CFO?

WITNESS FORSTER: We thought that the risks that we were taking back at that time were extremely remote, but clearly it was not zero risk.

COMMISSIONER HOLTZ-EAKIN: So these were substantially more risky than Mr. Cassano testified?

WITNESS FORSTER: Well they have turned out to be substantially more risky, yes.

COMMISSIONER HOLTZ-EAKIN: What would have happened if you'd bought them at the marks Goldman was offering?

WITNESS FORSTER: I guess we would've just had even greater risk. And as the market--we would have had a greater risk position. We would have had a greater notional at risk. And obviously as the market deteriorated still further through--for the remainder part of 2007 and 2008, we would now have even larger losses.

COMMISSIONER HOLTZ-EAKIN: And would you have had to mark your books to those transaction prices?

WITNESS FORSTER: I don't know. I'm not an accountant, I'm afraid. My role was to provide the information and the accounting folks would decide what was relevant information.

COMMISSIONER HOLTZ-EAKIN: Okay. Why don’t we just stop there. Thank you very much.

CHAIRMAN ANGELIDES: Do you want to--Mr. Holtz-Eakin, I have one quick question. The staff is there just to fill in the--

COMMISSIONER HOLTZ-EAKIN: I think, given the confusing nature of the discussion, we've got all these notes, it is best to just go to this in writing and we will get a clear story.

CHAIRMAN ANGELIDES: Okay. I have a quick question.

COMMISSIONER HOLTZ-EAKIN: Go ahead.

CHAIRMAN ANGELIDES: Mr. Vice Chairman, do you want to--well, this is just a technical question. You began buying CDS protection on AIG in 2007. By 2008 the price for that had increased. Just a technical question. So would you have marked to market the value of your AIG credit protection that you had bought?

WITNESS VINIAR: [Off microphone] I assume the answer is yes.

CHAIRMAN ANGELIDES: The answer what?

VICE CHAIRMAN THOMAS: Use your mike.

WITNESS VINIAR: Sorry. I assume the answer is yes.

CHAIRMAN ANGELIDES: All right, if we could follow up on that.

All right, Mr. Vice Chair?

VICE CHAIRMAN THOMAS: It gives me great pleasure to, not withstanding his opening remarks about the panel, to yield three minutes to Commissioner Hennessey for questions.

COMMISSIONER HENNESSEY: Thank you, Mr. Vice Chairman.

Just some additional questions I guess for Mr. Forster. AIGFP's risk manager at the time was Mr. Mikatis? Is that right?

WITNESS FORSTER: That's correct.

COMMISSIONER HENNESSEY: And what role did he have in overseeing the risk involved in the CDO business at AIGFP?

WITNESS FORSTER: I believe he took over the risk management function for the credit part of the book in 2007, I believe.

COMMISSIONER HENNESSEY: And as a practical matter, was he the primary decision maker? It's been suggested to me that he was a very strong risk manager, but that Mr. Cassano took a lot of the decision making for the CDO portfolio specifically and made those decisions himself.

WITNESS FORSTER: I think it's fair to say that Mr. Mikatis is a very strong risk manager. I think at the time our issues were that the--whilst there was some risk embedded in these contracts, that we viewed the risk to be extremely remote.

COMMISSIONER HENNESSEY: I understand the view, which is--that's consistent with everything I have heard. My question is, as sort of a practical matter, who was the real decision maker on the risks that were being taken in that CDO portfolio?

WITNESS FORSTER: Well ultimately I guess Mr. Cassano was in charge of FP, so he would have a big say. And then also obviously, as I know you heard yesterday, all the transactions were approved at the AIG, Inc., level, and that would also be another level of decisions.

COMMISSIONER HENNESSEY: I guess what I'm trying to get at is, did Mr. Cassano play a larger role in decisions about the CDO risk than he did in other kinds of risk at AIGFP?

WITNESS FORSTER: I honestly couldn't answer that. I mean, my role was only very much in credit, and there are obviously lots of other businesses that the company is involved in. I really couldn't answer the question, sorry.

COMMISSIONER HENNESSEY: Okay. AIGFP has been described by some as the world's largest credit hedge fund. Is that a fair characterization of where they were in 2007 and 2008? Not as a legal matter, but as a real economic matter?

WITNESS FORSTER: We clearly didn't think that was the case. Clearly what we'd taken were extremely large notional bets. We thought they were very much out of the money and very risk remote. They turned out in some cases, the multi-sector CDO business, to not be that case.

We do have much larger notionals in other businesses that have turned out to be perfectly good bets.

COMMISSIONER HENNESSEY: But you're telling me that within AIGFP your experience was that your colleagues did not think of your employer as the world's largest credit hedge fund?

WITNESS FORSTER: I mean obviously I can't speak for what my other colleagues thought.

COMMISSIONER HENNESSEY: In terms of--

WITNESS FORSTER: I never heard that phraseology at the time.

COMMISSIONER HENNESSEY: Okay. And a couple more questions. These collateral calls. Obviously the collateral calls--and maybe this is for you and Mr. Bensinger--these collateral calls are increasing the demands for liquidity.

At what point in time did you or people senior to you in AIGFP realize that those collateral calls might put FP out of business?

WITNESS BENSINGER: I don't really think that there was a determination that that would occur until very close to the middle of September when the markets began really falling off the cliff even more precipitously than they had after the Lehman bankruptcy. That weekend, the potential prospect of downgrades by the rating agencies of AIG, I mean that was really--

COMMISSIONER HENNESSEY: So up until September of '08, there really wasn't discussion of, you know what, these collateral calls might--not "would" but might put us under?

WITNESS BENSINGER: As I had said, when we raised the additional $20 billion of capital in May, all of the assumptions that we were using were predicated upon the fact that that additional capital buffer and liquidity buffer would be able to carry through, you know, intensive market conditions. But the market conditions deteriorated to the extent that they exceeded those assumptions.

COMMISSIONER HENNESSEY: Okay. A couple more questions about counterparty risk. Presumably when Goldman, or one of your other counterparties--

CHAIRMAN ANGELIDES: Oh, go ahead. Yes, Finish.

COMMISSIONER HENNESSEY: --wants to do business with you, they are looking at the credit rating of AIGFP, which for a long time was, as I understand it, AAA, right?

WITNESS BENSINGER: Yes.

COMMISSIONER HENNESSEY: Ya'll had to presumably deal with the scenario where there was a possibility that maybe AIGFP's own credit rating would be downgraded. Did you know that the firm's survival was contingent upon having say a AAA, or I don't know, a AA credit rating? And that falling below that would mean that the whole house of cards would collapse?

WITNESS BENSINGER: No, I don't think that that was necessarily the case. The company's ratings were stable. It was AAA until the spring or summer of 2005 during the events that I described in my opening remarks.

The company was downgraded to a AA level, where it really remained all the way through mid-September of 2008.

COMMISSIONER HENNESSEY: I'm asking a slightly different question. I'm not asking if you thought that there was a serious probability that it might be downgraded further. I'm asking, did you know that if the firm were for some strange reason downgraded further, that that event would cause the whole firm to collapse? Did you know that the firm's continued survival was contingent upon maintaining such a high credit rating?

WITNESS BENSINGER: I think the credit rating was only one element of many elements. I think the decline in the market prices that caused the significant portion of the collateral calls was really the most principal determinant.

I think the ratings downgrade was--

COMMISSIONER HENNESSEY: I get that. I'm trying to get at a different thing. If we imagine going back in time to 2007, or 2008, and I ask you: Suppose your firm is downgraded today to single A or lower, can AIGFP survive? What do you believe your answer would have been at that point in time?

WITNESS BENSINGER: It's impossible for me to answer that question as an isolated question. It was really in the context of everything else that was happening that was causing the liquidity strain.

COMMISSIONER HENNESSEY: Thank you.

CHAIRMAN ANGELIDES: All right. Let's wrap up here.

Ms. Born, and then Ms--oh, boy, it's been a long, long Commission journey. Ms. Born, and then Mr. Wallison each have a question.

COMMISSIONER BORN: Yes, thank you.

I just wanted to follow up on the way the Government bailout of AIG benefitted Goldman in that you got paid 100 cents on the dollar for the CDOs that you transferred to Maiden Lane III in order to get cancellation of the CDSs.

We have recently learned that there was another benefit that Goldman got from the Government at the same time. That is, that the Government forced AIG to waive all legal claims against Goldman relating to those CDOs. Are you aware of that?

WITNESS VINIAR: Only because I read it in the newspaper.

COMMISSIONER BORN: Well do you know whether or not anybody at Goldman Sachs discussed with a Government official, or a staff person at the Federal Reserve Bank of New York that waiver? Or whether or not it could receive that waiver?

WITNESS VINIAR: I'm not aware of that.

COMMISSIONER BORN: So if now, thanks to that waiver that the Government had AIG give to Goldman Sachs, if AIG--even if AIG believed that Goldman Sachs had defrauded it in negotiations to receive those credit default swaps from AIG, AIG would not be able to sue or make any claim against you? Is that correct?

WITNESS VINIAR: I believe, first of all, that whatever that waiver is, it was consistent to all of AIG's counterparties. But I don't know anything about it.

COMMISSIONER BORN: We would very much like to have a full answer on this. I understand your General Counsel is here. I hope that your General Counsel will be able to provide full information about any contacts that Goldman had with Government or Federal Reserve Bank officials about this waiver, and that we can see the waiver, the extent of it, and understand what possible economic benefits Goldman Sachs received from being relieved of any legal liability to AIG.

WITNESS VINIAR: Okay.

CHAIRMAN ANGELIDES: If you want to confer with counsel, we would be happy to--

WITNESS VINIAR: I think we'll provide you--

CHAIRMAN ANGELIDES: --if you'd like to take a little time. Okay, thank you.

Mr. Wallison. I wanted to give you the opportunity.

WITNESS VINIAR: Thank you.

CHAIRMAN ANGELIDES: Mr. Wallison?

COMMISSIONER WALLISON: I just have a technical, what I think is a technical question for Mr. Forster because I didn't get to it during my earlier questioning.

And that is, again I'm interested in this model. And the CDOs were supposed to be what were called "multi-sector CDOs." In your example of what was in them, you said RMBS, residential, CMBS, commercial mortgages, and home equity.

All of those are in the real estate area, and I'm just wondering whether when you were referring to multi-sector you were thinking only multi-sector within the real estate area, or were you thinking that this would include credit cards and other kinds of collateral in these CDOs. I'm just trying to get at what this model was supposed to be covering, and when it was--whether it was in fact addressing the kind of assets that it was originally conceived to address.

WITNESS FORSTER: Um, I mean I'm not sure of the exact breakdown of all the different asset classes that were in the different CDOs, but obviously predominantly it was residential mortgages in the U.S.

COMMISSIONER WALLISON: I think we had some testimony yesterday that almost all of the assets in these CDOs were residential real estate. And perhaps that's incorrect, but I would like to get a fix on that. So if you all could provide us with the information about what was in the CDOs in terms of percentages between 2003 and 2007, that would be quite helpful to us in understanding how this model applied to what you were doing.

CHAIRMAN ANGELIDES: Mr. Wallison, I just wanted to let you know, we actually--I believe the information has already been provided. We have provided a sample, which you have seen, but I just want to say we do have--they have already provided the information on all those transactions, all those CDOs, just to let you know. We do have it.

COMMISSIONER WALLISON: Good. Thank you.

CHAIRMAN ANGELIDES: We are going to break for lunch here. I am going to ask one quick question. And it is really of Goldman, because I've been--this whole discussion about people being on the other side of the trade.

You do take proprietary positions, though, without regard to folks being on the other side of trades, from time to time? Correct?

WITNESS VINIAR: Yes, we do.

CHAIRMAN ANGELIDES: Okay. And we'll get that specific information. So I remember when I was a kid, I still grew up in the era where I would be spanked occasionally, not a lot but sometimes, my father having grown up in an immigrant household probably didn't say this is going to hurt me more than it's going to hurt you, but I'm fascinated about how do you balance these matters with clients?

I mean, there's the--I think the e-mails back in the '07 period when it's clear you're going to start making down assets. And you're informing clients. I mean, do you say: This is going to hurt you as much as it hurts us? How do you balance your proprietary positions with your client's positions? I know it's a big question, but it seems to me this is an enormous challenge, given that you're taking positions, and your clients are taking position.

How do you do that?

WITNESS VINIAR: I'm not sure I understand the question.

CHAIRMAN ANGELIDES: Well your interests may diverge from your clients' interest. You may be, for example, net short on something where they're long on things. And so if you're beginning to push the market in a certain way that's not in their interest, how do you balance that? I mean, how do you do that? Do you say we always put our clients first?

WITNESS VINIAR: I think there's a misconception that we move the market. We are a participant in the market. We're, you know--

CHAIRMAN ANGELIDES: But don't participants move markets? I mean, aren't the nature of these fluctuations in our markets--I mean, obviously there are macro forces, but there are also the activities of participants both on the way up and the way down.

WITNESS VINIAR: Sure, but we're, we're--

CHAIRMAN ANGELIDES: And let me just finish this. You can't say that mortgage originators, borrowers don't move markets on the way up, for example, in housing, and then, you know, shorting of the market, ABX Index, CDS, I mean certainly a phenomenon here where both you have macro forces plus the activities of participants both moving markets up and down. And you're not exactly a tiny player here.

WITNESS VINIAR: In the mortgage market we actually were a pretty small player. We were, you know, 4 or 5 percent of the underwriting of RMBS and CDOs. So there are many--

CHAIRMAN ANGELIDES: Well, but you take four or five people who are 20 to 25 percent of the market, that's not insignificant.

WITNESS VINIAR: I think it would be very hard for us to move--

CHAIRMAN ANGELIDES: So your position is, you're just in the market? You don't move the market, and therefore conflicts don't arise?

WITNESS VINIAR: I think we largely are in the market; we largely do not move the market.

CHAIRMAN ANGELIDES: Yes, we want to eat today. I know it's a small matter--

COMMISSIONER GEORGIOU: But I just want to follow up. Yesterday I mentioned this to your other colleagues who were here. When we questioned Hank Paulson, who used to run your firm before he became Treasury Secretary and the architect ultimately of the bailout, when he testified in front of this Commission, he said that one of the biggest difficulties for management of investment banks and ultimately their regulators is to manage the conflicts of interest that are naturally created by the various roles that an investment bank like Goldman Sachs performs, to follow up on the Chairman's views.

CHAIRMAN ANGELIDES: Question--

COMMISSIONER GEORGIOU: One, you are acting on your own behalf. And two, you are acting on behalf of clients' behalf. And one of these e-mails talks about how 30th floor focus, which I assume means your top management, was on the fact that when you marked down your position to AIG in order to collect more collateral from them on the risk that you had, were exposed to them for, the consequence of those marks to other clients of yours like Bear Stearns Asset Management for whom you raised money, would have been disastrous. Because what happens is their marks would have to be written down, and then that would trigger the right of their investors to call back capital, and so forth.

So I guess my point is, and just a question to you, is for you to acknowledge that Goldman Sachs simply doesn't act in one way. It doesn't just act for client interests. It sometimes acts for clients. It sometimes acts on its own account. It sometimes acts as an advisor. It sometimes acts as an underwriter in which it owes fiduciary duties to investors and to the parties for whom it is raising money.

And all of these roles have potential conflicts of interest, which you have to manage. They are not nonexistent, but hopefully they are managed. Could you speak to that, please?

WITNESS VINIAR: I agree with that. That is very different from what the Chairman was--

CHAIRMAN ANGELIDES: Well not it's not, really. It's the same. And maybe there wasn't clarity. But, you know, just to be specific, on May 11th when Craig Broderick sent the e-mail in which he wrote that Dan Sparks and the Mortgage Group, quote, "were in the process of considering making significant downward adjustments to the marks on their mortgage portfolio, especially CDOs and CDO-squareds" and that, quote, "This would have potentially big P&L impact on us, but also to our clients due to the marks and associated margin calls on repo derivatives of other products. You need to survey the clients to take shot at determining the most vulnerable clients."

I mean, by this time I think you guys were net short. So aren't you telling your clients, this is going to hurt you more than it's going to hurt us? You have a conflict there.

WITNESS VINIAR: But there's a big misconception that we just decide to mark things and move the market. We mark based on where the market is. So we look at where the market is, and that is what our marks reflect.

It could have a positive or negative effect on us. It could have a positive or negative effect on our clients. But it's where the market is.

CHAIRMAN ANGELIDES: Right.

WITNESS VINIAR: That’s where were trying to mark to--

CHAIRMAN ANGELIDES: So here's what you would stipulate to. There are conflicts of significance to manage. You would say that's not applicable to marking because that's where the market is. But we have established earlier today there's a lot of latitude or judgments on where that market is when it's illiquid. Will you stipulate to that?

WITNESS VINIAR: Yes.

CHAIRMAN ANGELIDES: Okay. With that, a short succinct answer, I want to thank all the panel members for coming here today. I want to thank, actually in this instance both entities and their counsel, AIG and certainly post-subpoena Goldman, for the information they have provided. And I want to thank you all.

We are going to take--I know you're going to be thrilled by this, members, but we're going to come back at 12:35 to begin our second session, which will allow us a luxurious lunch. We will be back here at 12:35.

(Whereupon, at 12:18 p.m., the hearing was recessed, to reconvene at 12:35 p.m., this same day.)

1

AFTERNOON SESSION

(12:45 p.m.)

CHAIRMAN ANGELIDES: The Financial Crisis Inquiry Commission public hearing on derivatives and their role in the financial crisis will come back into order.

We are now at our final session of a two-day hearing, and this final session is entitled "Derivatives, Regulators, and Supervisor."

I want to thank our witnesses for being with us today. We are going to start this panel off, as we start all our sessions, and that is by asking all of you to please stand and be sworn. If you would please stand and raise your right hand, I will say the oath and you will affirm.

Do you solemnly swear or affirm, under penalty of perjury, that the testimony you are about to provide the Commission will be the truth, the whole truth, and nothing but the truth, to the best of your knowledge?

MR. DINALLO: I do

MR. GENSLER: I do.

MR. LEE: I do.

(Witnesses duly sworn.)

CHAIRMAN ANGELIDES: Thank you very much.

Gentlemen, thank you. We have received your written testimony. And knowing this Commission, it has been read and reviewed. We will ask each of you to make a five-minute opening statement, no more than five minutes. Some of you, or all of you, may have testified before, so you may be familiar with the devices in front of you. At one minute, a yellow light will go on. And the red light will go on when your time is up.

So what I would like to do is, Mr. Dinallo, start with you and we will go my left to my right and ask each of you to make your opening statements, and then we will go to questions from Commissioners.

And also, I should have said, please turn on your microphone.

WITNESS DINALLO: Thank you.

CHAIRMAN ANGELIDES: Thank you.

WITNESS DINALLO: Thank you, Chairman Angelides, Vice Chairman Thomas, and the Members of the Financial Crisis Commission for inviting me to testify.

I was the Insurance Superintendent for New York State from January 2007 through July 2009. My other professional experiences include leading numerous investigations of Wall Street firms as a senior member of the New York State Attorney General's office, heading regulatory affairs at Morgan Stanley, and being a general counsel of Willis Group.

Previously I've submitted extensive written testimony. This testimony was prepared with the assistance of the Insurance Department of New York State. However, the opinions expressed are my own.

I would like to use my oral testimony to make a few broad points about what I believe this crisis has taught us.

As you already know, the primary source of AIG's problems was AIG's Financial Products Division which had written credit default swaps, derivatives, and futures with a notional amount of about $2.7 trillion.

The counterparties to those swaps apparently thought that the AIG Holding Company's top credit rating meant that they were safe, but in fact that credit rating was based on the strength of AIG's insurance companies, which were largely unavailable due to regulatory requirements and protections.

Perhaps most important, AIG's Financial Products was able to make such huge bets with its credit default swaps with little backing up its promise to pay, thanks to deregulation in general, and three specific points:

First was allowing financial institutions to select their own regulator. By purchasing a small savings and loan in 1999, AIG was able to select as its primary regulator the OTS, which at that point would have been about 1/1000th of its balance sheet.

Second, Gramm-Leach-Bliley abrogated Glass-Steagall and permitted AIG to operate an effectively unregulated hedge fund or monoline with insufficient reserves to back up its promises. This was only possible because AIG had a top credit rating based on the strength of its insurance companies. But had AIGFP been a stand-alone company, I don't think anyone would have done the business with it.

Finally, there was the CFMA which specifically exempted credit default swaps from regulation. This meant there were no requirements to hold capital reserves behind the promise to pay as there are with insurance policies, bank deposits, futures, and even regulated gambling.

This changed, in my view, 100 years of known capital requirements and led to our Century's version of shadow banking.

My essential thesis is that these changes permitted AIG and FP and other institutions to sell wildly under-capitalized pseudo-insurance and other core "financial products" that previously had well-known capital requirements, reserving, and net capital requirements.

I would note that at a time when financial services' firms were in trouble because of insufficient capital, and at a time when commercial banks and investment banks had very serious problems, insurance operating companies remained relatively strong.

Clearly a lesson from this crisis is that all financial institutions should be required to hold sufficient capital and reserves to meet their promises. And, that derivatives should be for hedging, largely, not substitutions of core financial commitments.

Thus, while I am strongly in favor of innovation, I believe it is time to recognize that not all change is good. Innovation that allows financial institutions to take excessive risks, pick their regulators, and avoid century-old tested rules about net capital and reserves is in fact bad.

I would strongly examine the changes from the CFMA and its synergies with the changes around Glass-Steagall to understand what went wrong with our regulatory system and the impact that had on the financial crisis. Because I believe that, dating back to 1907, there is strong learnings to be had on this.

We had learned a lot from the first two financial crisis, '07 and the Depression, put in place I think very good, sound capital and other regulatory requirements; and then made serious, serious changes in 1999 and 2000 and, within eight years, I think you can see a direct, almost cause and effect on the impact of capital requirements, the regulatory regime, and the eventual financial crisis.

I am here to answer any of your questions. I am very excited and honored to be here, and I hope I can help you in any way possible. Thank you very much.

CHAIRMAN ANGELIDES: Thank you, Mr. Dinallo. Mr. Gensler?

WITNESS GENSLER: Good afternoon, Chairman Angelides, Vice Chairman--or should I say "Chairman Thomas"--and Members of this Commission:

I thank you for inviting me here to speak today. I would also like to thank former CFTC Chair Brooksley Born for her leadership of our Commission when she was there, but also her leadership on derivatives and advice she has given to the agency, and most recently that she has joined yet another advisory panel helping the CFTC and SEC sort through issues.

In response to your invitation, my written testimony includes reasons why the over-the-counter derivatives marketplace were not regulated not only here in the United States but also in Europe and in Asia. We have had this international situation where it's not regulated in either of these markets.

To quickly summarize, I think there were five reasons articulated around the globe in the past to exempt derivatives from regulation.

First--and I expand on this in the written testimony--but first, there was an institutional marketplace.

Second, the dealers were presumed to be regulated as if they were banks, or maybe they were banks themselves.

Third, it was presumed these markets, and articulated, that they would discipline themselves.

Fourth, the contracts were customized and generally not susceptible, at least early in these markets, to centralized clearing or trading.

And fifth, the old saw was: Well, if we regulated it here, it would go somewhere else.

I think significant growth and development in these markets and the financial crisis starkly calls into question each of these reasons.

In terms of our financial system and the crisis, I do think both our financial system and the financial regulatory system failed the American public. Though there are many reasons for these twin failures, and this Commission is delving into all of those, I will just focus on the role derivatives played in the crisis, starting with the most specific role it played, and going to the more general. And I will list six.

First of course the collapse of AIG, an ineffectively regulated derivatives dealer. Need I say more?

Second, the role that credit default swaps more broadly played, particularly credit default swaps written on asset and mortgage-backed securities. Whether it was multi-sector credit default swaps written by AIG or other similar CDS written by other providers, sometimes monoline insurance like by MBIA and Amback and so forth, these products--basically insurance--along with weak underwriting practices in the mortgage markets, and weak rating agency practices, I think all worked together in terms of promoting and facilitating, one might say amplifying, a housing bubble.

Furthermore, when the value of housing went the other way, these credit default swaps had a calamitous effect on the financial institutions that had written them. The AIGs, but not just AIGs, who had written them when housing went down. And of course they had to pay the piper and ultimately the Taxpayer stood behind it.

Third, the credit default swaps were also used to lower bank regulatory capital. This was done mostly in Europe. As you know, over 70 percent of AIG's credit default swap book was used to help lower capital charges elsewhere. When one system failed, then others had problems.

Fourth, I think the financial system was far to interconnected, and it was interconnected in part because of derivatives. You had a wonderful chart that I want to compliment you on that you put up on your website that showed this interconnectedness. I think it was for one large financial firm you had testifying here yesterday and today. But that web of interconnectedness, that web really puts everything at risk when in the future a Federal Reserve Chair or a Treasury Secretary can't let something fail. And I think in the middle of '08 we saw that for sure.

Fifth, the entities themselves, the dealers themselves in this market were not really well regulated. Sometimes they were banks, but they were not effectively regulated for dealers; but often they weren't banks, they were affiliates of banks. They were affiliates of Lehman, and Bear, and AIG. And as the former insurance commissioner said, they weren't really effectively regulated.

And then sixth, the over-the-counter derivatives market placed lax market transparency. Now I've heard, some people will debate whether this was really anything to do with the crisis, this lack of transparency. I believe the lack of transparency did make the financial system more vulnerable. Leave us not think of toxic assets, and wouldn't toxic assets have been more easier to price if the derivatives that related to them were actually transparent? Also, clearinghouses fundamentally need reliable pricing to price them.

Where are we today? The legislation reported by the Conference Committee and voted out of the House of Representatives yesterday this week is strong, comprehensive, and historic, and I support that legislation and hope it gets to the President's desk.

First, it will include strong regulation of the dealers themselves for the first time--

CHAIRMAN ANGELIDES: Can you wrap up pretty quickly, Mr. Gensler?

WITNESS GENSLER: Ten seconds.

It will have mandatory clearing and mandatory trading, and with that I am glad to take questions.

CHAIRMAN ANGELIDES: You did it in less than ten. All right, Mr. Lee?

WITNESS LEE: Thank you, Mr. Chairman, Mr. Vice Chairman--

CHAIRMAN ANGELIDES: Microphone, please.

WITNESS LEE: Thank you, Mr. Chairman, Mr. Vice Chairman, good afternoon:

I appreciate the invitation to appear here today. I respect the important work the Commission is doing to understand the causes of the financial and economic crisis facing our country.

During my 17 years in public service, which ended in May of this year, I served on Capitol Hill, including quite a few hours in this very room. I served at the Federal Deposit Insurance Corporation, and at the Office of Thrift Supervision.

I am appearing here today at your invitation and in my capacity as a private citizen. My testimony is not OTS's official view on any matters of law, policy, or procedure. But I do appreciate the opportunity to provide any insights I can offer to further your inquiry and report.

From early 2006 until March of 2008, I was Managing Director at OTS for complex and international organizations. During that time, my division had direct supervisory responsibility for AIG and other conglomerate holding companies supervised by OTS.

While I was serving as Managing Director, in early 2006 my group was asked to design a program specifically tailored to the supervision of large complex savings and loan holding companies.

In addition to developing the program, my group performed examinations and targeted reviews of the conglomerates under our purview. OTS's conglomerate examinations were performed by career examiners and specialists who were onsite at the firms themselves.

While OTS's authority existed because these entities owned federal savings banks, its examination reports were assessments of the overall enterprises and they were directed to the top-tier companies' board of directors.

OTS examined the firms according to the framework provided by the OTS Holding Company Program's core components, those being capital, organizational structure, relationship with the thrift institution, later changed to risk management, and earnings.

With respect to OTS's supervision of AIG, I would like to emphasize the following points:

The risk management policies and procedures the company put in place following the reshaping of management in 2005--policies, to be fair, that OTS occasionally praised in its reports--did not perform well under the stresses brought on by the deteriorating housing market in late 2007 and through 2008.

The subprime residential real estate stresses at AIGFP resulted from credit default swap products originated largely in the 2003 to 2005 time period. This portfolio was a key focus of our examination work from 2006 to 2008.

The derivatives at AIGFP were not regulated. The point has been made here earlier. Nor were they subject to any standardized regulatory reporting framework.

This lack of transparency, as has been observed by my colleagues here this afternoon, was an obstacle to the effective oversight of this business by AIG.

In the 2006 to 2008 time frame, OTS reports show increasing supervisory criticism of AIG's risk management financial reporting and corporate governance, including specific criticisms of the parent's oversight of the subsidiary AIGFP, among others.

These criticisms culminated in a downgrade of the holding company ratings, and enforcement action in the form of a Supervisory Letter which I signed in March of 2008.

AIG failed, as has been noted earlier in these hearings, because it could not meet obligations to counterparties. For its liquidity planning, AIG relied on faulty assumptions about available liquidity from the markets and from the firm's insurance operations.

This liquidity was either nonexistent or not available when it was needed, and this miscalculation had catastrophic consequences for the firm in September of 2008.

Shortly following the issuance of the Supervisory Letter I referenced earlier, I sought and accepted a position as a regional director with the OTS outside of Washington, D.C., and my involvement with this case ended at that time.

Clearly there are many lessons policymakers, regulators, and market participants can learn from the collapse of this company, and many of those have been addressed in my written testimony to the Commission here this morning. But I would like to underscore for the Commission a couple of recommendations.

First, regulators, when given responsibility for supervising large firms, must have the procedures and resources in place to fully meet these responsibilities. It sounds simple, but it is rarely that way in reality.

Finally, I would like to underscore that the regulation of derivatives' products ought to be a key national goal, and many of the concerns I had about this program have been addressed in many of the provisions contained in the Dodd-Frank legislation that is currently pending before Congress.

So I will close there and welcome your questions. Thank you.

CHAIRMAN ANGELIDES: Thank you, Mr. Lee. We will now begin the questioning. But I would like to just make one observation before we start. And that is: Mr. Lee, thank you for coming here at our request. Just as a point of information, we had requested that Mr. Rich, who is the former Director of OTS, Office of Thrift Supervision, be with us today. We were unable to get a response. We did issue, but were unable to serve, a subpoena because we were informed that Mr. Rich is overseas. But I wanted that at least to be on the record.

We had previously interviewed Mr. Rich, and we will follow up with him. But I want to thank you for voluntarily accepting the invitation when it was issued.

WITNESS LEE: You're welcome, sir. Thank you.

CHAIRMAN ANGELIDES: To be here on behalf of that organization.

So we will now begin. And I normally begin the questioning, today but I am going to defer my questioning and turn this over right now to the Vice Chairman.

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman, and I will take just a minute so that the Commissioners can have most of the initial questioning.

Mr. Dinallo, thank you. You are obviously the center of whatever storm it was. We have not had the ability to quiz the State of New York and its legal structure in dealing with it. We keep looking at the larger picture from a Washington perspective, and this is going to be valuable.

Chairman Gensler, I was going to ask you if you felt comfortable giving us some idea of what you thought some of the causes were. And then I was going to be very, very tentative to see if you would be willing to comment on the legislation.

But having spoken with you before, I really appreciate your willingness to just come out front. Because it is a very difficult job, especially sometimes when we are talking to some of the private entities, to get an answer that you can do anything with. So we are going to be able to deal with this.

And, Mr. Lee, I also want to thank you. My initial question, if I were going to ask you one, which I won't, would be what did you know and when did you know it? But I would of rather have asked that of someone else who was running the show and was here during that time, but we don't have the ability to do so.

My only question to you, Chairman Gensler, would be what were we thinking? I mean, for someone who wasn't involved in it, and you run down your list, and we look at some of the changes, how come they, as is almost always the case, seem so obvious? But people who were in the center of it, and you yourself again one of the practitioners, happened to think it's a positive thing to move from the private sector to the Government. I'm a little concerned when you go back into the private sector, especially if it's in the same area that you were governing within a governmental position.

But everyone we’ve talked to has said, we didn't see it. We didn't realize it. We didn't know. Nobody was expecting it. Prices were going to go up. From your perspective, both private sector and now as Chairman of the Commodities Futures Trading Corpora--, how come we didn't see it?

WITNESS GENSLER: Mr. Vice Chair, I think there's two things that could be in that question about what we didn't see.

One was the regulatory side, and one was this whole the excesses building up.

VICE CHAIRMAN THOMAS: Regulatory is always after the fact, and you never get it as good, and you're fighting the last war. So to a certain extent I understand that.

Although clearly I have always argued that transparency goes a long way in allowing everybody, market participants and the Government, to see what's going on. And I'm concerned about that. But I'm more interested in the private sector folk who, 30 times the multiples?

COMMISSIONER GEORGIOU: Okay, so let me address the second one, but I would be glad to address the regulatory side, too.

On the private sector side, I think that we had tremendous imbalances in our economic sphere. And you are researching many of those: low savings rates, this housing bubble that was facilitated I think in part by these credit default swaps but not alone by that. I think we also had very weak rating agency practices. Very weak underwriting practices.

That housing bubble, where it seemed like everything's just going up, when it started to turn and come the other way, then the excess leverage in the system, terribly high leverage in the system, both at AIG and at numerous other financial institutions--it was not isolated to investment banks or commercial banks, even though the 30 to 1 numbers you're talking about were investment banks--all of a sudden everybody got cut very hard.

There was very little room for mistake. Very little capital in the system. I think derivatives contributed to that, for sure. Not just because of the credit default swaps. I think overall derivatives allow greater leverage in the system.

VICE CHAIRMAN THOMAS: Let me then retain my time at this time, Mr. Chairman, and allow the other Commissioners to comment.

CHAIRMAN ANGELIDES: We will start with Ms. Born.

COMMISSIONER BORN: Thank you very much, and thank you all for being here.

I particularly welcome one of my successors in office, Commissioner, Chairman Gensler of the CFTC.

Regulation of the over-the-counter derivatives market was virtually eliminated in 2000 with the enactment of the Commodity Futures Modernization Act. And since that time, no federal regulator, including Mr. Gensler currently, has regulatory authority over that market, or oversight of that market.

Moreover, states, as Mr. Dinallo points out in his testimony, have been prohibited from enforcing their anti-gaming and anti-bucket shop laws with respect to derivatives.

By June 2008, less than eight years after deregulation, this market grew to more than $680 trillion in notional amount and played, I think, a major role in derailing our financial system and harming the economy.

The financial regulators, both state and federal, had their hands tied in trying to control the market because of the erroneous decision that no regulation was needed to protect the public.

I have hope today for meaningful regulation of this market to provide significant protection to us all if the financial reform bill that is currently pending before Congress becomes law.

And let me, with that, turn to Mr. Gensler. You said that in 2008 the financial system failed, and the financial regulatory system failed. In your view, you have said also that there have been failures with respect to the over-the-counter derivatives market.

How did that market fail?

WITNESS GENSLER: Well I think that derivatives which were initially meant to lower and mitigate risk, and a really very important hedging tool for thousands of companies and municipalities, also concentrated and heightened risk. They concentrated and heightened risk at AIG for sure. But elsewhere as well.

Secondly, beyond concentrating and heightening that risk, there is that interconnectedness, that wonderful graphic that this Commission has on just one entity, limits the flexibility of the Government to let something fail. So things not only became too big to fail, but too interconnected to fail, or to be allowed to fail.

And thirdly, I think specifically to the crisis-- oh, there's this wonderful graphic--

COMMISSIONER BORN: And that, I might add, is only 49 of the counterparties of Goldman Sachs, and they have testified they have more than 10,000.

WITNESS GENSLER: Right, so imagine if a Treasury Secretary, or a head of the Federal Reserve, was contemplating letting that institution fail. And then they have to think of those 49 others. And as we know in AIG, of the first $90 billion that went into AIG, $60 billion of it went straight through AIG to another party. This whole question of did they paid 100 cents on the dollar.

The same thing would happen probably here, without reform and new laws, that pressure. So it heightened and concentrated risk on these financial institutions.

Secondly, the interconnectedness. We can't escape that without real reform, these clearinghouse reforms that we so desperately need. But then thirdly, the credit default swap narrative is a very--it was an insurance product. And when the housing bubble burst, many institutions, not just AIG, then were going to come down asunder.

COMMISSIONER BORN: Well let's look at AIG first, because it was a colossal failure. Do you see that as--AIG's failure as related to its over-the-counter derivatives trading, and most particularly the credit default swaps?

WITNESS GENSLER: Oh, absolutely. Though they had many other lines of business, the concentrated risk was in AIG Financial Products, a lightly regulated London and Connecticut business; $2.7 trillion derivatives book; but it was concentrated in the credit default swap business.

COMMISSIONER BORN: You’ve said I think that we learned in the financial crisis that the failure of one large institution can bring others down as well, or at least has that potential.

Do you think that AIG, if it had been allowed by the Government to fail, would have had systemic risk implications?

WITNESS GENSLER: Commissioner Born, absolutely. I think that if AIG would have failed, we would have seen a series of other failures. I think that the financial system itself was as close to the brink in those critical weeks in September of 2008, I don't think any financial institution, even the strongest, if they were large and interconnected like this, was really--they were all vulnerable.

COMMISSIONER BORN: You might explain for the Commission how these counterparty credit risks that build up in the derivatives markets with millions of contracts would be handled differently if there were central clearing. And you might explain how that risk is diminished.

WITNESS GENSLER: Central clearing was an innovation of the 1890s and actually came in the wheat and corn markets. It was so that a contract that was for the future delivery of corn or wheat, somebody would stand in the middle that that farmer didn't have to rely on some jobber or money person from Chicago or New York to really stand there on the other end.

So a clearinghouse stands as a middle man, and on every day values the contract. Every days he says is it up or down.

So how it would work in this circumstance, all those lines, all those intricate spider's web [indicating the chart], the clearinghouse would be in the middle legally novating the contract, taking money on a daily basis so that if one party failed they would stand to complete the contract.

AIG had to get tens of billions of dollars immediately because they didn't have a clearinghouse mechanism in between.

COMMISSIONER BORN: Well wouldn't they have been posting margin--

WITNESS GENSLER: Yes--

COMMISSIONER BORN: --on a daily basis--

WITNESS GENSLER: --the clearinghouse--

COMMISSIONER BORN: --so that there would not have been this enormous exposure built up?

WITNESS GENSLER: That's right. A clearinghouse mandates that there's daily valuation and daily posting of margin, which is a performance bond in case one party fails. And fortunately the new legislation includes that, and I know the CFTC we would vigorously enforce it if it becomes law.

COMMISSIONER BORN: Do you feel that the interconnectedness of derivatives' counterparties poses a systemic risk to the financial system on an ongoing basis?

WITNESS GENSLER: It absolutely does. I think that the new legislation significantly addresses that, because--as the testimony in front of this Commission in January a CEO from Wall Street said, 75 to 80 percent of derivatives could be standard enough to be brought into clearinghouses. And that, would really be a significant enhancement, and lowering of risk.

COMMISSIONER BORN: Let's look a little bit now at credit default swaps and synthetic CDOs, which are essentially a package of credit default swaps, apart from the impact on AIG.

You said you thought that that played a role in the housing bubble and mortgage securitization bubble? Is that right?

WITNESS GENSLER: That's correct. I think it lowered some of the underwriting standards of Wall Street, but it also amplified the risks in the system. I mean, one homeowner’s mortgage could actually be in numerous different contracts and numerous credit default swaps, and it is I think very much a part of the ride up the roller coaster and the unfortunate calamity down the roller coaster.

COMMISSIONER BORN: What role do you think lack of transparency played in the financial crisis with respect to derivatives?

WITNESS GENSLER: I think it played a real role. This is legitimately quite a debate, and through this legislative process many people have taken the other side of this debate. But I personally think that it makes the system more vulnerable, lack of transparency.

In the securities and futures markets, President Roosevelt came to Congress in the '30s and asked for regulation of those markets in part to promote transparency.

Then everybody gets to price off of that transparency. Derivatives is really a dealer-controlled club, in a sense, where one party doing a transaction, a corporation, doesn't know what another party is hedging at.

In the crisis itself, we had things called toxic assets. Though those weren't technically over-the-counter derivatives, I think those assets would have had better pricing if they had reference in, particularly, the CDS marketplace.

COMMISSIONER BORN: Let me just ask you a question about the panic that occurred in September of '08 when Lehman Brothers failed, AIG then had to be rescued, other things were happening in the markets. Do you think-- and essentially there was a run on the shadow banking system, a run on investment banks, actually a run on banks, not through their deposits but through their shadow banking.

Do you think that derivatives were part of that run? That is, did uncertainties about counterparties' credit worthiness cause, in derivatives, cause anxiety? Were people trying to close out derivatives' positions, or get collateral, or take other actions?

WITNESS GENSLER: I think there were, though I was a private citizen and not on Wall Street or a regulator at the time. I do think that you're right, there was a run on the bank. The old bank in the movie, George Bailey and his bank, in that wonderful movie, the run was in money markets, the run was in prime brokerage, the run was in investment banking elsewhere.

The risk premium widened. Lehman failed. There was still some question as to how their derivatives book would be transferred. As it turned out, much of Lehman's interest rate book was in central clearing, and with 27 trades, a group out of London, LCH Swap Clear, actually did move that book successfully.

But there were days that people didn't know how it would be moved. And there was the customer side of the business that didn't move as successfully.

COMMISSIONER BORN: Just to wrap up on this concentration of risk in the hands of some large institutions--let's take the over-the-counter derivatives dealers as really big concentrations of derivatives' risk--do you think that makes those institutions too big to fail?

WITNESS GENSLER: Well--

COMMISSIONER BORN: Or plays a role at least?

WITNESS GENSLER: There are six institutions in the U.S. that have well over 95 percent. There's another 6 to 10 overseas. So these 15 or 20 institutions--

COMMISSIONER BORN: By the way, would you agree that Goldman Sachs has a derivatives' business?

WITNESS GENSLER: Well I left there 13 years ago, which if I might say was a Bar Mitzvah ago, but I believe that it does have--it's a swap dealer. It has a swap dealing desk.

COMMISSIONER BORN: Thank you. Just an aside.

WITNESS GENSLER: But to your question, your earlier question was just remind--I'm sorry?

COMMISSIONER BORN: My earlier question was whether or not interconnections--

WITNESS GENSLER: Yes.

COMMISSIONER BORN: --through the derivatives on the part of the, for example the big six derivatives' dealers, make them in effect too interconnected to fail.

WITNESS GENSLER: I think unless we have strong regulation to the President, and I am hopeful as you are that we will, we will have left these institutions too interconnected for a Government to realistically let them fail. But if we can take that 75 to 80 percent that might be able to get into clearinghouses, move them off the books of the banks into clearinghouses, force the daily valuation, the daily posting of margin, and all the risk mitigation, I think that we have a shot at this thing.

There's still going to be a risk. These things are highly concentrated financial institutions.

COMMISSIONER BORN: Thank you.

Mr. Dinallo, some people have suggested that the real problem at AIG related to its securities lending program, and that its exposure to AIG Financial Products through that company's credit default swap business was a mere secondary problem that it had. Do you agree with that?

CHAIRMAN ANGELIDES: By the way, five minutes?

COMMISSIONER BORN: Please.

WITNESS DINALLO: I'm sorry? I'm given five to answer the question?

COMMISSIONER BORN: No, no--

CHAIRMAN ANGELIDES: That was five minutes for the Commissioner.

COMMISSIONER BORN: I have five minutes.

CHAIRMAN ANGELIDES: You should make your answers as succinct and pithy as possible.

(Laughter.)

WITNESS DINALLO: Thank you. I will try.

CHAIRMAN ANGELIDES: A New York minute.

WITNESS DINALLO: I don't--no, I don't believe that's true. I mean, at least the calls that I received and the reason that we all ended up at the Fed and working at AIG throughout that week was the problems with the Financial Products Division, whose issues I think dwarfed the securities lending issues.

The securities lending issue was an issue, and it certainly exacerbated the situation. Although I will point out that no other insurance companies had a securities lending issue. And we examined them all under New York State law, and the New York State Insurance Department was fairly ahead of the curve on this in helping to wind down, or directing AIG to wind down its securities lending business away from asset-backed securities.

So for a year leading up, we had wound it down by 25 percent, even though we were only about 7 percent of the exposure as a regulator.

What I think did happen--and there was a toxic synergy here which goes to whether you should ever permit sort of a bolted-on derivatives business, is the counterparties certainly seeing that there were collateral issues at AIG then went and started to demand their securities back.

So there was in a sense--I don't mean this in a legal sense--but there was in a sense inside information about the demand for the cash back on the securities lending business, which was not seen anywhere else to anything of the same extent.

I do think that a pooled securities lending business is not a wise idea, on reflection, because I think it leads to sort of regulatory assignment questions. So it was pooled at the holding company level, and that meant that several states were all somewhat responsible for it.

I think that when you have operating companies, insurance operating companies, there really ought to be just one regulator over that operating company. And this I think created some kind of a regulatory gap--although people disagree about this. Certainly we were on top of it when I was there, although there was a long lead up that I think permitted them to go to a concentration in RMBS that I don't think was particular wise. Although it was all AAA rated, and you know all the positions about that.

So I don't think in any way, shape, or form it was the driver. In fact, when I testified in this room last time, the life insurers were fully solvent and they were certainly not the reason that there was any bailout or any reason that we were called to help with the issues on Financial Products Division.

COMMISSIONER BORN: So in a way, what may have happened was concern that came from what was happening at AIGFP with its credit default swaps' portfolio may have caused a type of run on the securities lending, on the part of the securities lending counterparties?

WITNESS DINALLO: I think it was that, and the general financial crisis where everyone was reaching for cash.

COMMISSIONER BORN: Right and wanted money--

WITNESS DINALLO: And by the way, just parenthetically, as my written testimony says, this is the one area where all of a sudden in some way that's a little bit attenuated but true, that all of a sudden the holding company could be reached into for cash into the operating companies, because they had lifted this business into essentially a holding company structure and you would not otherwise permit that.

COMMISSIONER BORN: Right.

WITNESS GENSLER: And can I just add, it was also the nature of the securities that AIG decided to take, residential-backed mortgage securities. So they were sort of doubling down more on the housing market.

COMMISSIONER BORN: Yes, indeed. Let me--

WITNESS DINALLO: Oh, there's just--another thing?

COMMISSIONER BORN: Sure.

WITNESS DINALLO: I think it's very interesting to think about statutory accounting versus mark-to-market accounting. Insurance companies do statutory accounting, and we can debate the wisdom, but it does permit you to take a long dated risk and match it to an asset, and basically manage yourself out of some poor decisions because you really only have to make sure that when the person, God forbid, passes away so to speak, dies, you have the asset to match against that liability.

There's a big debate I believe whether securities lending should be permitted for insurance companies because in a sense it exposes their statutory accounting to the mark to market accounting of investment banks, which is clearly what started to happen. That's like for another day, but I do think that there's an argument that there's a regulatory moat around the insurance company that should not permit for any drawbridges whatsoever, or you get exposures like with FP and exposures like the pooled securities lending business.

COMMISSIONER BORN: Well when AIGFP did have these tremendous collateral calls on its credit default swaps and got to the point where it wasn't able to meet its obligations, the Federal Reserve Bank of New York stepped in and the Federal Government then stepped in more generally, and has made commitments of over $180 billion to it, do you think that that was necessary in order to save--in order to prevent systemic harm?

WITNESS DINALLO: Well I agree with the Chairman's views that I thought it was necessary. I was there, and people seemed genuinely concerned, and shocked, and believing that, you know, there was some chance that commercial paper at major institutions was not going to roll over. These were sophisticated thinkers and speakers. That ATMs might kind of grind to a halt that week.

I think that it was necessary, because also I thought that the possibility that the American public, or the world would somehow start to have doubt in insurance products, which of course was not the reason for the crisis and didn't have anything really to do with AIG's issues, would be one step too far and you would end up having potentially runs on insurance companies, which you could argue doesn't actually happen, but people stop buying it and you essentially have a long-term run.

So I thought it was very, very important. What I always wished could have happened was--and I don't now whether this could have been done in an emergency way, and maybe this is the kind of thing that should be put in a statute--is I would have liked to have seen the U.S. Government just substitute its guarantee in rating for FP's obligations, instead of actually just pouring in the cash. Because essentially that would have taken off a lot of the issues, and I think that it wouldn't have looked quite like a bailout, and there would have been essentially the same outcome to a large extent.

Now I don't think TARP, or whatever it was called then, permitted that but maybe they could have gotten some kind of emergency measure. I think that would have helped a lot because that essentially was the issue, this belief whether they were going to be able to pay. Because, right, I'm sure you've heard before from yesterday, et cetera, that really it was a liquidity problem not a risk problem in that the actual vintages of the CDOs weren't, you know, the most modern ones.

So with the right long-term guarantees, you might have--and you will see it worked down to a number that's not nearly $200 billion.

COMMISSIONER BORN: Yes. Thank you. My time is up.

CHAIRMAN ANGELIDES: I apologize for falling down on my Chairman duties. Mr. Vice Chairman?

VICE CHAIRMAN THOMAS: That's okay, because you recognized me.

(Laughter.)

VICE CHAIRMAN THOMAS: Mr. Wallison, I want you to join in on this for just a minute. We've got this multiple chart up again.

Chairman Gensler, I want you to expand on your comment. Because we've heard opposing views, that derivatives helped to inflate the housing bubble. And this is where you have an example where, through synthetic and partially synthetic CDOs, you can multiply the number without having to multiply the actual mortgage packages.

And I believe Commissioner Wallison says that that's not necessarily a bad thing because they would have just gotten worse if they had to go out and multiply them.

Is that accurate?

COMMISSIONER WALLISON: Yes. The argument is that there was demand for exposure to subprime mortgages in the United States, demand around the world. Now it could be satisfied by making more subprime mortgages in the United States, or it could be satisfied through synthetic CDOs which replicated the potential risks and rewards such as they might have been in subprime mortgages.

So the argument is that, by allowing synthetic CDOs it made it possible for this demand for that exposure to be satisfied without actually having to make the mortgages. That's the argument. Do you want to respond to that?

VICE CHAIRMAN THOMAS: Well I want to add an option, or an elaboration and get your reaction to it, because arguably CDOs were dependent on CDS to exist. And so as more CDOs over time had a synthetic component, maybe you needed the synthetics to keep the cash market going.

WITNESS GENSLER: I think that the--you're calling them synthetic, or derivatives in this marketplace, and the cash had an interplay. Just as in the oil market, a future and the actual oil can have an interplay. But what I was saying earlier, and would firmly believe, is that credit default swaps allowed for the mortgage underwriting practice to be lowered, the actual due diligence and everything.

Somebody else was the gate keeper. Somebody else was bearing the risk. AIG, or MBIA, or somebody else. And a lot of investors were investing in collateralized debt obligations because there was what we used to call when I was earlier in the financial industry, called "bond wraps." They were done by insurance companies, not by derivatives people.

Those bond wraps and CDS usually meant that investors would invest more. So it's in that way that I think it in 2004 to 2007 contributed. It was not the only cause of the housing bubble at all, but I think it helped contribute during those critical years.

COMMISSIONER WALLISON: Well we're talking I think about two different things here, Mr. Vice Chairman, if I can continue--

VICE CHAIRMAN THOMAS: Go ahead.

COMMISSIONER WALLISON: I think we're talking about two different things.

WITNESS GENSLER: We may be.

COMMISSIONER WALLISON: A synthetic CDO doesn't have anything to do with an actual loan. It just replicates the risks associated with a CDO that includes the actual loans.

So I mean it doesn't add--it doesn't make those original CDOs that include actual loans any more or less risky.

Now you could buy a CDS on an actual CDO with real mortgages in it, and that might respond to the point you are making. I would add, though, that of course we've had insurance of all kinds of risks over time, and to say that insurance makes people more willing to take risk is well know, but the insurer, as Mr. Dinallo will tell you, has to understand the risks that the insurer is taking on.

But let's just go back to the issue of the synthetic CDO. My point was simply that when you have a synthetic CDO and it allows you to take the same exposure, then the subprime mortgages don't actually have to be made.

VICE CHAIRMAN THOMAS: And the purpose of my intervention--and then we'll get back to the regular round--was that I wanted you to amplify on the statement that you said that derivatives helped to inflate the housing bubble.

And then at some point, if it seems appropriate, if you could mention the rating agencies and their involvement in direction and substance of how it inflated, in your opinion.

WITNESS GENSLER: I think Commissioner Wallison was helpful. It is two, though related, separate points.

My overall point was not about synthetic CDOs, even though I know that's a much debated topic. Mine was just around the credit derivatives. And somewhat because of their newness. They didn't really exist to any extent 10, 11, 12 years ago. But in this period of time, contrasted to other forms of insurance, are a very new product, very ineffectively regulated insurer, so to speak, AIG Financial Products, and others. So I think that they did replace otherwise, you know, good judgment on underwriting factors of this.

And synthetic collateralized debt obligations, and just general collateralized debt obligations have very similar features in many regards, and to that I share your view. Those are separate points, though related.

VICE CHAIRMAN THOMAS: And then just on rating agencies, AAA, AA--

WITNESS GENSLER: Oh, Rating Agencies I think that, although it's outside the lane I swim in, I'm supposed to swim in the derivatives lane. I Think--

VICE CHAIRMAN THOMAS: I understand you've been in the pool a long time.

WITNESS GENSLER: Yes, but I think that the rating agencies contributed, and the weaknesses in the rating agencies particularly related to asset securitization product, whether that was because of conflicts of interest, whether that was other reasons, I'm sure you'll investigate, but I think they definitely contributed. Rating agencies, credit default swaps, poor underwriting standards, the housing bubble, you know, it was a little bit of a cycle, then it became a bigger cycle, it peaked, and those Case-Shiller numbers, and then collapsed.

VICE CHAIRMAN THOMAS: Insurance and assurance sometimes comes close to being in the same lane.

CHAIRMAN ANGELIDES: Right. Thank you, Mr. Chairman--

VICE CHAIRMAN THOMAS: Vice Chairman.

CHAIRMAN ANGELIDES: Mr. Vice Chairman. Boy, it has been a long journey. I am going to take a few minutes now before we move on to Mr. Wallison and Mr. Hennessey--

VICE CHAIRMAN THOMAS: Hennessey is first.

CHAIRMAN ANGELIDES: Oh, Hennessey is first. I keep looking right. And actually just take some of my time for a minute right now. And I want to actually ask--Mr. Dinallo, I want to ask you a couple of questions.

You made an interesting observation that AIG's ability to sell credit default swaps was based on the AAA rating of the holding company, which was based on the insurance subsidiaries whose assets were not available to backstop the activities of AIGFP.

So how on earth did that rating essentially get ascribed to instruments being written by an entity not backed by the assets that gave rise to the AAA? Is that a failure of the rating agency to make the distinction? Or is that a complete failure of the people buying the product to understand what assets were available?

WITNESS DINALLO: I think that it is both. It is I think the most profound miss I have seen out of this, that I would have some--

CHAIRMAN ANGELIDES: That's a pretty darn big one.

WITNESS DINALLO: It's pretty profound. And I think it is extremely important--and I don't mean to disagree with Chairman Gensler, but there is one incore distinction you have to make.

The difference between MBA and Amback, say, and the difference between FP is a really important distinction. I just want to take a minute and explain this, because I think it explains so much of what went on.

In the early '80s, the assurance--

VICE CHAIRMAN THOMAS: Excuse me. Mr. Dinallo, if you're going to explain it, there are actually people watching who have no idea what those letters—

WITNESS DINALLO: Okay.

VICE CHAIRMAN THOMAS: you just rattled off represent.

WITNESS DINALLO: So these are--okay, thank you.

VICE CHAIRMAN THOMAS: Thank you.

WITNESS DINALLO: Thank you, Vice Chair.

What we're talking about are financial guarantee companies, companies that take their capital, their rating, and they guarantee the obligations of others, whether it's an issuer of bonds, or eventually structured CDOs.

And when we started to see this happen in the Department of Law--I mean, in the Department of Insurance, it was early on that AIG back in the early '80s, and Citigroup, and others, started to do this. They started to, quote, "monetize" their rating.

And the Department demanded that these be set alone and called monolines. And they could only do this one business. They had to be standing alone. They had no access to the guarantee funds, to Government bailout. And they were highly regulated with very high capital requirements and a low return on equity. They weren't going to be leverage businesses.

And the belief was that if they went, you didn't want them to take down the Government through the guarantee funds, or an otherwise stable insurer. Is this starting to sound familiar? Okay.

There's a good argument that I told your staff that what AIG did, and the CEOs there and the executives, was they figured out after the CFMA that they could basically bolt on a severely under-capitalized monoline, get the AAA rating of the holding company, and sell guarantee insurance without the capital set-aside that it would have otherwise required under New York State insurance law.

That is why I believe it was so profitable for so many years, because it was doing a business that otherwise you would call on Wall Street "dumb money." But instead, they could get huge returns because they could sell insurance, as Chairman Gensler said, without the same capital set-aside.

That's like a miracle. When you get to do that, you make tons of money. You pay, eventually.

So I do think that essentially the rating agencies and the counterparties missed this. And they believed that in the trillion dollar balance sheet of AIG--

CHAIRMAN ANGELIDES: Somewhere, somehow, there would be money.

WITNESS DINALLO: Like it would in a monoline. There's tons of money in a monoline, and it comes up to meet the obligations.

CHAIRMAN ANGELIDES: So the AAA rating was accorded to the holding company? Or was it also accorded specifically with respect to backing these instruments?

WITNESS DINALLO: I think it's a little confusing. I'm not perfectly knowledgeable. Each operating company does have its own rating for insurance purposes, and I don't know. I presume that FP--my understanding was FP was guaranteed by the holding company, which is essentially them saying we have a double, or a triple A rating and we're basically monetizing that through FP.

CHAIRMAN ANGELIDES: But you really didn't have pure portability of the funds. All right, this is one of those cases of if it's too good to be true, it's probably too good to be true.

WITNESS DINALLO: And the other--well, also add onto it that normally when you have a monoline, you don't do collateral in events of default and margins to the counterparty.

CHAIRMAN ANGELIDES: It's only in the event of real default.

WITNESS DINALLO: Correct.

CHAIRMAN ANGELIDES: Correct. All right, now, Mr. Thomas, you wanted to ask something?

VICE CHAIRMAN THOMAS: Yeah, I want to try to jump from, Mr. Dinallo, what you were saying to the fact that OTS is at the table as a regulator and dealt with AIG as a regulator, only because of an acquisition, and that their ability to regulate would be nowhere near what you would think the degree of regulation would be, given what they were doing in AIGFP.

Can you just flesh that out a little bit? And obviously, Mr. Lee, we will want to bring you in on this, because I think that's the other thing that you need to talk about. Your explanation was terrific.

WITNESS DINALLO: I think--I just want to add that. So, so after Bearings--my understanding is, after Bearings went down, there was a series of regulatory requirements that each company doing business in London would have to show who its supervisor was and roll up all of risk. This was part of the Basel II requirements.

And so then in order to do business in London, you had to demonstrate this. Now the FSA would accept other regulators than itself. So all of the investment banks and others had to go out and get a group supervisor. And AIG's, I would have thought, would have been one of the insurance supervisors, or maybe someone else, but they did acquire this very small thrift, 1/1000ths of its balance sheet, in I think '99 or 2000, and thereby, by a trick of regulatory arbitrage, arguably, was able to designate the OTS as its holding company supervisor.

That was permitted. In fact, when I was at Morgan Stanley, I came after the fact. There was an argument that Morgan Stanley could have done the same because it owned Discover and some small banks in Utah. They chose the SEC.

So that is I think one of the other lessons, is there ought to be some common sensical nondiscretionary choices about who you're regulator is. It should not be dating. It should be a married relationship that you're sort of stuck with.

And I think that that has led to lots of switches in charters in federal and state banking situations where, if one regulator is too tough, they just flip over to the other regulator. That should just be prohibited. It's unbelievable that we permit it.

CHAIRMAN ANGELIDES: All right, just picking up very quickly, and then I actually want to pick up on what the Vice Chair was querying about OTS, but I want to finish with you quickly, and then I want to swing to you, Mr. Lee.

And that is, that in 2007-08, based on interviews with our staff, it appears that the State Insurance regulators did begin to address security lending challenges they saw at AIG. But one of the things that struck me was, you mentioned in the interviews, and it is in the materials given to us, that you essentially had control over 7 percent of the assets, and the investments were being run out of a holding company which you really said was a matter of regulatory arbitrage in another respect, correct?

WITNESS DINALLO: Well, there's a--

CHAIRMAN ANGELIDES: Could you have stopped that? Could you have said, pull these back to the insurance subsidiaries?

WITNESS DINALLO: Yes. I don't know--I don't know if New York standing alone could have, but I guess each--

CHAIRMAN ANGELIDES: You could have said--

WITNESS DINALLO: --I guess historically--

CHAIRMAN ANGELIDES: You could have said to the insurance subsidiary--

WITNESS DINALLO: Yes.

CHAIRMAN ANGELIDES: --we're not going to allow AIG investments to invest your assets.

WITNESS DINALLO: Yes.

CHAIRMAN ANGELIDES: So in a sense the state insurance regulators, looking back on this, should have done that?

WITNESS DINALLO: Let me make--I think it's a more subtle answer. And the reason is, there's a good--I believe that when they first were proposed this, they thought that it was a good risk mitigation.

CHAIRMAN ANGELIDES: Sure, because you have a larger pool--

WITNESS DINALLO: Correct.

CHAIRMAN ANGELIDES: --and as Treasurer of the State of California I ran both the state investment pool and the local agency investment fund.

WITNESS DINALLO: Yes.

CHAIRMAN ANGELIDES: You get efficiencies, you get diversification. So I assumed that was the assumption.

WITNESS DINALLO: But I think what I would have done--

CHAIRMAN ANGELIDES: Is subject the larger pool to regulation?

WITNESS DINALLO: --if I had been there, I would have either not permitted it, or I would have said that there needed to be one, sort of one regulator who was deemed to be responsible for watching the concentrations.

Now there's also--and we've produced these documents. There's also a large lag in when the mix of securities invested comes into the regulator. And that is something I think needs to be fixed.

And then, once the recognition occurred of how concentrated it got, they started--"they" meaning the Insurance Department and other state regulators--started to walk them back. Which I think they were doing successfully before--

CHAIRMAN ANGELIDES: What was the lag again?

WITNESS DINALLO: Well, there are these regulatory filings that I'm not perfectly familiar with, and I would refer to the Insurance Department, but there was an argument, and they sort of go back and forth that on a risk-based capital calculation that there was an argument that they were too concentrated. And also I just happen to recall, as I'm sitting here now, that there was sort of a, not a real-time reporting on the investments of the securities lending, I believe. Which is sort of normal, when you think about it.

But intra-quarter you could go very long
something, and by the time the regulator sees it the
decision has already been made.

CHAIRMAN ANGELIDES: I think it’s fair--And you only
had control over 7 percent.

WITNESS DINALLO: My recollection is that the
State of New York's life insurance companies that
participated in this was about 7 percent.

CHAIRMAN ANGELIDES: So how--and very quickly,
because I do want to move on and I only have a limited
amount of time, so I just want to ask you, in that regard,
if you only had 7 percent control, how would you effectuate
control? Would you do it collectively with the other--

WITNESS DINALLO: Well New York--well New York
became the head of a--in part because of the expertise of
the Department it became the head of a multi-state task
force to work with AIG to wind back the securities lending
program, which I think it was doing successfully.

CHAIRMAN ANGELIDES: Well it seems--and I want to
move on to the OTS now--it does seem in the big picture here
that AIG, either our regulatory system was so fractured, so
dysfunctional, or that AIG was extraordinarily adept at
weaving its way through the gaps in the system--because if
you look at both securities lending and you look at credit
default swaps, these two very large positions, which

ultimately resulted in $40 billion of loss in credit default swaps, $55 billion in securities lending, and essentially went through the sieve of regulation--

WITNESS DINALLO: I just want to say, I have said before that, as with kindergarten, everything you ever want to know about the financial crisis you can learn from AIG, across the board.

CHAIRMAN ANGELIDES: All right. Well let's move to the OTS. I want to just say, starting this off, Mr. Lee, I'm a big believer in the ultimate responsibility of leaders, and Mr. Rich isn't here.

So anything I say here should be taken as observations about the organization as a whole. You have come to the chair today, and in fairness to you I don't want to make you the personal brunt of this, except to say it does appear that AIG also--there was a race to the weakest here, that AIG did, as Mr. Dinallo said, decide to pick its regulator based on what met its needs, not the larger public interest, which I guess makes sense from their perspective.

I just wanted to put some things in the record, so that, for the benefit of the public. Which is, starting off with the appropriateness of OTS as a regulator.

Mr. Rich, who is not with us today, in the interview with our staff said: We as an agency were like a fly on an elephant. He said: We did not have the capability to supervise a company like AIG. It was not reasonable to expect a small agency like OTS to supervise a complex entity like AIG.

And he does observe that when the Federal Government had to bail out, that Mr. Geithner was none too pleased with the performance of OTS.

Let me ask you, just starting off, did OTS not have the capacity to regulate this behemoth?

WITNESS LEE: I think that's a great question. I think resources are clearly, we didn't have the resources to bring to bear that other regulators brought to similarly situated holding companies. So I think that's a fair question to ask.

I will say this: I lived for two years regulating this company with the fear that there would be an unanticipated event that would occur out of a subsidiary that we hadn't been at, or in relation to a product or a business that we didn't have any knowledge of. And I don't think the record supports that in this case.

I think OTS, taking the limited resources that were at its disposal, did assemble a team of people and a regulatory plan that not only picked up on the risks at AIGFP in particular, but also at the parent company, and brought those risks to the attention of the parent company board well in advance of the problems in September of 2008.

And not only did we bring those issues to the attention of the board, but we followed up with ratings downgrades and supervisory enforcement actions that I think bear record that, notwithstanding the limitations we had from the resources perspective, that we did a pretty good job of identifying the key issues that confronted this company in 2008, and we elevated those issues to the highest levels in the company.

CHAIRMAN ANGELIDES: Well I think I'm going to disagree with you, based on at least the documents I have seen, and perhaps you could provide us more at least with respect to the critical time period of 2006-2007, and what I'd like to do right now is, here's my understanding:

That between 2001 and 2008, OTS conducted 27 regular, limited, or targeted investigations; 21 of the 27 were limited or targeted; and none of the 6 regular examinations provided any meaningful conclusions or written narratives pertaining to the key risks of at least the CDS portfolio.

And after June '07, AIG got a composite rating of 2, which meant that AIG was fundamentally sound.

Just going into it very quickly, OTS conducted at least four targeted, or limited scope examinations of AIGFP. The March 6, '06, examination noted that the notional amount of super senior credit derivative transactions increased, and that revenue underlying this segment rose 29 percent, but no safety and soundness assessments were made.

And I would like to enter into the record the relevant portions of that report from March of '06. So if that could be--that's page 9, but it's the relevant portions of the March 2006 examination.

In 2007, OTS adopts a supervisory plan, but as part of that it lays out some limitations. It says that: Include a section entitled "Limitations of the review" saying it should be recognized there's no absolute assurance that the OTS evaluation of a firm will uncover all serious problems or deficiencies which may exist.

In an internal OTS document entitled "CIO Program," here's what it says. It says: Background, for internal purposes only. At the time the 2007 supervisory plan was being drafted, the EIC--and I'm just paraphrasing here--the EIC over the prior two years had been permanently assigned elsewhere. No replacements or additional resources were being provided for additional leadership or examination.

It goes on to say that the authors of the plan felt it was therefore necessary to include the above language spelling out the limitations of such work. It details the limits on resources.

And I think the final thing I’d like to say in this regard is, if you look at the April 23rd, 2007, AIGFP visitation review, OTS concluded that AIGFP has adequately designed its credit and market risk management programs to match its activities and risk management personnel adequately addressed them.

It goes on to say that the board of AIGFP and the senior management at AIG and AIGFP provided adequate oversight. And we saw those guys yesterday, and frankly we would stunningly disagree.

The level of market risk inherent in AIG's FP operation was moderate. AIG minimized financial market risk by entering into offsetting derivatives transactions and substantial hedges, and that they mitigated and managed market risk exposure.

I would like to enter into the record the relevant portions of the April 23rd, 2007, report of examination of AIG.

And, Mr. Lee, it just seems to me that OTS didn't get this right.

WITNESS LEE: Well I think, you know, the Commission obviously has a lot of information about AIGFP that we didn't have in April of 2007. At that time, just to clarify what we were looking at here, OTS was looking at a company that underwent a substantial transformation in 2005.

The long-time former CEO left and was replaced by company insiders who felt like they needed to completely redesign the corporate governance and risk management processes at the company.

So what we were looking at in the 2006 reviews and in the early 2007 reviews were policies and procedures that the company had put in place in response to the events of 2005.

So our assessment of those really was, do they represent best practices as it relates to enterprise risk management? Do they conform with what we're seeing elsewhere in the marketplace? And do they appear to position the company to be able to respond to a range of risks that it might face over the long term?

This was a company at the time that had a strong capital foundation. It had a strong earnings platform. And the major weaknesses in the subprime lending area and the concentration that had built up in their balance sheet in that area had not manifest themselves.

So what we were evaluating were policies and procedures that had not been tested. And I think, you know, one of the topics of conversation among us that were working on this program at the time was that the proof would be in the pudding. At the end of the day, these policies that they had put in place, and the people that they had hired, and the framework that they had constructed would be tested and we would know then for sure if indeed they were adequate.

Obviously when they came under pressure in late 2007, they did not respond. We found numerous breakdowns in their risk management process that was quite different than what the company had indicated to us was how the program would perform.

And I think what you see is OTS responding forcefully and immediately to that new information once it came into place.

CHAIRMAN ANGELIDES: Well, and you're saying that's in what time period?

WITNESS LEE: That would have been in the late 2007 through early 2008 time frame, once we began to understand about the communications breakdown between AIGFP, which was coming under pressure from counterparties, and the parent. Once we understood that the risk management process that had been put in place was not behaving as advertised--

CHAIRMAN ANGELIDES: Well let me probe that very briefly.

WITNESS LEE: Sure.

CHAIRMAN ANGELIDES: Because what we understand is that OTS in April says it will conduct a more in-depth review of subprime exposure, including subprime exposure within AIGFP's super senior credit default swap portfolio during a targeted review in 2008. And they decided to put it off, and it didn't get done.

There was never any targeted review. Now you said it was downgraded from a 2 to 3 again in what period? I have--

WITNESS LEE: That would have been in March of 2008.

CHAIRMAN ANGELIDES: And you're saying that's what your response was, to downgrade. What else did you do?

WITNESS LEE: Well, we also--

CHAIRMAN ANGELIDES: Because you spotted the problem in 2007--

WITNESS LEE: Late 2007, that's correct.

CHAIRMAN ANGELIDES: Yes, and I might add that the September 2nd, 2008, review which begins obviously, you know, just a couple of weeks before, you know, the collapse, and is concluded October 17th, at that point includes a representation that the CDS portfolio represented a risk concentration to AIG, which Inspector Clouseau could have determined by that point.

But my question for you is--

WITNESS LEE: That's fair, sir, but you've got to understand I'd been in Dallas, Texas, for six months at that point. So--

CHAIRMAN ANGELIDES: Okay, that's fine.

WITNESS LEE: So you can follow up with the OTS on that, sir.

CHAIRMAN ANGELIDES: As I said, not ad hominem, but, you know, it's a little stunning that the OTS makes a finding on October 17th after the Government's infused $85 billion into the entity, that there's a risk concentration.

But what specific actions were taken in the wake of understanding the exposure in '07?

WITNESS LEE: Right. So in late 2007, obviously there's a number of public filings that the company is making, as well as our own internal conversations with the company, with the auditors, with the internal auditors.

We began to pick up that AIGFP is coming under pressure from counterparties with respect to its CDS book. AIGFP for us had always been something that we looked at as an indicator of a parent's control over subsidiaries. It, in and of itself, was not chartered by OTS. It did not have a functional regulator. And the products, as we've heard here this morning, were not regulated by anyone, least of all us.

But what--

CHAIRMAN ANGELIDES: Can I ask a question?

WITNESS LEE: Sure.

CHAIRMAN ANGELIDES: As a regulator of the holding company--,

WITNESS LEE: That’s correct.

CHAIRMAN ANGELIDES: you had the ability both under the European Director and your Statute to look at all risks to the holding company, correct?

WITNESS LEE: We could look at all the risks, but our ability to take action with respect to FP was limited by the fact that it wasn't a bank, it was not a thrift--

CHAIRMAN ANGELIDES: But you could take it with respect to the holding company.

WITNESS LEE: We could take it with respect to the holding company, sir, and that's what in fact we did. I think what, you know, rather than attack FP directly, our audience, as I indicated earlier, was the company's board of directors. Because we felt like they were the ultimate accountable actors, you know, in any corporate governance structure. And the ones that are most able to deal with these sort of existential issues.

So as FP comes under pressure and we begin to understand the problems with the valuation methodologies. the problems that they're encountering with their modeling system, problems with risk management, we follow up at that point by recognizing that reality with our ratings, as well as sending them a supervisory letter, which is a form of enforcement action that directs the company to take specific steps.

And what we directed them to do was to immediately deal with the known risks that we had in front of us at that time, correcting the material weakness on the valuation side, and dealing with the subprime exposure, quantifying that so that top-level decision makers could make the decisions that they needed to save the company.

And so we asked them to immediately take those steps, and to provide us with a plan for how they were going to do that, and how they were going to correct the serious deficiencies that we had found in the early months of 2008. So that's what we did.

CHAIRMAN ANGELIDES: I appreciate that. I would just probably make the--I would make the observation that the cake was probably well baked by this point.

WITNESS LEE: Yes, sir. I think that's a very important point to make, because I think the chickens that were coming home to roost in 2008--

CHAIRMAN ANGELIDES: They'd been hatched for quite some time.

WITNESS LEE: --were hatched in 2005. So I think, you know, that was a--and, you know, in an interesting way, you know, the company in our conversations with us throughout 2006 and 2007, when the issue of subprime exposure came up, and it came up quite a bit, particularly as 2007 rolled on, the company, their argument to us was, we got out of these products before everyone else, as an indication of how smart they were. And it wasn't necessarily,

CHAIRMAN ANGELIDES: Of course.

WITNESS LEE: you know, they were arguing that they were ahead of the curve in the sense of having spotted the problems and the weaknesses in the subprime market and having exited this business well beforehand. But as we all know now--

CHAIRMAN ANGELIDES: Well, smart only in part because they didn't hedge, and they increased their exposure on securities lending.

WITNESS LEE: Well, Clearly. And, Mr. Chairman, I wonder if I can--

CHAIRMAN ANGELIDES: And then I want to move on. Very quickly. If it's a new point,--

WITNESS LEE: Sure that’s fine, absolutely

CHAIRMAN ANGELIDES: I'd rather move on to other members. If it's something where you want the ability to respond to something I've put at you, I want to give you that chance.

WITNESS LEE: Yeah. I think, just to correct the record on a couple of time line points Mr. Dinallo made.

CHAIRMAN ANGELIDES: Okay, that's fine.

WITNESS LEE: As well as on the liquidity profile, which I think might help the Commission understand a little bit of the earlier conversation.

One is, I can't speak to AIG's motivations when it bought the thrift, but it bought the thrift in early 1999. I think it's fair to point out that when they made that purchase, the only way an insurance company could enter the retail banking business was via the thrift charter.

They were not allowed by the Glass-Steagall Act from buying a commercial bank or a state-regulated banking company. So, you know again, I don't know what their motivations were, but I think it's fair to point out that, you know, this wasn't a situation where they could have chartered a bank, they could have had a national bank, and they chose a thrift because the OTS was the regulator they wanted.

Second point, the European FCD, which he mentioned earlier, came into effect in 2005. And that was after a long bit of work. So you see there's about six years of difference between the Financial Conglomerates Directive coming into play in Europe and the OTS regulating this company beginning in 2009. So it hardly is a connected event.

CHAIRMAN ANGELIDES: All right. Thank you for that on the record.

I do want to add one last thing into the record. That is, subject to counsel's review for the relevant portions, I am going to enter the September 2nd, 2008, targeted review of AIG Re: Regulatory Capital Credit Default Swaps. And when I say "subject to counsel's review" to make sure that what's entered are the relevant portions of that report into the record. Thank you.

Mr. Wallison--oh Mr. Hennessey. You know, I just--I'm right-handed.

COMMISSIONER HENNESSEY: I'm used to it at this point.

CHAIRMAN ANGELIDES: I'm right-handed. It comes so naturally for me to look right.

COMMISSIONER HENNESSEY: Thank you, Mr. Chairman. I'm sure. That's what everyone tells me.

(Laughter.)

COMMISSIONER HENNESSEY: Thank you all for coming.

Mr. Lee, I guess if I could start with you, I don't know if you saw the AIG panels, but my basic question is, why did AIG fail? I think the answers that I heard from AIG were: We got caught in the same liquidity crunch that everybody else did, and we didn't sufficiently manage our liquidity.

I have tried to press to explain why they needed-- was it just a decrease in the supply of available liquid funds? Or were there also unexpected increases in their need for liquidity like unexpected collateral calls?

And I have been trying to explore both whether or not now they think the mismanaged the actual credit risk that they had and/or do they think that they mismanaged their ability to predict the collateral calls.

Could you give me your views on this whole realm here? Where did they foul up? Because what I thought I heard from Mr. Cassano was: The model was right. The model is still right. They let me go. And if only they had kept me on board to continue negotiating, AIG never would have gone under.

So what are your views on this whole universe? And then, Mr. Dinallo, I will go to you if you have views on this question, as well.

WITNESS LEE: Well clearly the immediate cause of failure was a liquidity crisis in 2008. And one of the frustrations that I think we had at the firm--with the firm while we were involved here in 2006 and 2007 was that there was an extraordinary amount of emphasis placed on credit risk modeling, which is relevant if you are a bank and you are holding these assets in a capitalized subsidiary or on the balance sheet of a bank where you are required to hold certain levels of capital against that. And you're going to hold these products over the long term.

So you place a lot of emphasis in that respect on credit risk modeling. But I think what the vortex that AIG, and particularly AIGFP got caught up in is that they were modeling it as if it was a banking product which they could hold to maturity, when in fact it was a mark to market product.

And I think, you know, that’s a distinction that was lost on the company. I think they placed far too much assurance, and you heard some of it yesterday, on the credit characteristics of the products that they were insuring, which are fine and dandy, but they don't really get you past the fact that there is a collateral trigger in there, and that if the market valuations go to 50 cents on a dollar you've got to come up with cash today to pay for it.

COMMISSIONER HENNESSEY: Okay so--

WITNESS LEE: Their liquidity planning was not sufficient. I can talk to you more about our analysis of that if you like.

COMMISSIONER HENNESSEY: So the reason why the distinction between treating it as a banking product and a mark to market product is because of the collateral triggers?

WITNESS LEE: Absolutely.

COMMISSIONER HENNESSEY: Okay.

WITNESS LEE: And so banking, like if you're holding a housing loan on the books of a bank, you don't have to mark that loan to market every day. But these were securities that obviously either had a market price, or as happened in late September of, you know, 2008, well beginning in 2007, but moving toward 2008, you begin to get more and more dysfunctional pricing out in the market. Trades are sporadic. They're occurring in distress sales, and whatnot.

And that proved to be a real challenge for the folks who were trying to assess the valuations on the accounting side.

So as that happened and you saw the counterparties begin to take greater marks on this, it raises the call on AIG, which would not have been the case if you were dealing with a particular loan on the books of a bank and you can model out the probability that that loan would fail and what the likely impact on the bank's balance sheet would be.

COMMISSIONER HENNESSEY: Good--

WITNESS LEE: So I think, you know, this was something that was an argument they made to use over and over again, is that, you know, we think we're protected because these underlying products have a very low probability of default.

And, you know, I don't know this to be the case, but I've read in the paper that even today there’s still--the credit characteristics are pretty strong in terms of cash flows on these instruments.

COMMISSIONER HENNESSEY: That's what Mr. Cassano was saying.

WITNESS LEE: Right.

COMMISSIONER HENNESSEY: But when there--

WITNESS LEE: But what he missed, and I think, you know, what he failed to take into account, obviously, was the extraordinary demands that could be placed overnight due to the actions of third parties. Rating agencies could downgrade the ratings of the instruments. They could downgrade the ratings of the overall company. Or the company itself, the counterparties could demand collateral as a result of their markdowns.

COMMISSIONER HENNESSEY: Okay--

WITNESS LEE: So the company did not get that.

COMMISSIONER HENNESSEY: Okay, and I want to explore the "did not get that." In your judgment, setting aside questions of whether or not their model was correct on a hold-to-maturity basis, but all of those other risks that occur between when I'm holding it now and when it matures, do you think they didn't understand those risks? Or they understood them and either didn't care about them, didn't acknowledge them, or just wanted to take them?

Someone characterized AIGFP to me and said, look, this was the world's biggest credit hedge fund. And then the important part: And they knew it.

What I heard from the panel this morning was: No, we didn't think of ourselves as a credit hedge fund.

What's your view?

WITNESS LEE: You know, I don't have a clue if they thought of themselves as a credit hedge fund or not. But what I do understand it--

COMMISSIONER HENNESSEY: Did they understand these risks, at least--you know, did Cassano understand these risks? I've got to tell you, Mr. Sullivan and Mr. Lewis sounded like they didn't know or understand anything that was--

WITNESS LEE: Well presumably Mr. Cassano's operation negotiated the contracts that contained the triggers that were in there. So presumably he understood that there was a probability. He probably--you know, again I'm not going to speculate on what they were thinking, but the representations that they made to us was that the probability of those things being exercised beyond the stress scenarios that they had already modeled out, the demands on the company's liquidity that they had already modeled out, were very remote but they in fact happened.

COMMISSIONER HENNESSEY: So in effect they understood the risks and were willing to bear them because they figured out--they figured they were so low probability events they didn't have to worry about them.

WITNESS LEE: That's probably fair, yes.

COMMISSIONER HENNESSEY: That's a big gamble.

Mr. Dinallo, do you have any views on this?

WITNESS DINALLO: Thank you Gary, In my written testimony I have a lengthy quote from an article that I thought was very helpful because it pointed out that the type of credit default swaps they sold, the type of pseudo insurance, was the sort where, as you've learned, they had to put up collateral in downgrades. They also had to put up and pay in diminution of value of the CDOs as opposed to their actual default, which is to me completely antithetical to an insurance book.

And in fact, I confirmed today that the Insurance Department, while it's not in the law, has never permitted the posting of collateral or any other such aspects when they let monolines and others sell credit default insurance.

So I just simply believe that they did not otherwise set aside the billions of dollars that it would have taken to sell that kind of a product, coupled with the liquidity that they would have needed if they are in fact correct on their directional bets.

And I think it's somewhat--well, to say it's that simple is kind of, you know, I don't mean to be rude, but it was a huge, huge liquidity miscalculation that I think--and the reason I cut out the article and put it in there is because it again explains how they were so profitable.

Wall street was willing to do a lot of business and pay for a credit default insurance that also gave you money when values went down and posted collateral when there were other instances.

I also think, having been there and heard the discussions and been involved with the rating agencies with the then-CEO on the week that I was there, that they did not realize that if they accessed the lines of credit--so they had put in about $20 billion of lines of credit--that that was going to cause a rating downgrade.

I think that is an important point, right? So someone, I can imagine the debate with the CEO. The chief risk officer says, hey, boss, we have all these things over here in FP and we need cash in case there's collateral calls.

And he says, well, I don't want deploy cash that way. I want to deploy cash in a more leveraged way. I just don't want it to sit at the holding company level.

And the credit officer, or somebody says, okay, how about if we do lines of credit? Would that make you happy? And the credit officer said, yeah, we can do lines of credit. And they went and got all these lines of credit. There were about $20 billion.

And then when you access them, the rating agencies tell you we'll bring you down three notches. So that was just going to cause more collateral calls, right? It was a vicious circle.

So some of the liquidity they thought they had was in fact false, in a sense.

COMMISSIONER HENNESSEY: Okay. And I want to explore this a little bit because the first part of your answer, it sounded like they were knowingly taking huge bets on the credit risk. The second part where you're talking about the lines of credit, the words you were using made it suggest that they didn't understand how hypersensitive they were making the survival of their firm to a credit downgrade.

WITNESS DINALLO: I don't know if I can get in their head on that. I'm not trying to be evasive. I do think that they knowingly sold a certain kind of very attractive pseudo credit default insurance without--you know, with a belief that somehow, as Mr. Lee said, you know, that these chickens would not come home to roost.

However, when you are regulated as an insurance company, generally the regulator requires that you go out to the standard deviations of event possibilities and you put aside enough capital for those events. And that’s the difference, to a large extent, between I believe an unregulated entity and a regulated entity.

Here was the worst of all worlds. Because if you took them--as I put in my testimony--and cleave them off as a hedge fund standing alone, the Darwinian aspect of it would have set in and no one would have done the business with them because they just wouldn't have seen the adequate capital there.

Somehow they got away with it. I don't mean this like in a criminal sense, but they got away with it because the world thought--again, back to this balance sheet--that there was all this capital to make good on these collateral possibilities.

COMMISSIONER HENNESSEY: Okay, I want to repeat it back to you to make sure I understand it.

AIGFP was getting away with taking a whole lot more risk than they otherwise would have been able to had they been a standalone entity because the market perceived them to have basically credit protection by being part of this insurance company? Is that the basic?

WITNESS DINALLO: Yes. I believe, and have written that, yes.

COMMISSIONER HENNESSEY: Okay. Good.

CHAIRMAN ANGELIDES: Can I say something just on your line of questioning, and on my time, but inherent in this also is that if you were a regulated insurance entity with the capital requirements, you also would be backstopping policies which paid out on economic loss.

So in this instance you had neither the capital--you didn't have the capital, plus you had the uncertainty of the mark to market events. So it was like a double whammy.

WITNESS DINALLO: That's why I cut--I think it was--on the same day, back in August, Henny Sender and Gretchen Morgenson wrote articles--and I think I cut in the one from Henny Sender, explaining just what you said. Which was, there was this double issue. Because the kind they sold was so toxic to be something that an insurance regulator would be just like, we don't--it would be like what you said. It's like if you own a house, and you get insurance on the house, and your house gets dilapidated, and you have to pay on the dilapidation not on the fire that burns down the whole house. That's the kind of insurance they sold, and that's really not insurance.

CHAIRMAN ANGELIDES: Thank you—-dilapidated--

COMMISSIONER HENNESSEY: Good, yes thanks. A related question, again for the two of you, and understanding that especially Mr. Lee, don't worry, I'll get to you, Mr. Gensler, your focus was on AIG and AIGFP, and my question is about the counterparties to it.

I have heard different views. Actually I've heard a fairly consistent view over the past day-and-a-half about people's views on what they think would have happened had AIG not been bailed out, sort of the effects of the counterparty risk were hypothesizing about, you know, a counterfactual, we can't possibly know.

Great. Set all that aside. What is your view? Was there in fact a significant systemic financial risk-- I'll start with you, Mr. Lee, as best you can tell--had the Fed not stepped in?

WITNESS LEE: You know, I'm reluctant to speculate. I had at that point in time been out of involvement with this firm for six months,--

COMMISSIONER HENNESSEY: Because you’d been gone.

WITNESS LEE: --and I read it in the newspaper, read about it in the paper, but I was not on the ground at the time—

COMMISSIONER HENNESSEY: Than let me ask--

WITNESS LEE: --looking at the facts before the Fed and the Treasury.

COMMISSIONER HENNESSEY: Let me ask a related question. When you were still there, AIG presumably at that point in time was a significant counterparty to a bunch of large and medium-sized financial firms.

WITNESS LEE: Yes Sir.

COMMISSIONER HENNESSEY: Can you give us some sort of qualitative feel for how important was the continued existence of AIG to other significant, large--you know, significant financial firms?

WITNESS LEE: Well I think clearly AIG played a pivotal role in the marketplace in the sense that they were on the other side of a lot of business with a lot of other large financial institutions. And that was the case for most all banks.

If you look at the information that we collected, and we began in 2006 to collect regular data on not only exposure to sectors but to various counterparties, they clearly had concentrations with the various, you know, named financial firms that you can speculate about, not only here but in Europe.

But each of those concentrations, in and of themselves, did not represent a concentration of capital, you know, that appeared to be extraordinary, or out of the ordinary. But there was exposure to a number of these firms. And I think if you collected that information from the other banks, you would have seen the same thing.

There was a tremendous degree of interconnectivity. And I think you had also a tremendous exposure to housing. So when you have this, you know, we talked about the perfect storm, I mean when you have this situation where there is a lack of transparency about housing exposure, there's no market indicators of price, you have the seize up that we saw in September.

COMMISSIONER HENNESSEY: Okay and actually--And I'm going--

WITNESS DINALLO: I can give you a first-hand account--

COMMISSIONER HENNESSEY: Please.

WITNESS DINALLO: When I got the call on Friday, September 12th, you know, it started a series of dialogues both with the company and with the Fed and Treasury.

And, you know, as of Saturday, Tim Geithner was of the view, you know, we can't really help them. You're the insurance regulator. See what you can do on the insurance companies. We'll talk to OTS. Go in there and help out. And blah, blah, blah.

By about Tuesday it was pretty clear that his whole, you know, views had changed pretty dramatically. I believe, from talking to him and people like Bob Steele, that their views were changing because they saw the impact of Lehman. They saw the belief that paper was not going to roll over at some of the major institutions, and there was a clear, palpable fear factor that you would have a full-blown credit seizure, which we haven't seen since 1907.

And I don't think anyone was just kind of acting, because I was in the room and you could just about smell it.

Now having said that, I have said that there were maybe other ways it could have gone about, but it was very clear to me that people were informing us, and that they were very, very concerned about what would have been the headline risk in the credit markets around the world.

When I got on board--because initially I was more skeptical, because the insurance companies were essentially good, and I didn't like the headline that this thing is going to be, you know, need to be bailed out, or the filing of bankruptcy.

But when I got on board for the bailout was when you started to see people get in line in Singapore for their insurance policies in AIG Asia. And that to me was very, very concerning because the headline that all of these hundred insurance operating companies had somehow failed, which wouldn't have been true but that would have been potentially the interpretation across the world, I think could have caused the last leg of the stool that was hanging in pretty good, which was insurance as opposed to banking and investment banking, to be seriously undermined in its confidence in the public.

CHAIRMAN ANGELIDES: Mr. Holtz-Eakin.

COMMISSIONER HOLTZ-EAKIN: Can I just follow up real quick on that? At the time there was a claim--and I just want to know if this is true; I've been wondering for years--that if AIG failed, that some of these insurance products, in particular the insurance they wrote on construction bonds, would fail, and that we would have to close basically every construction site in the United States. This is one of the assertions in the moment.

What was the real degree of spillover to the nonfinancial part of the world?

WITNESS DINALLO: I think that's an overstatement. I think what you heard, which I think is true, is that by a twist of fate the renewal periods for many of the property lines, including construction, were like very near on the horizon, like that quarter.

And this is what I said earlier--and I'm sorry if I said it too fast--was that the way an insurance company ultimately fails is not a run on the bank, because you can't go and take your money out really, but if all of a sudden for an entire quarter or year, annual, you don't get people re-upping, and they go somewhere else, then a year from now, ten years from now, depending upon the line, you will feel it like a sledge hammer.

And so I think that’s what they're talking about. Because if it had failed, risk managers all over the world would have said: We're not going to renew. We're not going to buy insurance from AIG. And then you would have had a big blockage that would have moved through AIG's system to great disadvantage.

CHAIRMAN ANGELIDES: Mr. Hennessey, three minutes?

COMMISSIONER HENNESSEY: Yeah, three minutes. Just to comment on this, I think Peter and I have slightly different perspectives on the counterfactual question. And I think there's a burden on the perspective that I have to explain--and I don't understand it well enough--how do we think that systemic failure might have occurred?

Because there is a difference between particular counterparties, you know, having effects on their balance sheet when someone like AIG goes away versus a generalized surge in fear, which means liquidity dries up in the market. And I think it is really important to understand, if you're imagining the dominos toppling, which dominos are knocking which ones over and why.

And I just--I don't feel like I have a good understanding of that.

Mr. Gensler, let me give you a different question and then you can answer that question, and what I was asking before.

Back to this question on the leveraging. Let me see if I can state this as succinctly as possible. Is there a problem with the leveraging that can occur from a naked credit default swap that is separate from capitalization and transparency? Would properly capitalized, properly transparent naked credit default swaps have solved whatever additional housing bubble problems occurred? Are there additional elements to naked credit default swaps in the way they existed over the past decade that further contribute to the housing bubble? I hope that makes sense.

WITNESS GENSLER: With your focus specifically on the "naked" part of the credit default swap I gather?

COMMISSIONER HENNESSEY: I think so, yes. But feel free to expand it if-

WITNESS GENSLER: Alright I'm going to expand it to your earlier question of what happened. I think the financial sector--AIG being the best example--mispriced risk. Mispriced risk means also to the public that you don't have enough capital or cushion behind the contracts you're writing.

And often some of these risks weren't even priced at all. Liquidity risk foremost. The run on the bank: Bear Stearns, Lehman, AIG, ultimately many that even survived mispriced that liquidity can dry up very quickly. I mean--

COMMISSIONER HENNESSEY: Can you explain, just on that, what does the word "mispriced" mean?

WITNESS GENSLER: It means that they don't take into consideration that sometimes bad things happen in markets. And that I would not--

COMMISSIONER HENNESSEY: So the underestimated certain probabilities of bad scenarios?

WITNESS GENSLER: That's right. Underestimating bad scenarios, and not preparing yourself just as an individual household has to prepare themselves with a cushion of cash in case bad things happen.

COMMISSIONER HENNESSEY: Okay, I think of that as "underestimating risk," because the price is just whatever you and I can negotiate. If I under-estimate the risk that X is going to occur, is that what you're getting at?

WITNESS GENSLER: Well I think--let me do the whole list real fast.

COMMISSIONER HENNESSEY: Okay, Good. Please.

WITNESS GENSLER: I think they underestimated risk, and thus between counterparties sometimes mispriced, but foremost, AIG and others, liquidity risk, correlation risk that bad things can happen. Naked credit default swaps actually add to some correlation risk, and I think they under-estimated the risk that many things bad can happen.

And then tail risk, which means normal distribution for economists goes something like this (indicating). Sometimes you have fat tails. At the ends, on Wall Street, and I was there for--I left 13 years ago, we often mispriced, or misestimated the tail risk.

All of that relates usually to complexity. All of those things mispriced. In AIG's case, I think fundamentally they misestimated and thus often mispriced credit risk. Not only others' credit risk, but their own. What happened if they got downgraded, as they did? And ultimately it was basically a house of cards built on a housing bubble.

They had so many bets on the housing market, the $70 or $80 billion of multi-sector CDO was based on the housing market.

COMMISSIONER HENNESSEY: Right. When I'm talking with people who don't do this kind of stuff, my one-line description is everybody made the same bad bet.

WITNESS GENSLER: Yes, but often they misestimated what happens when those were all correlated and came home to roost, so to speak, that confidence was shot and they could no longer fund themselves. They could no longer borrow often in the overnight market.

COMMISSIONER HENNESSEY: That's the liquidity angle.

WITNESS GENSLER: That was the liquidity issue. And so for the gentleman who says, well, if you just gave me time, if I just had more time at the gaming table I'd be all right. But, you know, sometimes you run out of chips. Sometimes nobody will hand you more chips.

COMMISSIONER HENNESSEY: Good. Did you have something on this?

WITNESS LEE: Well I would just make the point about failing to game out the liquidity scenario properly. I think that's a good, obviously a key criticism here.

If you look at the way the parent company that enjoyed, you know, the high rating from the rating agency, that parent company in and of itself did not generate a tremendous amount of liquidity. It was a holding company that had various regulated subsidiaries underneath it--a bank, multiple insurance companies, and whatnot.

And I think if you look at the liquidity analysis that we did in our 2007 report, you know, the company relied on a number of facilities. It relied on commercial paper, access to capital markets, debt instruments, bank lines, and it relied primarily on dividends from the insurance operations where the bulk of their revenues were up to the parent, which they could then use to fill the pot at AIGFP and other subsidiaries that had liquidity requirements.

And I think, you know, a key factor here is having, you know, that sort of overreliance. You've got a company at the top with a guarantee for an operation like AIGFP which didn't have any requirements to be separately capitalized, as Mr. Dinallo has made the point, and that’s a key point. You end up in a situation where, when the liquidity is not available from these subsidiaries, if it's in effect trapped, you get into a position where you're not able to meet a multi-tens of billions of dollar call on an overnight basis that they were presented with in September.

So, you know, I think it's not only measuring--you know, modeling out the shock scenario, but having real access to the liquidity that you think, and the market perceives you to have the access to, I think is a critical point here.

COMMISSIONER HENNESSEY: Right. I mean, the three themes that I have seen now coming up over the past several months are, you know, one, some of these firms getting into trouble just because they mismanaged their liquidity risk; two, some of the weakest of those firms saying it really wasn't that I particularly mismanaged my liquidity risk, it was this was a once-in-a-thousand-year storm, and no one could be prepared for that, in which case I said well how come you guys died and the other ones didn't?

And then the third is, some of those firms--and we saw this from AIG--they seemed to stop at liquidity risk. They're willing to admit that they underestimated their liquidity risk, and then they are unwilling to admit that there were other risks that they underestimated which then caused the loss of confidence and the crisis.

These weren't just runs on the bank, if you will, or runs on the institution because of some spurious rumor; there was an actual underlying reason for the fear why people were starting to pull back.

CHAIRMAN ANGELIDES: All right, should we--let's move on. Mr. Wallison. And then we’re going to--

COMMISSIONER WALLISON: Thank you. Thank you, Mr. Chairman. Boy, there's so much. So much material to talk about here.

Let me start with this, just the subject we were just dealing with. We know that everyone mispriced or misestimated the risk here. Everyone who has come before us, including Warren Buffett, has said he didn't see this coming. Didn't believe that there could be anything like the disaster we've had in the subprime mortgage market.

I won't get into why we have this disaster in the subprime mortgage market. I've made that clear in past hearings. But one of the things that I think we have to understand about CDS, credit default swaps, is that this is a two-sided transaction.

And so, yes, indeed, the party that has to put up the cash is the party that is suffering when it is out of the money. But the other party, however, has reduced risk. It is a more sophisticated kind of arrangement than the normal bank loan.

In the normal bank loan, the bank lends out the money. If something happens to its client during the time that-- its borrower, during the time that the transaction is ongoing, the bank is stuck, in the normal case. The client does not have to put up any additional collateral after the loan is made.

So we have a really different kind of instrument here. And I don't think there is enough understanding of this. And so, Commissioner Hennessey has raised the question in the past, and I think it is a very sophisticated and interesting question, and that is: Well what’s the real-- why are we blaming credit default swaps? I mean, they're just replicating in effect another kind of loan.

And the way I can illustrate that point is to say: If AIG had simply bought these mortgages, all the mortgages or other instruments that were in the CDOs, simply bought them and held them on its balance sheet, and we'll say FP did it, so to take it out of whether AIG would be able to do it or what other kinds of regulation there might be attaching to AIG, but if it had just put it in its balance sheet, would it have made any difference?

And I think you can say, yes, it might have made a difference because, as these things declined in value, because everyone was beginning to recognize what was happening in the housing market, as they declined in value, then they wouldn't have had to put up any collateral. But--And it was the collateral, the cash, that weakened them.

But that gets then to the question of marking to market. And we had a little bit of discussion about that. And so I'd like to start with you, Mr. Lee, because if an institution of any kind--let's assume that you have jurisdiction over that, and you are applying the standards that now apply in marking to market--would it not be true, if the assets of that institution were declining in value as were the assets of any financial institution that was holding CDOs made up of subprime mortgages during this period, would be declining, what would happen to its financial condition?

WITNESS LEE: Well—Sorry About that, Well I think what happened was what in fact happened to a lot of the institutions that were carrying these instruments on their books.

They would have to recognize the new valuation and mark down, in essence, the value of the portfolio to a market price. And, you know, you heard the Goldman Sachs guys talking this morning a lot about how difficult it was to price. But yet you could arrive at a formula of both projected cash flows and the lack of market transparency to arrive at a mark for those instruments.

But I think in this case had AIG been holding these instruments themselves on the books, they would have simply taken a markdown, which would have reduced their overall tangible equity capital. So it would have been a hit to capital, as opposed to having to produce cash, which is a critical difference here. It’s--you know--

COMMISSIONER WALLISON: Oh, yes.

WITNESS LEE: So then the company is presented with the dilemma. Do they ride on with lower capital on the books, which could jeopardize their overall rating? Or do they go to the markets and try to raise more?

COMMISSIONER WALLISON: Sure.

WITNESS LEE: It's the traditional problem that a bank has when it marks down a loan portfolio.

COMMISSIONER WALLISON: Absolutely true. And this is a very important distinction I think. But what we have to understand is that it is a two-sided distinction. Because if they--the difference, as you point out correctly, when a bank has to write down a loan, it takes a hit to its capital, it does not normally have to put up any cash.

On the other hand, when it has to put up cash to its counterparty, the counterparty's condition is enhanced.

So the bad loan that the counterparty might have with the bank or other borrower becomes not such a bad loan.

So when Goldman Sachs had made demands for collateral on AIG, what Goldman Sachs was doing was in effect improving its position by getting collateral from AIG.

All we're saying here is that a CDS is a, in effect--obviously there are different conceptual ways of putting it--but it's a different kind of loan transaction. It's a loan transaction in which, when the loan begins to weaken for one reason or another, one party has to restore some of the loss, or in some cases all of the loss, to the other party while the loan is weakening.

And it is two-sided. And in fact, as Goldman Sachs said this morning, as the markets move up and down the collateral moves back and forth among the parties, for just that reason.

So we’re blaming an instrument, credit default swaps, for something that is unique to that instrument, and is different about that instrument than any other kind of financial relationship. And so you get to wonder whether it is the instrument that’s the problem. People were not familiar with how to use that instrument. Or whether it is in fact the underlying asset that was the problem, which in this case was subprime mortgages.

Do any of you want to respond to that? But we'll start, Mr. Lee, with you, and then obviously someone else is very eager to respond, Gary Gensler, and then Mr. Dinallo.

WITNESS LEE: Well I think the point that you make is fundamentally sound. I mean, the credit default swap was a tool. But I think what it did is it outpaced the structure that it was allowed to operate in.

So what you in effect had was a product that had some characteristics of a loan, but had other characteristics that made it more risky than a loan, which was allowed--you know, this in the sense they had to produce cash upon immediate--

COMMISSIONER WALLISON: It was more risky for the borrower, but not necessarily for the lender.

WITNESS LEE: Right. Exactly.

COMMISSIONER WALLISON: Okay.

WITNESS LEE: So but AIG would have been the borrower in this case.

COMMISSIONER WALLISON: Right, In this case--

WITNESS LEE: But they would have had to put up money upon first sign of weakness.

COMMISSIONER WALLISON: Um-hmm.

WITNESS LEE: So what you have is I think a situation where you have a product with inherent weaknesses that's allowed to exist in a structure without separate capitalization and without any sort of transparency as to what those weaknesses are, and how they might perform under a range of stress scenarios.

So I think, you know, the lesson learned from this I think is that, you know, credit default swaps obviously carry with them attendant risks that outpace what we can measure in the credit characteristics of the product that's being in effect insured. And it's those sort of issues that we have to address going forward.

COMMISSIONER WALLISON: Sure, but it’s--let me just--

WITNESS LEE: --what my colleague--

COMMISSIONER WALLISON: But let me just follow this up before I give Mr. Gensler an opportunity to speak. And that is, that you are perfectly right. A lot of the properties of a credit default swap were not fully understood by the people who were working with them.

We heard testimony from the people at AIG this morning that some of the senior officers didn't even know that they had capital--collateral obligations in connection with these when they weakened.

But I do want to make the point, and make sure the point is understood, that that aspect of this instrument also makes it less risky to the lender. And so we are really talking about a new device in the market. People have to get used to it, have to understand it a little bit better, but it's not as though it is something that we ought to react against it and attack it because it's something new. And unfortunately we do that from time to time, especially when we don't understand the principles when we're starting out.

Now, Mr. Gensler, please.

WITNESS GENSLER: Thank you, Commissioner Wallison. I think that it's both.

I think the underlying--whether it be a loan or a credit default swap--the underlying housing market was a bubble and it burst.

But you also speak to the core difference between derivatives and underlying loans. Derivatives there's no exchange up front, or rarely an exchange of principal.

So if AIG wanted to be in the lending business, they could have loaned $527 billion. That was the height of the credit default swap notional amount, or seventy-some billion in this multi-sector CDO market.

They never actually had to go out and get that $527 billion. So that's why I have been a very real advocate, and am glad Congress is moving forward hopefully on derivatives reform where we regulate these new products. We still allow them, as you say, allow credit default swaps and other swaps to be used for hedging purposes, but we have significant new regulation where the AIG of the future would have to have capital margin business conduct, and the like.

COMMISSIONER WALLISON: Well we won't get into the question of whether regulation is necessary. That isn't what we're supposed to be doing. We're supposed to be talking about what contribution this might have made to the financial crisis, and I understand your point.

Mr. Dinallo, do you want to respond to this at all?

WITNESS DINALLO: Yeah because I mean I think it wraps what Commissioner Hennessey was saying also. He said properly capitalized CDS. My thesis is actually simple, I think.

I look at all financial products and I basically bucket them into four categories. There's bank deposits. There's insurance. There's gambling, futures, anything with a deliverable date. And then there's like all other investments: bonds, stocks, et cetera.

Derivatives are in my view derivative of one of those four buckets. Okay? And there's no fifth. A credit default swap is, in my view, either a gambling or speculation when it's naked, or when it's covered it's an insurance instrument.

Those four buckets have had a hundred years of regulatory knowledge of what is the necessary capital to sell those instruments. And when we basically told the world that there were no capital requirements if you did those things by a derivative, Wall Street, like water, will always go for the lowest capital opportunity because that's how you do the business. You use a leverage to make profit.

And basically, my view is that the derivatives that you're talking about, which have very important uses to hedge, if you can't actually get the underlying instrument but some regulatory or investment requirement says you have to, so you substitute, but if all of a sudden you permit the wholesale substitution of those core financial products, and the regulatory capital requirements that go with them, that's how you get 36 to 1 leverage ratios and 63--

COMMISSIONER WALLISON: All right, I understand---

WITNESS DINALLO: -- It’s very important--

COMMISSIONER WALLISON: --but I'm running short--I'm running a little short on time. I understand your point.

WITNESS DINALLO: I think that's how you should look at a CDS.

COMMISSIONER WALLISON: Yes, although again when you get into the question of who protects whom here, people, especially consenting adults, should be able to look at the capital of the people they are dealing with and decide whether there is enough capital there.

But that's--

WITNESS DINALLO: But we have very--But, sir--

COMMISSIONER WALLISON: --I don't want to get into that right now because I have some time--

WITNESS DINALLO: --but we have very strong rules--

COMMISSIONER WALLISON: May just interrupt--

WITNESS DINALLO: Can I just point out one thing?

COMMISSIONER WALLISON: I understand--I understand--

COMMISSIONER WALLISON: On the equity side we have closely regulated the shorting of equities, but on the credit markets, for reasons I don't understand, we have completely let it be all bets are off. And I think that really hurt the financial system.

COMMISSIONER WALLISON: Okay. Thank you very much.

Let me just turn to you, Mr. Gensler, in the limited amount of time that I have available, because you've said a couple of things that I really must deal with, because I've heard it so often now and I'm not sure what the audience out there is understanding.

But you say in your testimony that derivatives have $300 trillion in notional value. This is the term you use. We've heard $600 trillion. Twenty times the size of the U.S. economy.

Now does that represent $300 trillion in risk?

WITNESS GENSLER: The U.S. derivatives market is about half the world market. That's why $300 trillion. And it's the underlying loans, or underlying market value of, it's called "notional amount."

COMMISSIONER WALLISON: Right.

WITNESS GENSLER: And so it's just arithmetic. It means every time you buy maybe a $50--

COMMISSIONER WALLISON: It's what you use to calculate with, right? If you're paying or receiving in an interest rate swap, you're calculating it on the basis of notional value, but you're not really sending that amount back and forth. Right?

WITNESS GENSLER: Well, you may or you may not, depending upon the derivatives. It does mean that throughout our economy for every dollar purchased, on average, if you buy $50 of gas at a filling station, you can think, roughly speaking, there's $1000 of derivatives somewhere in the economy associated arithmetically with this.

It means that on that $300 trillion of derivatives, which are not currently regulated, there's risk in the backing system.

COMMISSIONER WALLISON: But does it mean $300 trillion in risk that is somehow twenty times the economy of the United States? Is there that much risk somewhere?

WITNESS GENSLER: There's that much notional amount of--

COMMISSIONER WALLISON: But again--

WITNESS GENSLER: These derivatives. It's what the risk is calculated against--

COMMISSIONER WALLISON: Right.

WITNESS GENSLER: But the risk, let's hope, is a lot smaller than that.

COMMISSIONER WALLISON: Right. And the numbers I've heard for the 600--

CHAIRMAN ANGELIDES: Mr. Wallison, how much more time do you need?

COMMISSIONER WALLISON: Another five?

CHAIRMAN ANGELIDES: Could we do--Why don't we start with three and go from there,--

COMMISSIONER WALLISON: Okay.

CHAIRMAN ANGELIDES: --just because we have to be--and this is partly our fault for the whole day, but we have to clear out of here.

COMMISSIONER WALLISON: Alright, Alright.

CHAIRMAN ANGELIDES: So why don't we do three.

COMMISSIONER WALLISON: The number I have heard is six-tenths of one percent for the entire $600 trillion. The risk is six-tenths of one percent. For credit default swaps, what is the percentage of notional value that credit default swaps involve in trillions? Do you happen to have that number?

WITNESS GENSLER: The credit default swap market, the most recent figures are between $25 and $30 trillion notional amount worldwide.

COMMISSIONER WALLISON: Okay. Again, is that an actual risk number? Or is it something that--

WITNESS GENSLER: I think as it relates to credit default swaps, that's a pretty good measure of the underlying corporate loans, and bonds, and mortgages. But there is something called "compression." It probably compresses down to a smaller figure than $30 trillion.

COMMISSIONER WALLISON: Well the number, just for the record, the number that I have heard is something like two percent is the actual amount of risk. Let's not argue about it now because we're running of time.

WITNESS GENSLER: Yeah. I've heard much bigger figures than that.

COMMISSIONER WALLISON: Yes, and you can argue that the figures are bigger, but they're not bigger by multiples, ten or twenty. It's somewhere in the lower percentage amount that is the actual risk. Because a lot of--if I make a credit default swap with you for $10 million, that's a total of 20, even though there's only $10 million involved.

Everything gets counted many, many times depending on how many counterparties there are.

WITNESS GENSLER: The--

COMMISSIONER WALLISON: Let me--I'm going to have to push ahead because--

CHAIRMAN ANGELIDES: Well these are not questions, they are statements.

COMMISSIONER WALLISON: These are statements for the record. These are statements for the record, but I will have a question for you.

And that has to do with the idea of interconnection. Because a lot was--that chart was put up there, and we showed that--there's the chart--and it showed that Goldman Sachs was interconnected with a whole lot of other firms.

And the thought was, well, if AIG failed there were losses automatically to everybody for many, many people who were interconnected there.

In fact, is it not true that there's a third party involved in all of this? It's called "the reference entity." And for there to be a loss on a credit default swap, the reference entity actually has to fail, default. Yes? No?

WITNESS GENSLER: I would say the third party is the U.S. Taxpayers. I think what stands behind this under our current regulatory regime is the U.S. Taxpayers. And we have to fix that--

COMMISSIONER WALLISON: Let's assume that we are not talking about--let's assume that we are talking about two small institutions that are dealing with one another, and not talking about anyone who is systemically important. So the U.S. Taxpayer is not involved.

If the reference entity does not fail, is there a liability under a credit default swap between A and B?

WITNESS GENSLER: Absolutely yes. Often the liability is posting collateral, and mark to markets. Unless it's in a clearinghouse--what happened in AIG, even without failures of the underlying mortgages, we had a calamitous situation that, yes, the Taxpayers, with all respect, did stand behind.

COMMISSIONER WALLISON: Well, of course they did with AIG, as we know, because there was fear that AIG was systemic--

WITNESS GENSLER: And there was not underlying defaults--

COMMISSIONER WALLISON: --but in any other, in any other situation the only liability as between the two of them is to pass collateral back and forth, unless there's an actual default. Isn't that correct?

WITNESS GENSLER: Which causes this interconnectedness that makes it so hard for Government officials, of any party, to let an institution fail when they are so interconnected with other large financial institutions through derivatives.

CHAIRMAN ANGELIDES: Let's do this. Can we do this? Let's move on, and if we have time at the end before we have to vacate, we will swing back.

Senator Graham.

COMMISSIONER GRAHAM: Thank you, Mr. Chairman. I don't like to disagree with my friend Peter, but I think there are some--

CHAIRMAN ANGELIDES: Can you pull your mike towards you?

COMMISSIONER GRAHAM: --I think there are some other real-world differences between a credit default swap and a typical mortgage. And just to mention a few, one the gentleman from AIG, when asked how did you evaluate these derivatives, said we did it based on the rating services.

There was no effort to do any real due diligence as to whether the specific instruments that were behind those derivatives were of value or not.

I think if you're looking at an individual mortgage, you're going to be interested in who the person that is responsible for servicing that mortgage is, and all the conditions that led to the mortgage being issued.

So there’s a dramatic difference in the level of due diligence.

Second is the scale of the matter. A mortgage is a mortgage, but once you get it into the derivative world, one mortgage can become many, many times the level of risk of that individual starting point. And so the whole system is aggravated and expanded in terms of its risk.

And finally, a mortgage on a home is different, in my judgment, than a loan on a truck, or a commercial airliner. A home is a part of a network of society. And when one home starts to get into financial difficulty, it has a contagion effect on a much larger set of Americans.

So I think that there are some real-world differences that are worthy of our consideration in the difference between a mortgage and a credit default swap.

Let me ask, going back to the period around the failure of AIG, Mr. Lee I think it was you who said there weren't very many--I know you were out of the OTS at this time, but I believe you were the one who made the statement that there weren't a lot of options available as to how to handle AIG.

To you, or the other two panelists, was that because of a lack of imagination of what the options might have been? Or a lack of legal alternatives that could be looked to? Or both? Or some other reason why the options were as narrow as they were?

WITNESS LEE: Well I'm happy to speculate. I don't know that that'd be helpful to you. But I think clearly the magnitude of the problem that the Government was facing with AIG, whether it's in reference to the interconnectivity or just the dollar amounts that were involved, made--and the lack of transparency, to be fair, behind the instruments--made things very difficult for policymakers at that time. And not being privy to what they were looking at, and not looking at it, it does seem like that, you know, given the pace at which following the failure of Lehman Brothers and the ripple effect through to AIG, and the pressure that came about with the downgrade in the ratings of the parent company, it did present an extremely difficult scenario to the policymakers at that time.

And again, I wasn't there. I wasn't in the room. So it makes it very difficult for me to talk about it. But perhaps some of the other panelists could offer more observations.

COMMISSIONER GRAHAM: For instance, if there were something available to a nonbank institution like AIG, and I recognize that it does have a banking affiliation, similar to what happens when a real bank gets in trouble, the FDIC shows up on Friday afternoon and does a more or less orderly transition. If that option had been available for an AIG, (a) would that have been a desirable option to have available? And if so, how might the outcome have been different?

WITNESS LEE: Well I think that's a good point, because, as I pointed out in my testimony, I think any guarantees in this area going forward have to be specific an enumerated.

Because from the guarantee flows, the Government's ability to ultimately intersect with the problem and define a range of options, you pointed out deposit insurance being a great example. That deposit insurance brings with it prudential regulation which allows regulators to be heavily involved not only in the products that are on offer, but the types of--on the deposit and the lending side. But also give the regulators a clear window into the deterioration of the balance sheet.

And there is a well-established FDIC process, as you know, for resolving failed institutions. And I think one of the real challenges of the system that we were operating under prior to the AIG failure is that you had a lot of products that were not subject to these sorts of prudential regulatory authority.

We didn't have the transparency to understand how they would perform under a range of circumstances. And there was no back-end process for dealing with a failure. And I think it was the having to make it up as we went that brought, you know, a very chaotic atmosphere to the whole situation. And I think it made things extraordinarily difficult for policymakers at that time, which I think, you know, some of the work that's been done in Congress in the time since is very important because it does at least begin-

-and again, I've not read the bill and I don't know if the scenario we've arrived at is perfect, but it does begin at least to build a structure around how we would deal with the failure of a systemic institution.

And I think, you know, having all that defined an enumerated and subject to process beforehand is critical. Because trying to do it over a weekend under extraordinary pressures from the marketplace and elsewhere dealing with multitudes of billions of dollars makes things very difficult for the policymakers.

COMMISSIONER GRAHAM: Any other comments on that?

WITNESS GENSLER: Well Senator, I would say that having such resolution authority for nonbanks I believe is critical.

I know that the bill Congress is addressing itself to that, and it looks like that will be part of the law.

Absent that, then you can't go in and abrogate contracts, or negotiate out that somebody is going to get 90 cents on the dollar, or 93 cents. It was sort of an all-or-nothing.

And as I said to Commissioner Born's question earlier, I do think if AIG went, after Lehman went, there would have been enormous liquidity, runs on liquidity for all of these other financial institutions.

And then the next one, and the next one. You know, it would have been a very quick, I believe, domino effect, which was already happening.

WITNESS DINALLO: I would only add that there would be a resolution authority kind of like what the Insurance Department has over the monolines currently. You would have stepped in and you would have, in an orderly way, not permitted collateral postings, and claims jumping. You would have, as we did, we negotiated and commuted, sort of safely, softly landed several monolines and did not, you know, become the linchpin of the financial crisis.

And part of it is because you have the resolution authority you can commute some of the contracts. You can resolve them. And you work it down the way you are alluding to.

I think that would have been enormously helpful. I also say that, again I think I raised it at the time, that under TALF or TARP or whatever the term was then, you know, all of that, if the U.S. Government could have stepped in and basically just substituted itself, I think it would have been much more orderly and would not have had the optics that I think caused a lot of very angry--justifiably angry Americans.

COMMISSIONER GRAHAM: If I could have one minute for what's going to be a summary comment.

CHAIRMAN ANGELIDES: One Minute--Yes. Absolutely.

COMMISSIONER GRAHAM: I think there's an interesting parallel here to the other big crisis we're dealing with now, which is the Deep Water Horizon collapse.

For 20 years the deep water exploration industry spent enormous amounts of money to develop very sophisticated technology to be able to drill at depths which previously would have been thought to be impossible.

What didn't--and they did that largely because there was a big financial reward for being able to reach those new reservoirs of petroleum. What didn't happen was a parallel investment in the safety and the capacity to respond to an untoward event caused by that deep water drilling.

It seems to me that we've had somewhat of a similar situation here; that the financial community, with very innovative, creative, largely driven by the high financial rewards of success in developing these new instruments and processes, has outstripped the safety, soundness, and capacity to respond to a bad outcome.

And, that one of the challenges for us as we diagnose this problem is to think about how, to what degree can we suggest a diagnosis that would encourage people to put those two levels, the profit-making innovation and the nonprofit, actually costly investment in the safety, soundness, and capacity to respond on a parallel track.

So whether it's a mile under water, or on Wall Street, we don't end up with another situation as we are today. End of commentary.

CHAIRMAN ANGELIDES: Thank you, Senator.

Mr. Holtz-Eakin.

COMMISSIONER HOLTZ-EAKIN: I want to thank everyone for taking the time to do this. Thank you, Mr. Chairman.

Chairman Gensler, I want to push a little bit on the sort of listing you gave of the contribution of derivatives to the financial crisis and see if I understand it. In particular, the notion of special interconnectedness that comes from derivatives.

Before we do that, let me back up. We're trying to sort of be as focused as we can about the contribution to the financial crisis, which is our mandate, not necessarily policy toward derivatives in general. And so, just for the record, there appears to be--and I'm asking you to agree or disagree--no particular contribution from interest rate swaps, currency swaps, commodities, that in fact the derivatives in play--stock options--the derivatives in play are CDOs and credit default swaps in particular, so that we should focus on that.

Do you agree with that?

WITNESS GENSLER: No, I don't agree with that. I believe that all derivatives played some role. The entire marketplace contributed to interconnectedness. Dealers that were concentrating risk and not necessarily just lowering risk, and lack of transparency.

I respect that some people disagree with me on that, but I have a different view on that--

COMMISSIONER HOLTZ-EAKIN: So can you give me an example of concentration of risk from interest rate swaps? How did that play into the crisis?

WITNESS GENSLER: That--

COMMISSIONER HOLTZ-EAKIN: Please elaborate. You are the first person to assert that.

WITNESS GENSLER: I understand your question. I understand your question. I think that all of the large financial institutions were so interconnected--whether it was this (indicating chart). This is the interest rate side. The bigger bubbles. And then the credit default swaps are over here somewhere (indicating).

That interconnectedness limits the flexibility of government regulators, whether in Europe or in the U.S., to let something fail.

I mean, if one believes, as I think you and I probably both believe, that there should be a freedom to fail in our economy, we really do limit the ability of government, policy makers, and leaders of any party to let one of these institutions fail.

So I think in the--not the cause in '07, but I'm talking about in the critical weeks in '08, in September, it really limited the flexibility of government leaders, this interconnectedness and the concentration that was there.

I agree with you, though, the large narrative of credit default swaps is the more specific, tangible narrative. But in the middle of the crisis, I think the interconnectedness and the concentration of derivatives, and five or six dealers here, and ten overseas, made it far more difficult to maneuver.

COMMISSIONER HOLTZ-EAKIN: So in that crisis in 2008, had there been no derivatives, would the financial system not have been interconnected in repo markets, lending asset-backed corporate paper?

WITNESS GENSLER: One of the luxuries--

COMMISSIONER HOLTZ-EAKIN: Do you need derivatives to get interconnectedness? Or is the financial system by definition not interconnected to begin with?

WITNESS GENSLER: I think that there are many ways that it is interconnected, and derivatives is a very critical one. But you're right. Tri-party repo, repo, stock loan, lending itself, there are additional ways. And we would agree that there’s probably five or six key ways.

But this way, which is sort of a modern finance in the last 15 to 20 years, has made it far more difficult to let something fail. I remember my personal experience visiting Long-Term Capital Management and looking at its derivatives' exposure. Though no government money went into that institution in '98, a significant reason as a policymaker when I was at Treasury and working with the New York Fed at the time, that we were concerned was its $1.3 trillion derivatives book and its interconnectedness to 12 to 15 other institutions.

COMMISSIONER HOLTZ-EAKIN: So let's back up then to a place which we've been talking about, AIG where it was not permitted to fail.

Would you point to derivatives as the source of its failure? Or, as we had the discussion earlier in particular with Commissioner Hennessey, the management's enterprise failure to manage its various risks? What caused its failure?

WITNESS GENSLER: Oh, absolutely I would agree with, if it was Commissioner Hennessey who said that, or just Commissioner Holtz-Eakin, I would agree that--

COMMISSIONER HOLTZ-EAKIN: I think we share this view.

WITNESS GENSLER: Well then I share it with you. I think that enterprise, that management underestimated its risk and thus mismanaged its risk, and probably mispriced its risk ultimately on the housing market, but all of these pieces of liquidity risk, correlation risk, credit risk, and so forth.

But then it put the U.S. Taxpayers at risk, particularly through its derivatives book. It put the U.S. Taxpayers at risk that each one of us in this room have $600 obligated. That's just $180 billion divided by the population.

COMMISSIONER HOLTZ-EAKIN: I understand that. So if I go back to Mr. Wallison's example--I just want to figure out the derivatives contribution here, Mr. Wallison's example--AIG could have had the securities on its balance sheet. They could have diminished in value. And then AIG would have had the sad necessity to go out and raise more capital. It would have needed to go get more cash.

Or, it could have left these securities on someone else's balance sheet, entered into the contract which says there's a credit default swap; when they diminished in value, the other entity automatically got the capital it needed through this contract, cash went out, and AIG was in the sad position of having to get more cash.

What's the difference? And what's the contribution of a derivative?

WITNESS GENSLER: It's a significant difference. Derivatives allow risk to be held by a party without putting up the principal, the public, the money up front. So at $527 billion of credit default swaps, $2.7 trillion total. But that $500 billion book, they didn't put any money up front. They were collecting premium, like an insurance company collects premium--

COMMISSIONER HOLTZ-EAKIN: I'm aware of the cash flows. But the same scrutiny and exposure to the real risk, which is the risk that the underlying security will diminish in value because the housing bubble is over, is present in both transactions.

WITNESS GENSLER: With all--

COMMISSIONER HOLTZ-EAKIN: And the failure--This is my point. And the failure to assess correctly, and provision for that risk is the ultimate failure, not the presence of a derivative.

WITNESS GENSLER: I think whether it's a cash market or a derivative, you can have the same inherent risk. And I would agree with you those same inherent risks of a housing bubble.

In this circumstance, the derivatives added significantly to AIG's circumstance because they didn't put up that $500 billion initially. And secondly, it wasn't regulated. Whether it be cash markets or derivatives, it wasn't regulated to have capital in that AIG Financial Products, with all respects to what the Office of Thrift Supervision was doing.

So it was so ineffectively regulated, it almost--you know, it was a horrible calamity that that entity had that much risk. And short of regulation, and short of putting up the half a trillion dollars, the result was the housing bubble caught--

COMMISSIONER HOLTZ-EAKIN: And short of regulation--I just want to make sure I get your thinking on this, and I'm sorry I have a short amount of time--had we pulled that particular unit out, Financial Products, the market would have also disciplined them to have more capital? But it was its inclusion within AIG that disguised that risk? Do you agree with that? That's an assertion we heard before.

WITNESS GENSLER: Well I certainly believe that the marketplace was transacting business with AIG Financial Products because it had a AAA rating at the holding company. But the largest derivative dealers are part of large, complex financial institutions.

So that is why I think it has been a gap in our financial regulatory system--a gap that I somewhat was associated with, if I might say. Looking back, I think all of us should have done more to protect the American public.

But that gap, we really need to regulate the derivative dealers. Whether they're independent or they're part of a large, complex financial institution, we desperately need to regulate these dealers.

COMMISSIONER HOLTZ-EAKIN: My time is up. I want to thank both you gentlemen. I'm sorry I didn't have time to inquire, as well. But my old debating partner and I had to have a chat. Thank you.

WITNESS GENSLER: No, no, it was good, because--I should disclose, we've seen each other on the campaign trail in 2004, and in 2008, and it's good to see you again, if I might say, Doug.

CHAIRMAN ANGELIDES: Mr. Georgiou.

COMMISSIONER GEORGIOU: This bipartisan love fest is nice to observe in this town. It doesn't happen very often.

(Laughter.)

COMMISSIONER GEORGIOU: You know there's been some indictment of the derivatives causing a problem because they weren't Exchange traded. It's the case that cash CDOs and cash RMBS, residential mortgage-backed securities, are also not Exchange traded.

I wonder if any of you might give us a comment on whether you think the financial crisis might have been smaller, or different, if the cash securities themselves underlying some of these derivative instruments were also required to be Exchange traded, so that there was more transparency of pricing and counterparty risk?

Mr. Gensler, I guess I'll start with you.

WITNESS GENSLER: Well I think that transparency helps lower risk to the American public. I also think it benefits end users, whether it is in the cash market or in the derivatives marketplace.

Within the derivatives marketplace, you need enough standardization, you need enough liquidity, and many of the products of AIG were so customized that they may not have lent themselves even to being on Exchanges.

But I do think that the more transparency, whether it be in the cash markets for mortgage-backed securities or the derivatives markets, the more transparency we have it lowers risk to the American public. We're less vulnerable, because even the customized product then can be priced in reference to that which is Exchange traded.

COMMISSIONER GEORGIOU: And where? Where do you think these--I mean, what Exchange ought they to be traded on?

WITNESS GENSLER: Well I can best speak about derivatives' products, but I think that--and Congress is hopefully about to adopt this--that where there are derivatives that are cleared and are listed, so this may be only a portion of the marketplace, but where they're cleared and they're listed, they could be traded on electronic platforms called Swap Execution Facilities, or they could be traded, if the retail public is involved, on fully regulated Exchanges.

Most of this is between institutions, so it could be on these alternative trading platforms.

COMMISSIONER GEORGIOU: Right. And to use the old canard that we ought not to let the perfect be the enemy of the good, or whatever it is, you know, the mere fact that you can't Exchange-trade all the customized derivatives, or particularized RMBS, or CDOs, you know, that does not mean you ought not to try to put the rest of them, the ones that are relatively easy to standardize, on an Exchange.

Because at least you are, theoretically, reducing the risk to the system by standardizing that Exchange, ensuring counterparty credibility, and credit behind it, and transparency.

WITNESS GENSLER: I'm in complete agreement. I think that transparency of the standard part of the market then becomes a reference to the rest of the market. I think it makes markets more efficient. It's what we have in the securities and futures market.

It also makes these clearinghouses far less risky, because then they have a reliable price upon which to price the daily mark to markets, and the posting of margin.

COMMISSIONER GEORGIOU: Messrs. Dinallo and Lee? Any thoughts on this?

WITNESS LEE: Well, sir, I would just point out that I completely agree with what Gary says about transparency. Because obviously that brings better information to all sides of the transaction.

But, you know, during this dislocation in late 2008, as I indicated, I wasn't looking after AIG at that point, but I was regulating a number of financial institutions that did have these securities on their books.

And I think the difficulty that we had then was not necessarily getting information about trades, but just the lack of trades. And the only trades that occurred were at, you know, distress sales. You had hedge funds that were unwinding and dumping these things on the market at 20 cents on the dollar. And there was a perceived disconnect between the economic intrinsic value of the security over time versus what it could price.

And so, you know, while I think, you know, the virtue of transparency stands for itself, I think that I'm not sure an Exchange would have helped us in that instance. Because you just had such an incredible spread between bid and ask that we were not able to ascertain the true market value based on the traditional market signals.

So I mean at the time, a lot of our banks were coming to us saying we're holding these things, and our examiners were asking questions about you need to either take other than temporary impairment, which is--you know, they weren't mark to market because they were in the bank's portfolio, but it was nonetheless an attempt to discover price. And they would show us a lot of material coming out of the markets about, you know, the trades within these tranches of securities.

And, you know, it wasn't--there just wasn't a lot of them in the first place. And in the second place, the prices were extremely distorted by the distress nature of the sale. So I'm not really sure in that particular situation that we faced in the fall of 2008 that it would have actually benefitted to have them on an Exchange or not. It was just a complete lockup of the market in that instance. I hope that’s helpful--

COMMISSIONER GEORGIOU: Mr. Dinallo, any thoughts? It's not necessary if you don't have any. Okay.

Let me harken back to something that I guess probably everybody here has heard from me ad nauseam, that the proliferation of these securities, the RMBS, the CDOs based on the RMBS, the CDOs-squared, the CDOs-cubed, the synthetic CDOs, the derivatives based on all these products, was--it's asserted, were all created because people demanded that clients, potential clients demanded that they own all of this risk.

And, that it was sort of being pulled like pulling teeth out of the investment banking community who were compelled to create these instruments because there was so much demand for it.

The other argument of course is that they were pushing them out because everybody made money on them at every stage of the process. And this is to follow up on Senator Graham's point.

You know, everybody made money. The originators of the mortgages, the brokers that originated the mortgages, the securitizers, the lawyers who drafted the instruments, the auditors, the credit rating agencies, everybody got paid a fee, in cash, at the time that all of these various esoteric securities were created, without regard to their ultimate success or failure.

And I've been trying to make the point that maybe if more people had skin in the game, or had to sort of eat their own cooking, who were originating all these products, that there might have been a greater degree of safety in the products, in the origination. That is, more articulate due diligence and more care would be taken in the creation of the products if everybody knew that their economic future depended upon the success or failure of these instruments.

And one suggestion, some have said, is that maybe they ought to take their fees not in cash but in the instruments they create. So that both the institution they work for and maybe even the bonuses to individual employees involved in their creation was dependent upon the performance of the instruments.

Does anybody have any thought on whether the financial crisis might have been averted if, or ameliorated, or lessened in the event that the participants had more of a stake, personally with regard to their earnings, in the securities that they created?

WITNESS DINALLO: I have testified previously that I think that the originator of the loans no longer had any interest--you know, securitization was a good thing on the first round, but there's not that much risk in a community.

I agree with Commissioner Hennessey's observation along the way that--I think it was, I apologize if I'm wrong--that what credit default swaps did was permit these trading books to basically have this I believe false sense that they had insurance on the downside for all these exotic CDOs that you just ticked off.

And without the ability to sell insurance without adequate capital, you would’ve never had them basically take on--create, buy, and take on those kinds of instruments because essentially they became AAA when people said, well, we have a CDS on it it’s AAA, and then they were leveraged out again.

So I actually think that, yes, I think there needs to either be radical changes in the origination responsibilities, or there can't be this belief that you have some kind of backstop which a thousand years of insurance experience shows us requires a certain amount of capital that we think we've magically evaded with a derivative.

COMMISSIONER GEORGIOU: I'm out of my time, but could we get the answers from the others?

CHAIRMAN ANGELIDES: Any observation? You don't need to feel compelled. If you've got something compelling to say on it, or any strong view?

(No response.)

CHAIRMAN ANGELIDES: Okay. Do you believe the premise is essentially correct?

WITNESS LEE: I do. I think the--

CHAIRMAN ANGELIDES: That's all.

WITNESS LEE: --the products were extremely complicated and the lack of transparency played a role here. So when the markets froze up you had extremely sophisticated people who had packaged extremely sophisticated products, and they didn't know what was in them.

CHAIRMAN ANGELIDES: All right.

WITNESS LEE: And the rating agencies were a proxy for knowing. And when that process broke down, then you had a market lockup.

CHAIRMAN ANGELIDES: All right, let's do this. We do have--

COMMISSIONER GEORGIOU: Thank you. Thank you very much.

CHAIRMAN ANGELIDES: --a schedule. Let's do this, very quickly. Ms. Born, and Mr. Wallison each have a question, and then we will wrap this down, Members.

COMMISSIONER BORN: I just have one last question for Mr. Dinallo.

You said in your testimony that the deregulatory effect of the Commodity Futures Modernization Act played a role in the financial crisis. And I wondered if you could elaborate a little bit on how that worked.

WITNESS DINALLO: I believe that there are core financial products that the regulatory regimes of different regulators, whether it was the banking regulators, the insurance regulators, futures, and even legal gambling regulators over bonds and investments, understood, through good learning, what the right capital requirements were for doing that business.

Sometimes it's called "net capital." Sometimes it's called "reserving." And what the CFMA did, in my mind, was it told all of Wall Street: you no longer have to hold this capital to do that kind of a business. You can replicate it through a derivative in an unregulated entity and, like magic, you don't have to use billions of dollars of holdback capital. You can do it with very little capital.

And it's unregulated, and no one can go over there and argue with you. This is not about enforcement. This is about regulation, which is what regulators do. They set capital requirements, basically.

And within eight years you saw, in my view, this huge ramp up as Wall Street figured out how to replicate what otherwise used to cost more capital into much more leveraged and apparently profitable ways.

And that, to me, is what led to a large extent to the financial crisis, was this belief that we were going to get less risk, when in fact we completely crushed through the risk. Whether it was--I don't want to make this just about insurance, but of course that would be arguably my expertise, but in all areas you saw a migration away from capital requirements, which I thought were wise and were good learnings, into basically capital-free enterprises. And to me that’s how you ended up where we are now talking about it.

COMMISSIONER BORN: Thank you.

CHAIRMAN ANGELIDES: Mr. Wallison.

COMMISSIONER WALLISON: Thank you, Mr. Chairman.

Very quickly. I actually have three questions, but I'm going to only pose one now, and I would like you to respond to the other two in writing, and even the third in writing.

This is for Mr. Gensler. And my first question would be: The posting of margin in a clearinghouse in a situation in which people don't understand the risk, as is the case we just had, why will that not cause a problem for the clearinghouse in the future when a lot of failures occur? That's the first--don't answer now.

The second one is: AIG failed in a market, in a market where everyone was not weak--if it had failed in a market where everyone was not weak, would there have been a need to rescue AIG? In other words, is it interconnected in such a way as to create serious problems if they're not already weak? And the experiment that we're talking about here is one in which everyone is weak. Don't answer. Please respond in writing.

Lehman Brothers is the one example we have of a very large player in the market--and this is the question I would like you to answer now--Lehman Brothers failed, out of business. The one area that we know it was interconnected with was the Reserve Fund. That was a simple loan. Reserve Fund held something that Lehman Brothers was unable to pay. And so it suffered the loss that broke the buck, and that caused a run on the Reserve Fund.

But other than that, is there any evidence--and you can actually provide this in writing, too, if you want, don't have time to think about it now--is there any evidence of other institutions actually becoming insolvent as a result of Lehman Brothers' failure? That would be a validation of the interconnection argument.

WITNESS GENSLER: We will gladly check to see if there's evidence of somebody becoming insolvent directly. But it's the indirect effect of the interconnectedness. When Lehman Brothers fails, all risk premium, all concern about financial institutions is heightened, and in part the interconnectedness.

Now clearinghouses, to your first question--

COMMISSIONER WALLISON: Don't--

WITNESS GENSLER: No, it's Lehman. Lehman Brothers, actually there was a clearinghouse on interest rate swaps that moved in 27 trades. They moved the interest rate swap positions of Lehman. Then also at the Chicago Mercantile Exchange Clearinghouse for Futures, were able to move by that Monday. You know, it was failing over a weekend. Was able to move those futures' positions.

So Lehman's futures and interest rate swap positions were able to be moved very quickly. Whereas, even over many months later there are still people trying to get some of their money out of Lehman.

So I apologize if I connected your first question to your third, but it was evidence of Lehman Brothers and clearinghouses.

COMMISSIONER WALLISON: That's fine. But actually if you can put more of that down in your answer to all three questions, that would be fine. And I appreciate that.

WITNESS GENSLER: I'm looking forward to it. I'm hoping one of my colleagues wrote the questions down.

COMMISSIONER WALLISON: Well, we always send the questions out anyways,
so you don't have to worry about that.

WITNESS GENSLER: We have it.

CHAIRMAN ANGELIDES: Yes.

COMMISSIONER WALLISON: Thank you.

CHAIRMAN ANGELIDES: All right. Any other questions from Commissioners?

(No response.)

CHAIRMAN ANGELIDES: Are we sated? Well, not really. Sated for the day. I want to, before we adjourn, I want to do the following:

I want to thank the witnesses for coming here today. Thank you for your time, your preparation, for your answers to our questions.

I want to thank, as always, the Members of the Commission who are really extraordinary in the way they prepare for and take seriously the mandate and the charge we have been given.

I want to thank our staff, who works endless hours in preparation for these hearings, and just the public. What you have seen is the tip of the iceberg. Our chance to discuss issues in public. We are trying to do in the limited time frame we have as exhaustive a look as we can at the crisis, or the causes of the crisis, and on behalf of the American people. And the staff is doing a great job of assisting us.

I want to thank the public who tuned in today, or may see it on C-Span as I did at 1:45 a.m. last night. I got to watch Commissioner Born and Vice Chairman Thomas doing their questioning.

And finally I want to thank Senator Dodd and the Senate Banking Committee, and the staff of the Committee, for being such a good host to us, not just in May but again for these hearings.

With that, this public hearing of the Financial Crisis Inquiry Commission is adjourned. Thank you, very much.

(Whereupon, at 3:28 p.m., Thursday, July 1, 2010, the hearing was adjourned.)