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Yale Program on Financial Stability

Lessons Learned

Eric Dinallo

By Maryann Haggerty

Eric Dinallo was New York State Superintendent of Insurance from January 2007 through July 2009. In New York, as throughout the United States, insurance companies are regulated at the state level. In his position as Superintendent, Dinallo oversaw the insurance operating companies of American International Group (AIG) within New York. AIG's holding company, however, was supervised at the federal level. Much of AIG's problems came from its non-insurance subsidiary AIG Financial Products (AIGFP), which was a major presence in the market for credit default swaps (CDS), a type of derivative that was a factor behind the 2007-09 financial crisis. This "Lesson Learned" is based on an interview with Mr. Dinallo.

Informal communication networks were key during a tumultuous time.

Insurance company supervision in the United States is highly decentralized, unlike banking supervision. In the case of AIG, at the time the nation's largest insurance firm, its interconnections with other financial firms threatened the stability of the entire financial system.

Insurance regulators from around the country belong to the National Association of Insurance Commissioners (NAIC), through which they establish standards and best practices. They also communicate informally, and those informal relationships supported coordinated action during the crisis. Dinallo recalls,

It ended up becoming, frankly, a lot of phone calls, and just outright reach-outs. Because as you know, there's no meta-regulator for any of it. You're essentially relying on what I would say, trust with the other supervisors. It doesn't matter how big the state is or small. If they're the primary regulator for that insurance subsidiary, then you kind of have to work together or not.

I ended up doing a lot of it by phone, and by creating weekly calls with all of the states that had a stake in AIG. Then weekly international calls. It was definitely ad hoc. . . . The states, I think, work very hard to produce united results through NAIC, because they don't want the perception that somehow, it's random and hodgepodge. But the fact is that it's only as good as those communications and those trusts. You can't really make anyone do anything, because they are the king or queen of a castle that is [their particular] regulated entity.

Insurance is a unique financial service, and those outside the industry needed to be educated.

Insurance companies prepare financial statements using what are known as statutory accounting principles (SAP), as opposed to the generally accepted accounting principles (GAAP) that other kinds of companies use. In essence, statutory accounting aims to show whether insurers are in a position to pay off claims. Dinallo recalls that this and other details of the insurance industry were unfamiliar even to top banking regulators. He draws a sharp line between the insurance subsidiaries that he supervised, and the parent company that got into trouble. Despite the problems at the holding company, the insurance operations were solvent.

I was going to go out there and make statements about my confidence in the insurance companies of AIG. Because I did believe that on a statutory accounting basis, they had more than enough assets to match their long-term liabilities on a statutory accounting basis. Not mark-to-market. . . .

When [New York Fed President Timothy] Geithner heard this, I made this joke. . . . I think he thought I was explaining the Mayan calendar to him. It was so alien and so weird. But basically, life insurance companies have long-term liabilities, and they match it with long-term assets that are going to perform by maturing 20 years from now. That's why so much of the reserves are put towards basically debt, Treasuries, etc., that are highly rated. So that they will almost certainly, hopefully, certainly perform. Which means mature. You're going to get the coupon along the way, albeit a small yield.

The volatility before maturation over the 20 years does not count.

Securities lending exposed AIG to increased risk from counterparties.

In securities lending, the owner of a financial asset—such as stock or derivatives—lends that asset to its counterparty. That borrowing counterparty might be a short seller or an arbitrageur. The lender holds collateral—often cash—and is paid fees. The borrower hopes to make money, too, for instance by selling the share and buying it back for less.

In 2008, AIG's securities lending operation lost billions of dollars when borrowers began to return securities and demand their cash collateral back. AIG didn't have that cash, because it was invested in mortgage-backed securities that were rapidly losing value. Those securities lending losses, which were separate from the CDS losses at AIG FP, were part of the reason for the federal bailout.

Insurers generally considered securities lending a low-risk business. But as Dinallo points out, in the case of AIG, its counterparties in securities lending were also counterparties in transactions at AIG FP.

But what was happening was, as FP was getting in trouble, all the counterparty banks went and ripped the cash out of the securities lending agreements. They put back the securities and took the cash, which is their right. But the only way they knew to do that, and the only reason that they did it, was because they had concern about the company itself through being counterparties of FP.

One of my lessons is, personally, I think securities lending is . . . make a little, lose a lot. It is such a marginal gain on monetizing, that I've never understood why it's permitted. It just looks dangerous. AIG showed it was dangerous. It's not worth the wax, or whatever the word is.

AIG's lines of credit were not useful in the crisis.

AIG had long-established lines of credit, but couldn't draw on them when it needed liquidity, Dinallo says.

If you want to talk about lessons learned: There's a level at which [lines of credit] are worthless. Because when AIG went to access those lines of credit which they had paid for, for years and years and years—every one of the credit rating agencies said that they would be downgraded. I made the calls and was told that if they touched the lines of credit, they're going to get knocked down four levels. Every single one told me. Moody's, S&P, everyone.

I was like, "But they bought these lines of credit." "Yep. But if you need them then you're not credit worthy." I was like, "This is circular logic. They had the risk analysis and foresight to get the lines of credit." "Nope, four levels." Which would have been disastrous for the insurance companies.

But then why even have the lines of credit? I mean, all that money spent on those lines of credit, and when they needed them, they were useless. Honestly useless. I mean, to me, that's a lesson. If I were a CEO I would be like, "The last time I checked, when you need them you can't get them, so why pay for them?" I don't know. Maybe the board makes you do it or whatever. But I would warn the board, "Look at AIG. They were useless."

Regulatory reserve requirements protect the financial system, and crisis-era derivatives evaded such requirements.

Banks and insurance companies are all required to hold regulatory reserve, money they can use to meet obligations even in bad times. "The system is wired to have regulators and solvency behind it," he says.

Then we just invented this thing called derivatives, which we thought was alchemy or something. . . .If you tell Wall Street that they can sell insurance, in essence, or

speculative futures, with no reserves set aside, they're going to make a fortune. Until they have to pay on claims.

My view was that we actually had somehow convinced ourselves that credit default swaps [were safe]—both the speculative, naked credit default swaps that [were] making shorts in the equities market, where you don't even have any exposure to the company, [and] the insurance side, where you do have exposure to the company. Say they're a counterparty for technology, or for debt or whatever.

We had permitted both sides to be unregulated, and sure enough, Wall Street found that that was going to be a hugely profitable business. Because you don't have to set aside any money, because it was deregulated under the Commodities Futures Modernization Act. . . . The moment they were deregulated, they were used overnight to attain whatever business and outcomes and commitments [that were available] because you no longer had to set aside capital for the same activity. That's what I never understood.

Insurance company solvency supports confidence and protects consumers.

Dinallo says that guarding insurance company solvency is one of the major goals of industry regulation.

I'm not trying to be trite. It's just a fact that solvency is the best consumer protection. I think some people didn't love it because it sounded like I was not serious about market-conduct supervision. But it seems to me that solvency is the best consumer protection there is. Because the insurance companies have obligations, and the number one thing is to make good on those obligations.

Insurance companies should be regulated by insurance regulators who understand the industry and can explain what is needed to prevent more severe problems.

At AIG, the holding company was regulated at the federal level by a banking supervisor, the Office of Thrift Supervision. Dinallo maintains that both insurance subsidiaries and their holding company parents should be overseen by regulators who understand insurance operations.

This is not some argument for state supervision. But I think if the company is predominantly an insurance company, then it ought to be regulated at the holding company by an insurance regulator. I don't think it's that deep. It could be New York. It could be someone else. We could debate who it should be. New York seemed like a logical choice for AIG. But I just think that's kind of the way it ought to be.

Now if the feds could develop the expertise, and the man- and womanpower to actually do that at a hold-co level, I'm hip with that. It doesn't have to be just a state

regulator up there. But the problem is, that's such a huge apparatus that they don't have, and they probably will never have.

In a crisis, understanding the industry allows a regulator to keep the most important long-term obligations in mind, Dinallo says.

“You just keep with the script. It's solvency, it's policy-holder confidence. It's a system that requires money keeps on coming in, so you can pay out on the other side 30 years from now. It's different than any other financial obligation out there. You have the right to have a unique voice against people who will think it's a little bit anachronistic. Statutory accounting, the Mayan calendar, etc.”

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