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### Superintendent of the New York State Insurance Department, Eric Dinallo Testimony to FCIC (The Role of Derivatives)

Eric Dinallo

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TESTIMONY TO  
THE FINANCIAL CRISIS INQUIRY COMMISSION

HEARING ON

THE ROLE OF DERIVATIVES IN THE FINANCIAL CRISIS

BY ERIC DINALLO  
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THURSDAY, JULY 1, 2010

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I would like to thank Chairman Phil Angelides and the members of the Financial Crisis Inquiry Commission for inviting me to testify today at this hearing on American International Group, known as AIG.

My name is Eric Dinallo and I was the Insurance Superintendent for New York State from January 2007 through July 2009, including the period when the crisis developed at AIG.

I very much appreciate the Commission holding this hearing so that we can discuss what happened at AIG and what lessons we can learn to improve financial services regulation and avoid similar crises in the future.

Before I go into detail, I would like to make a few broad points that I think are essential for understanding what happened at AIG and what lessons we can learn. Please note that when I speak of AIG, I am referring to the parent company, which is an international financial services company not regulated by the state insurance departments. I am only discussing AIG's insurance companies when I state that explicitly. Also, when I use the words "we" or "us" or "our" I am referring to the New York State Insurance Department during the time period when I served as Superintendent.

First, the crisis for AIG did not come from its state regulated insurance companies. The primary source of the problem was AIG Financial Products, which had written credit default swaps, derivatives and futures with a notional amount of about \$2.7 trillion, including about \$440 billion of credit default swaps. Collateral calls by global banks, broker dealers and hedge funds that are counterparties to credit default swaps were the main source of AIG's problems.

The main reason why the federal government decided to rescue AIG was not because of its insurance companies. Rather, it was because of the systemic risk created by Financial Products. There was systemic risk because of Financial Products' relationships and transactions with many major commercial and investment banks, not only in the U.S., but around the world.

Second, and perhaps most important, it is essential to understand why AIG Financial Products was able to make such huge bets with its credit default swaps with essentially nothing backing up its promise to pay if the bet went against it. In general, AIG took advantage of the general tide of deregulation, but there are three specific parts of deregulation that working together created a perfect storm of financial disaster: 1. allowing financial institutions to select their own regulator, 2. allowing financial conglomerates by doing away with the divisions required by the Glass Steagall Act, and, 3. deregulation specifically of credit default swaps.

By purchasing a small savings and loan in 1999, AIG was able to select as its primary regulator the Office of Thrift Supervision, the federal agency that is charged with overseeing savings and loan banks and thrift associations. Clearly, OTS's expertise was in savings and loans, not complicated international financial institutions conducting a

huge derivative business. The net effect was that AIG Financial Products was not effectively regulated, as OTS has admitted in testimony to Congress.

Glass Steagall wisely separated financial services businesses that provided guarantees, such as insurance policies or bank deposits, from businesses that took on risk, such as investment banking. But the Gramm-Leach-Bliley Act permitted AIG to operate an effectively unregulated hedge fund with grossly insufficient reserves to back up its promises. Had AIG Financial Products been a stand alone company, it is unlikely that its counterparties would have been willing to do business with it because its commitments would never have carried a triple-A credit rating.

Finally, the Commodities Futures Modernization Act of 2000 specifically exempted credit default swaps from regulation.

In sum, the combination meant that AIG could operate an ineffectively unregulated hedge fund selling billions in unregulated securities making billions in promises with no reserves to back up those promises. Clearly that was a recipe for disaster.

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

When those decisions to deregulate were made, the arguments were that financial innovation was essential and if the U.S. did not allow activities here, the market and the profits would go elsewhere. Sadly, it is not clear that not all financial innovation is positive, not all reduces risk, and not all promotes economic growth. A major international competitive advantage is the U.S.’s stable, secure and transparent financial system. If we allow that to be damaged or destroyed, the cost for all Americans will be steep.

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

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

Fourth, the federal rescue of AIG was possible because there were strong operating insurance companies that would enable the federal government and taxpayers to be paid back. The reason why those insurance companies were strong is because state regulation walled them off from non-related activities in the holding company and at Financial Products.

In most industries, the parent company can reach down and use the assets of its subsidiaries. With insurance, that is greatly restricted. State regulation requires that insurance companies maintain healthy reserves for policyholders' claims backed by investments that cannot be used for any other purpose. That is why policyholders were and continued to be protected.

Now, let me provide some background. Before the crisis, AIG was a huge, global financial services holding company that did business in 130 countries. At that time, AIG had 71 U.S.-based insurance companies. In addition to those US based insurance entities, AIG had 176 other financial services companies, including non-U.S. insurers.

State insurance departments have the power and authority to act as the primary regulator for the insurance companies domiciled in their state. So the New York Department is primary regulator for only those AIG insurance companies domiciled in New York. At the time of the crisis, the New York Insurance Department was the primary regulator for 10 of AIG's 71 U.S. insurance companies: American Home Assurance Company, American International Insurance Company, AIU Insurance Company, AIG National Insurance Company, Commerce and Industry Insurance Company, Transatlantic Reinsurance Company, American International Life Assurance Company of New York, First SunAmerica Life Insurance Company, United States Life Insurance Company in the City of New York, and Putnam Reinsurance Company. AIG's New York life insurance companies are relatively small. The New York property insurance companies are much larger. Other states act as primary regulator for the other U.S. insurance companies.

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

As noted, by purchasing a savings and loan in 1999, AIG was able to select as its primary regulator the federal Office of Thrift Supervision, the federal agency that is charged with overseeing savings and loan banks and thrift associations. The Office of Thrift Supervision is AIG's consolidated supervisor for purposes of Gramm-Leach-Bliley. In testimony to the U.S. Senate, OTS has stated that it was responsible for regulating the AIG holding company and its Financial Products unit.

When companies are permitted to pick their regulator, the opportunity for regulatory arbitrage is created. The whole purpose of financial services regulation is to appropriately control risk. But regulatory arbitrage increases risk because it creates the opportunity for a financial institution to select its regulator based on who might be more lenient, who might have less strict rules, who might demand less capital.

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

One of the most important aspects of regulating financial services institutions is setting of appropriate capital and reserve requirements. You asked what the reserve requirements were for AIG Financial Products and for the monoline or financial guaranty insurance companies that we regulate. I cannot tell you what the reserve requirements, if any, were for Financial Products, as New York did not regulate that entity.

New York Insurance Law imposes explicit capital requirements on monolines; specifically, monolines are required to maintain a minimum surplus to policyholders of \$65 million. But the \$65 million is an absolute minimum. The financial guaranty law also requires that monolines establish and maintain contingency reserves equal to the greater of (i) fifty percent of the premiums written for each calendar year for each category of business or (ii) a percentage of principal guaranteed. The mandatory percentage depends upon the relative safety of the insured obligation and ranges from 0.55 percent for municipal obligations to 2.5 percent for non-investment grade obligations. The law also requires the establishment of loss reserves in the event of adverse development (i.e., reported claims) which must be calculated in the manner applicable to authorized property/casualty insurers.

You also asked if AIG's capital and capital requirements were sufficient from 2005 to 2008. The New York Department is not in a position to comment on any capital requirements for AIG holding company or Financial Products. I can assure you that the capital of the AIG group's licensed U.S. insurers was certainly sufficient to ensure the orderly operation of the AIG insurance companies. What's more, it is clear that AIG holding company's top triple-A credit rating was based on the strength of its insurance companies. But since the assets of the insurance companies cannot be used for the obligations of the holding company, AIG Financial Product's counterparties were mistaken if they thought AIG's strength protected them. The use of insurance company funds to support the operations of Financial Products would have been improper and disallowed under the Insurance Law. Had AIG FP been given a credit rating based on its

own resources it is unlikely that it would have been perceived as strong enough to keep the promises it was making.

This is one of the important lessons of the financial crisis: the problem of illusory credit ratings. Let me be clear what I mean by illusory. Unlike the credit ratings for securities based on subprime mortgages, there was a solid basis for the top triple-A credit rating for AIG's parent company. But as noted, that was based on the strength of its core insurance companies and the assets of those companies could only be used to support the insurance operations.

AIG was probably not the only company to take its strong credit rating from its core business and use that presumed financial strength to go into another line of business where that strong credit rating was meaningless because the assets of its core business were protected by regulation. Thus, AIG used its perceived strength to have its Financial Products unit sell credit default swaps, though it was an illusion that the holding company's strength could be applied to the promises Financial Products was making. I would call that AIG monetizing its top credit rating—using it to make huge profits—for awhile, anyhow.

The primary source of the AIG's problem was AIG Financial Products, which had written credit default swaps, derivatives and futures with a notional amount of about \$2.7 trillion, including about \$440 billion of credit default swaps. For context, that is equal to the gross national product of France. Losses on certain credit default swaps and collateral calls by global banks, broker dealers and hedge funds that are counterparties to these credit default swaps are the main source of AIG's problems.

In September 2008, the credit rating agencies told AIG that it was about to be downgraded. A downgrade would result in AIG Financial Products and AIG facing tens of billions of dollars of demands for cash collateral on the credit default swaps written by Financial Products and guaranteed by the holding company.

It is worth noting what AIG was doing with those credit default swaps. The focus has been on swaps guaranteeing bonds backed by subprime residential mortgages. There were plenty of those. But AIG was also selling credit default swaps to help banks avoid their own regulatory requirements for reserves in two ways. First, thanks to AIG credit default swaps, the banks could pretend the bonds they held backed by subprime mortgages were risk free and not hold adequate reserves against them. Second, the banks also used swaps directly to avoid regulations regarding their own reserve requirements.

I would like to quote from a March 6, 2009 story in the Financial Times by Henny Sender titled "AIG saga shows dangers of credit default swaps":

In retrospect, a glance at AIG's second quarter 2008 financial statement makes for an interesting read. Buried in that report is a cautionary tale showing just how dangerous credit derivatives can be when combined with insufficient risk

management and regulatory oversight – or both sides of these transactions. Unfortunately, few people read the report when it would have been relevant. The report fully discloses the \$446bn in credit insurance AIG sold. The swaps were written out of AIG Financial Products, a non-bank hidden at the heart of the insurance giant. But because AIG wasn't regulated as a bank, it wasn't saddled with any requirements to hold capital against these massive potential liabilities. A large part of those credit default swaps, about \$307bn worth, was bought by European banks in endearingly named “regulatory capital forbearance” trades. By buying such insurance, these banks didn't have to hold capital against their long-term holdings of securities. Another large chunk went to Wall Street firms to hedge their holdings of complicated securities backed by subprime mortgages. By the end of the year, just this part of this massive book of credit default swaps would cause almost \$30bn in losses and trigger what is likely to prove one of the most costly bail-outs ever. Meanwhile, the \$307bn “forbearance” book produced a mere \$156m in revenue for the first half of last year. These exposures probably represent one of the most skewed risk-reward equations of all time.

AIG did such a booming business selling credit protection because it offered to post generous collateral if the value of the insured securities dropped or if its own credit rating fell. (Other providers, such as the monoline insurers, balked at such terms.) That collateral was meant to give AIG's clients assurance that they were safely hedged. In fact, that sense of safety was always an illusion. Clients hadn't reduced their risk; they had increased it.

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

In sum, an essentially unregulated institution, AIG Financial Products, sold unregulated securities, credit default swaps, which were used to help regulated banks evade regulation and hold less capital in reserve than necessary.

That leads us to a discussion of credit default swaps. Let me first establish why the insurance regulator for New York is a relevant authority on credit default swaps. I will expand on these issues at greater length, but to provide a context, I will start with a brief summary.

As credit default swaps were developed, there was a question about whether or not they were insurance. Since initially they were used by owners of bonds to seek protection or insurance in the case of a default by the issuer of the bonds, this was a reasonable question. In 2000, under a prior administration, the New York Insurance Department was asked to determine if certain swaps were insurance and said no. That is a decision we have since revisited and reversed as incomplete. I will provide more detail on these important decisions shortly.



After I took office in January 2007, the impact of credit default swaps was one of the major issues we had to confront. First, we tackled the problems of the financial guaranty companies, also known as bond insurers or monolines. Credit default swaps were a major factor in their problems. Afterwards, we were involved in the rescue of AIG. Again, credit default swaps were the biggest source of that company's problems. Through these experiences, we have needed to carefully study the history and issues surrounding credit default swaps. And we have learned the hard way their impact on markets and companies.

Let's discuss what a credit default swap is and the different kinds of credit default swaps. A credit default swap is a contract under which the seller, for a fee, agrees to make a payment to the protection buyer in the event that the referenced security, usually some kind of bond, experiences any number of various "credit events", such as bankruptcy, default, or reorganization. If something goes wrong with the referenced entity, the protection buyer can put the bond to the protection seller and be made whole, or a net payment can be made by the seller to the buyer.

Originally, credit default swaps were used to transfer and thus reduce risk for the owners of bonds. If you owned a bond in company X and were concerned that the company might default, you bought the swap to protect yourself. The swaps could also be used by banks who loaned money to a company. This type of swap is still used for hedging purposes.

Over time, however, swaps came to be used not to reduce risk, but to assume it. Institutions that did not own the obligation bought and sold credit default swaps to place what Wall Street calls "a directional bet" on a company's creditworthiness.

In May 2008, I began to refer to swaps bought by speculators as "naked" credit default swaps both to draw the analogy to naked shorting in stocks, which ironically are regulated, and to make clear that the swap purchasers do not own the underlying obligation. The protection becomes more valuable as the company becomes less creditworthy. I have argued that these naked credit default swaps should not be called swaps because there is no transfer or swap of risk. Instead, risk is created by the transaction. For example, you have no risk on the outcome of the third race until you place a bet on horse number five to win.

I believe that the first type of swap, let's call it the covered swap, is insurance. The essence of an insurance contract is that the buyer has to have a material interest in the asset or obligation that is the subject of the contract. That means the buyer owns property or a security and can suffer a loss from damage to or the loss of value of that property. With insurance, the buyer only has a claim after actually suffering a loss. With the covered swaps, if the issuer of a bond defaults, then the owner of the bond has suffered a loss and the swap provides some recovery for that loss. The second type of swap—naked swaps—contains none of these features.

One problem is that with swaps, defining covered and naked can be much more complicated. For example, company A that does business with company B may seek to protect itself from not being paid by company B by buying a credit default swap on company B's debt. Clearly here the buyer has a material interest, but not directly in the bond. Or the buyer of a credit default swap may own the underlying bond when it buys the swap, but then sell the bond but keep the swap.

At the time of the crisis at AIG, because the credit default swap market was not regulated, there was no valid data on the number of swaps outstanding and how many were naked. At that time, estimates of the market were as high as \$62 trillion. By comparison, at that time there was only about \$6 trillion in corporate debt outstanding, \$7.5 trillion in mortgage-backed debt and \$2.5 trillion in asset-backed debt. That's a total of about \$16 trillion in debt private sector debt.

Now, I think it would be useful to go into some of the old, but highly relevant history.

Betting or speculating on movements in securities or commodities prices without actually owning the referenced security or commodity is nothing new. As early as 1829, "stock jobbing", an early version of short selling, was outlawed in New York. The Stock Jobbing Act was ultimately repealed in 1858 because it was overly broad and captured legitimate forms of speculation. However, the issue of whether to allow bets on security and commodity prices outside of organized exchanges continued to be an issue.

"Bucket shops" arose in the late nineteenth century. Customers "bought" securities or commodities on these unauthorized exchanges, but in reality the bucket shop was simply booking the customer's order without executing on an exchange. In fact, they were simply throwing the trade ticket in a bucket, which is where the name comes from, and tearing it up when an opposite trade came in. The bucket shop would agree to take the other side of the customer's "bet" on the performance of the security or commodity.

Bucket shops sometimes survived for a time by balancing their books, but were wiped out by extreme bull or bear markets. When their books failed, the bucketeers simply closed up shop and left town, leaving the "investors" holding worthless tickets. The Bank Panic of 1907 is famous for J.P. Morgan, the leading banker of the time, calling other bankers to a meeting and keeping them there until they agreed to form a consortium of bankers to create an emergency backstop for the banking system. At the time there was no Federal Reserve. But a more lasting result was passage of New York's anti-bucket shop law in 1909. The law, General Business Law Section 351, made it a felony to operate or be connected with a bucket shop or "fake exchange." Because of the specificity and severity of the much-anticipated legislation virtually all bucket shops shut down before the law came into effect, and little enforcement was necessary. Other states passed similar laws.

Section 351 prohibits the making or offering of a purchase or sale of security, commodity, debt, property, options, bonds, etc. without intending a bona fide purchase or sale of the security, commodity, debt, property, options, bonds, etc. If you think that

sounds exactly like a naked credit default swap, you are correct. What this tells us is that back in 1909, 100 years ago, people understood the risks and potential instability that comes from betting on securities prices and outlawed it.

With the growth of various kinds of derivatives in the late 20<sup>th</sup> Century, there was legal uncertainty as to whether certain derivatives, including credit default swaps, violated state bucket shop and gambling laws.

The Commodity Futures Modernization Act of 2000 (“CFMA”), signed by President Clinton on December 21, 2000, created a “safe harbor” by (1) preempting state and local gaming and bucket shop laws except for general antifraud provisions, and (2) exempting certain derivative transaction on commodities and swap agreements, including credit default swaps, from CFTC regulation.

CFMA also amended the Securities Act of 1933 and the Securities and Exchange Act of 1934 to make it clear that the definition of “security” does not include certain swap agreements, including credit default swaps, and that the SEC is prohibited from regulating those swap agreements, except for its anti-fraud enforcement authority.

So by ruling that credit default swaps were not subject to state laws or SEC regulation, the way was cleared for the growth of the market. But there was one other issue. If the swaps were considered insurance, then they would be regulated by state insurance departments. The capital and underwriting limits in insurance regulation would threaten the rapid growth in the market for these derivatives.

So at the same time, in 2000, the New York Insurance Department was asked a very carefully crafted question. “Does a credit default swap transaction, wherein the seller will make payment to the buyer upon the happening of a negative credit event and such payment is not dependent upon the buyer having suffered a loss, constitute a contract of insurance under the insurance law?”

Clearly, the question was framed to ask only about naked credit default swaps. Under the facts as presented, the swap was not insurance, because the buyer had no material interest and the filing of claim does not require a loss. But the entities involved were careful not to ask about covered credit default swaps. Nonetheless, the market took the Department’s opinion on a subset of credit default swaps as a ruling on all swaps.

In sum, in 2000 as a society we chose not to regulate credit default swaps. And the leadership of the New York Insurance Department at that time chose to be part of that choice.

It bears repeating. The fear in 2000 was that if the U.S. or New York regulated credit default swaps and required holding sufficient capital, the market would go where unregulated sellers could make more money. We forgot that the biggest competitive advantage of the U.S. financial system has always been that we offer safety, security and

transparency. If we destroy that perception, the long-term cost to our society is incalculable.

Why did that matter? As we have seen, the financial system has been placed in peril because there was no comprehensive management of counterparty risk. Deals were made privately between two parties. These bilateral arrangements mean that there are no standards for the solvency of counterparties. The buyer does not know how much risk the seller is taking on. And there are no requirements for the seller to hold reserves or capital against the risks it is taking on by selling swaps.

None of this was a problem as long as the value of everything was going up and defaults were rare. But the problem with this sort of unregulated protection scheme is that when everyone needs to be paid at once, the market is not strong enough to provide the protection everyone suddenly needs.

Unlike insurance, credit default swaps are marked to market. That means, the value of the swap reflects the current market value, which can swing sharply and suddenly. Value changes require the sellers to post collateral. Sudden and sharp changes in the credit rating of the issuer of the bonds or of the bonds themselves can produce large swings in the value of the swaps and thus the need to post large and increasing amounts of collateral. That capital strain can produce sudden liquidity problems for sellers. The seller may own enough assets to provide collateral, but the assets may not be liquid and thus not immediately accessible. When many sellers are forced to sell assets, the price of those assets falls and sellers are faced with taking large losses just to meet collateral requirements. As the prices of the assets are driven down by forced sales, mark-to-market losses increase and the collateral posting cycle continues. Meanwhile, the underlying assets may continue to perform; paying interest and principal in full.

The above is a substantial part of the problem at AIG. A ratings downgrade on September 15 produced immediate collateral calls. The company did not have sufficient liquid assets at Financial Products or at the holding company to satisfy these calls.

You asked about New York's ability to regulate credit default swaps. While the CFMA preempted state gambling laws, it did not preempt state insurance law. Apparently it was felt that New York's letter made that unnecessary.

But given the temper of the deregulatory times, it is fair to assume that if New York had tried to unilaterally regulate credit default swaps in 2000, it would have been overruled one way or another. In fact, at the time, the New York Department was part of the decision to deregulate credit default swaps.

However, when we understood the impact of credit default swaps, New York chose to act. In May 2008, I publicly warned of the scale of the problem and explained that some credit default swaps were clearly insurance. Thereafter, I published opinion articles making this case. On September 22, 2008, we announced that New York State would, beginning in January 2009 regulate the insurance, or covered, part of the credit default

swap market which had been unregulated—the part which the Insurance Department has jurisdiction to regulate.

That announcement played an important role in spurring national discussion about a comprehensive regulatory structure for the CDS market. The result has been exactly what was envisioned—a broad debate and discussion about the best way to bring controls and oversight to this huge and important market and concrete progress toward a centralized risk management, trading and clearing system. After our announcement, then-SEC Chairman Cox asked for the power to regulate the credit default swap market. The New York Federal Reserve began a series of meetings with the dealer community to discuss how to proceed.

The proposals included establishing an exchange, a central counterparty or a clearinghouse for credit default swaps. On November 14, 2008, the New York Federal Reserve, the Securities and Exchange Commission and the Commodities Futures Trading Commission entered into a MOU to facilitate information sharing and data across a number of areas, including CDS.

At the request of federal regulators and recognizing the federal agency efforts and anticipated legislative action by Congress, the Department publicly announced that it would delay its intention to begin regulating part of the CDS market effective January 1, 2009.

Though I am no longer at the New York Insurance Department, staff there has provided me with the following information so that I can bring you up to date on New York's actions on this subject.

Governor David Paterson has put forward Program Bill #50. The bill does not expressly provide a regulatory regime for credit default swaps. Rather, the bill removes all mention of CDS from Article 69 of the Insurance Law (the "financial guaranty statute"). These references were added by the 2004 revision of the financial guaranty law, which sanctioned by statute practices that had previously been permitted by the Department administratively. The removal of the statutory references to CDS is intended to eliminate any implication that some or all CDS are somehow exempt from regulation as insurance. Rather, the Department will view a CDS as insurance if by its terms it meets the definition of "insurance contract" as set forth in N.Y. Insurance Law § 1101(a)(1).

The Department is aware that this position represents a radical departure from the current treatment of CDS, and that this could disrupt the operation of the credit markets. Mindful of this, Program Bill #50 also contains a provision that would allow the Superintendent to exempt CDS from the requirements of the Insurance Law under certain circumstances. This discretion would be exercised if an effective regulatory regime (presumably federal) were instituted to govern the CDS market.

The Department supports a holistic solution to regulating this market in its entirety. That can only be created by the federal government. Any effective solution should include

mechanisms to bring much needed transparency to this market as well as centralized data, capital requirements to ensure that there is sufficient capital and liquidity, and a security or guarantee fund to manage counterparty default.

There are appropriate uses for credit default swaps. Some amount of speculation can provide useful information and market liquidity. The best route to a healthy market in credit default swaps is not to divide it up among regulators. It would not be effective or efficient for New York to regulate some transactions under the insurance law, while other transactions are either not regulated or regulated under some other law and by some other agency. The best outcome is a holistic solution for the entire credit default swap market. Again, that has to come from the federal government.

The unregulated marketplace in credit derivatives was a central cause of a near systemic collapse of our financial system. Credit default swaps played a major role in the financial problems at AIG, Bear Stearns, Lehman and the bond insurance companies. A major cause of our current financial crisis is not the effectiveness of current regulation, but what we chose not to regulate. This lack of regulation has been devastating for thousands of New Yorkers and every taxpayer in the United States. We must see that this does not happen again.

Credit default swaps must be regulated and sellers must be required to hold sufficient capital. That will make them more expensive, but it will mean the guarantee has real value.

Does requiring adequate capital mean the end of financial innovation? Of course not, it just means that most institutions will operate with less leverage. Risk and reward are integral to capitalism. But innovators should risk their own capital, not the entire financial fabric. Setting that balance is where effective regulation comes in.

We have looked at the history of credit default swaps. It is also worth noting the history that allowed AIG to set up a unit, Financial Products, which could conduct this business.

By 1933, those who lived through the 1907 credit crisis and the 1929 stock market crash had recognized two things: there were certain sacred financial services products, such as bank deposits and insurance policies, that had to be protected at all costs, and those products should never be exposed to the possible excesses of leveraged investment banking. The wall between those businesses was institutionalized in the form of the Glass-Steagall Act of 1933, which kept commercial banks, insurance companies and investment banks out of each others' lines of business. Underlying the inherent wisdom of Franklin Roosevelt and his advisers was the fundamental principle that guaranteed consumer deposits – whether bank deposits or insurance premiums – must be kept separate from high-risk investment vehicles such as investment banks and their modern equivalents, hedge funds and private equity. The goal was to encourage the benefit to the economy of risk-taking by some financial institutions, without creating the risk of runs on commercial banks or insurance companies by keeping those activities behind solid walls.

Those walls were removed in 1999 by the Gramm-Leach-Bliley Act. The theory was that large financial institutions able to do commercial and investment banking and insurance would diversify risk and thus be stronger and less risky.

How has that turned out? Consider AIG, an excellent insurance company, which became a financial-services conglomerate. AIG's Financial Products unit was able to sell hundreds of billions of dollars of credit default swaps and run up \$2.7 trillion in notional exposure because ratings agencies and counterparties wrongly assumed that AIG's triple-A rating and \$1 trillion balance sheet stood behind it. In fact, AIG's insurance company reserves were still protected by the moat of state insurance regulation and not available to bail out Financial Products' bad bets.

The point is that standing alone – as Glass-Steagall would have required – AIG Financial Products, looking like a recklessly-run hedge fund, could not have taken on all that risk. Only being part of a financial conglomerate made that possible. Even though AIG's healthy insurance companies and their reserves were protected, those companies took a substantial hit from the reputational damage. The outcome was the worst of both worlds. AIG Financial Products did not diversify risk but, instead, concentrated and correlated risk. So we discovered that an under-capitalized and under-regulated unit of a huge financial services conglomerate could risk not only that entire enterprise but the many banks with which it did business, also. It was those risks of a broad market impact that made the government rescue of AIG necessary.

To prevent cascading damage to the economy, the government not only requires commercial banks and insurance companies to hold sufficient reserves to deliver on their guarantees. It also implicitly guarantees it will act to stop runs on commercial banks through the Federal Deposit Insurance Corp and on insurance companies through state resolution bureaus and guarantee funds. Through the financial supermarkets, the government's implicit and necessary guarantee to act to stop runs was effectively extended to risk-taking activities with insufficient reserves. Thus the risk-taking activities could both use high leverage to boost profits and also benefit – without paying the cost – from the protections of the guaranteed section of the company. If that is not moral hazard, what is?

Thanks to Gramm-Leach-Bliley financial supermarkets were allowed to grow “too big and too interconnected” to fail, putting policyholder and bank depositor money at direct or indirect risk. Instead of reducing risk, the new law created a new, systemic risk that could bring down an entire institution or the entire marketplace – and leave governments no choice but to intervene.

You also asked about the AIG securities lending program. It is important to understand that securities lending did not cause the crisis at AIG. AIG Financial Products did. If there had been no Financial Products unit and only the securities lending program as it was, we would not be here today. There would have been no federal rescue of AIG.

Financial Products' trillions of dollars of transactions created systemic risk. Securities lending did not.

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

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

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

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

As early as July 2006, the New York Department and other state regulators were engaged in discussions about the securities lending program with AIG. Those discussions at first related to the issue of risk-based capital and how the companies were reporting their securities lending program on their financial statements.

It was in the course of those discussions that we learned about the details of AIG's securities lending program.

AIG securities lending was consolidated by the holding company in a special unit it set up and controlled. This special unit was not a licensed insurance company. In theory, having the parent company operate securities lending centrally was not inappropriate. The insurance companies could have benefited from reduced operational costs, increased expertise and reduced risk from sharing any losses. That, of course, assumes a securities lending program that is run prudently. However, as with some other holding company activities, this unit pursued its securities lending program aggressively rather than prudently.

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



The program historically maintained sufficient liquidity to meet cash demands and the remaining funds were invested almost exclusively in the highest-rated securities. Even the few securities that were not rated at the top level of triple A, were either double A or single A. Today, with the perfect clarity of hindsight, we all know that those ratings were not aligned with the market value of many mortgage-backed securities, which made up 60 percent of the invested collateral pool.

In addition, there was a mismatch in maturity between the mortgage-backed securities and the short-term lending. As state regulators monitored the program, we became increasingly concerned about the market value and liquidity of the mortgage-backed securities and about the maturity mismatch. AIG officials did not agree with our concerns and continued to defend the choice of investments, even as they were winding down the program.

In 2007, because of those concerns and as the problems in the subprime mortgage market began to affect the price of the securities, state regulators began working with the company to start winding down the program. Unfortunately, the securities lending program could not be ended quickly because, beginning in 2007, some of the residential mortgage securities could not be sold for their full value. At that time there were still few if any defaults, the securities were still paying off. But selling them would have involved taking a loss.

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

Neither the NYSID nor any other state regulator issued a written directive to AIG to wind down the securities lending business. The lack of a directive is not unusual. First, regulators are usually able to ask for and obtain even substantial changes in insurers' behavior without having to make a formal, written demand. Insurers recognize that state regulators have substantial power and usually prefer to cooperate. Second, a written request that would be disclosable to the public asking a company to sell a large quantity of securities would alert others to the insurer's plans thus making sales more difficult and expensive. Also, in the case of securities lending, raising written (and thus public) questions about the program could cause counterparties to contractually end the loans (versus continuing to roll over the loans) and cause forced sales and losses. The state regulators were successfully working with AIG to expeditiously reduce the size of the program in an orderly manner to reduce losses without the complications of a written request.

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

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

There are two essential points about AIG and its securities lending program. First, without the crisis caused by Financial Products, there is no reason to believe there would have been a run on the securities lending program. We would have continued to work with AIG to unwind its program and any losses would have been manageable.

Second, even if there had been a run on the securities lending program with no federal rescue, our detailed analysis indicates that the AIG life insurance companies would have been solvent. Certainly, there would have been losses, with some companies hurt more than others. But we believe that there would have been sufficient assets in the companies and in the parent to maintain the solvency of all the companies. Indeed, before September 12, 2008, the parent company contributed slightly more than \$5 billion to the reduction of the securities lending program.

But that is an academic analysis. Whatever the problems at securities lending, they would not have caused the crisis that brought down AIG. And without Financial Products and the systemic risk its transactions created, there would have been no reason for the federal government to get involved. State regulators would have worked with the company to deal with the problem and protect policyholders.

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

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

On September 22, 2008, the Department sent a Section 308 letter to all life insurance companies licensed in New York requiring them to submit information relating to security lending programs, financing arrangements, security impairment issues and other liquidity issues. (Section 308 is the provision of the NYS Insurance Law that gives the Department the authority to request additional information between periodic examinations.) The New York Department staff then conducted a thorough investigation of the securities' lending programs at life insurance companies that were licensed in New York. The results were reassuring. Almost all of the companies had modest sized

programs with highly conservative investments, even by today's standards. Companies with larger programs had ample liquidity to meet redemptions under stress. What became clear was that AIG was in a uniquely troubling situation.

Through our chairmanship of the National Association of Insurance Commissioners Statutory Accounting Practices Working Group, we also successfully worked to have the NAIC adopt increased disclosure rules for securities lending programs.

You asked if AIG was able to take advantage of a regulatory gap by having its holding company operate its securities lending program. I believe the answer is no. It is true that the company was able to take inappropriate risks with the program. But there is no reason to believe that it could not have directed all its insurance companies to take similar risks if they were all operating their own programs.

The program was invested in triple-A rated securities, as required. State insurance regulators, like almost everyone else at the time, thought those ratings meant something.

The key point is that while state regulators did allow AIG to be too aggressive, we came to understand the problem through our normal regulatory activities and forced the company to change. Regulation, like all human activities is a process of learning. The state insurance departments have learned about the need to keep a much closer watch on securities lending and have set clear standards. And it is worth noting that it was only AIG that was using securities lending in such a risky manner. And, like everyone else, we have learned a hard lesson about the value of credit ratings, an issue the NAIC is still working to resolve.

Our involvement with AIG changed substantially on Friday, September 12, 2008. The immediate spark for the crisis was the sudden decision by the credit rating agencies to downgrade AIG without waiting to see the results of its restructuring only two weeks away. The downgrade would require AIG to post additional collateral against its credit default swaps and against its guaranteed investment contracts. AIG's initial estimates were that it would need about \$18 billion in cash to post collateral. While AIG had assets, including its insurance companies, worth many times this amount, the assets were not liquid and could not be used to solve the collateral problem. Thus it appeared initially that the company had a liquidity problem. That is, it was not short of capital, but it was short of cash because it could not turn most of its assets into cash quickly enough.

The Department received a call from two AIG senior executives informing us of the company's serious and immediate liquidity problem, and asking for assistance. We had conference calls with AIG leaders Saturday morning and then went over to their office for the remainder of the weekend to provide assistance and be in a position to expedite the consideration of any regulatory actions that might be needed to get through the crisis.

The Department worked with AIG to develop solutions, vet proposals and find transactions that would stabilize AIG while protecting policyholders. As a result, we

developed a proposal that the Governor announced on Monday, September 15. This plan would have allowed AIG to temporarily access about \$20 billion of excess surplus assets in its property/casualty insurance companies while fully protecting policyholders.

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

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

We were very carefully vetting the assets being purchased by the property insurance companies to ensure they were of high quality. We were also being careful to make sure that the amount of securities remaining in the companies was sufficient to pay all claims, meet statutory risk-based capital requirements and still have billions of dollars in extra surplus.

When it became clear that the company needed more money and that the original plan was not feasible, the Federal Reserve asked two banks to try to form a commercial bank group to raise the necessary funds. Eventually, it became clear that no commercial private sector rescue was possible. At that point, the Treasury and Federal Reserve proposed the \$85 billion bridge loan and our proposal was no longer needed.

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

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

policyholders by ensuring that insurance operations are purchased by stable, responsible entities capable of operating them successfully. And the Department will also ensure that the regulatory approval process is efficient and does not hold up transactions.

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

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

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

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

I would note that at a time when financial services firms are in trouble because they do not have adequate capital and are too highly leveraged, at a time when commercial banks and investment banks have very serious problems, insurance companies remain relatively strong. Clearly a lesson from this crisis is that all financial institutions should be required to hold sufficient capital and reserves to meet their promises.

Now, I would be happy to answer your questions.