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Testimony of Former Government worker for the FDIC and OTS, C.K. Lee, Before the FCIC

C.K. Lee

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Testimony of C.K. Lee
Before the
Financial Crisis Inquiry Commission
Washington, DC
July 1, 2010

Thank you, Mr. Chairman, for the invitation to appear 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 government, I served on Capitol Hill, at the Federal Deposit Insurance Corporation (FDIC), and at the Office of Thrift Supervision (OTS). I am appearing before the Commission at your invitation and in my capacity as a private citizen. My testimony and responses to your questions are my personal view of events that happened several years ago and are not OTS's official view on any matters of law, policy, or procedure. The most comprehensive explanation of OTS's holding company authority as it relates to AIG is available in the testimony OTS provided on May 26, 2010 to the Congressional Oversight Panel. I recommend that testimony to the Commission and ask that it, along with my letter accepting the Commission's invitation, be included in the record of today's hearing. I do appreciate, however, the opportunity to provide any insights I can offer to further your inquiry and report.

I joined OTS in mid-2004 to advise the agency on international affairs. From early 2006 until March of 2008, I was Managing Director for Complex and International Organizations (CIO). During that time, CIO had direct supervisory responsibility for AIG and other conglomerate holding companies supervised by OTS.

While I was serving as Managing Director, in early 2006, the CIO group was asked by OTS senior management to design a program specifically tailored to the supervision of large, complex savings and loan holding companies. Building on previous work by OTS staff in Washington and the Northeast Region of OTS, the CIO group developed specific examination processes and procedures tailored to complex firms (or conglomerates), performed examinations and targeted reviews of the conglomerates under its purview (GE, AIG and Ameriprise Financial), and developed relationships with domestic and international regulators who could provide insight into the operations of subsidiary entities for which we did not have primary supervisory responsibility.

OTS's conglomerate examinations were performed by career examiners and specialists who were on site at the firms' headquarters or other locations as necessary. OTS examiners occasionally joined regulatory colleagues outside OTS on specific reviews – including the UK FSA and France's Commission Bancaire. OTS's examination reports, per the OTS holding company handbook, were assessments of the overall

enterprise, and they were directed to the attention of the top-tier boards of directors. OTS examined the firms according to the framework provided by the OTS holding company program's CORE components – Capital, Organizational Structure, Relationship (later Risk Management), and Earnings. OTS reviewed financial data and material provided by the firms, conducted targeted reviews of subsidiaries, and collected information from the various functional regulators and other parties to substantiate the conclusions and ratings in its annual examination reports.

With respect to OTS's supervision of AIG, I cite and support the points made by OTS in its May 26, 2010 testimony. I emphasize the following:

- OTS's holding company authority over AIG existed because the company owned a thrift institution. OTS's approach was premised on preserving the safety and soundness of the subsidiary thrift and protecting the deposit insurance funds from problems that could arise at the parent.
- OTS's 'equivalency status' under the European Union's Financial Conglomerates Directive did not convey any additional authority or powers to OTS for supervising AIG. It simply clarified how the European operations of US firms would be treated under European law and provided definition to the relationships between regulators.
- In the 2006-2008 timeframe, OTS reports show increasing supervisory criticism of AIG's risk management, financial reporting and corporate governance – including criticism of the parent's oversight of the subsidiary AIG Financial Products (AIG FP). These criticisms culminated in a downgrade of the holding company's ratings and an enforcement action in the form of a Supervisory Letter in March, 2008.
- The subprime residential real estate exposure at AIG FP resulted from credit default swap products originated largely in the 2003-2005 time period, and was a key focus of OTS's examination work during 2007 and 2008. The derivatives at AIG FP were not regulated, nor were they subject to any standardized reporting framework. This lack of transparency was an obstacle to the effective oversight of this business by AIG.
- In 2007, OTS recommended the company revisit its modeling assumptions in light of deteriorating subprime market conditions. AIG relied too heavily, in our view, on models. Shortcomings in the modeling of credit default products camouflaged the true extent of the risk. AIG's models used market derived assumptions that were generally acceptable to the rating agencies and the company's external auditor. Nonetheless, as was the case across the financial sector, these models were woefully inadequate at forecasting the scenario AIG eventually faced.
- The risk management policies and procedures AIG 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.
- OTS's March, 2008, enforcement action cited, among other things, deficiencies in AIG's risk management program that led to AIG FP effectively limiting the parent company's access to the bad news emanating from the troubled subsidiary. In addition to downgrading the firm, OTS directed AIG to correct all control weaknesses and improve corporate oversight of subsidiaries like AIG FP.

- AIG failed because it could not meet its obligations to counterparties. For its liquidity planning, AIG relied on faulty assumptions about available liquidity from the markets and firm's own insurance operations. This liquidity was either nonexistent or not available when needed and this miscalculation had catastrophic consequences for the firm in September, 2008.
- We are arguably here because of the extraordinary taxpayer assistance provided to AIG in September, 2008. Before that time, AIG enjoyed no explicit or implicit taxpayer guarantee. To the extent there were disputes regarding derivatives contracts, I understood these parties and counterparties – Goldman Sachs and JP Morgan, among others – were sophisticated financial operators. If it came to that, any disputes would be handled in the relevant courts of jurisdiction through long-established process.

Shortly following the issuance of the Supervisory Letter, on March 10, 2008, I sought and accepted a position as regional director with OTS in Dallas. My involvement with AIG ended at that time.

There are many lessons policymakers, regulators and market participants can learn from the collapse of AIG. Some of these issues are addressed in the Dodd/Frank financial legislation pending in Congress. I offer the following for the Commission to consider:

- Regulators, when given responsibility for supervising large firms, must have the procedures and resources in place to fully meet these responsibilities.
- Derivatives products must be regulated and transparent in order to ensure regulators, market participants and firms themselves can better recognize 'stealth' concentrations – like the exposure to housing that built up on AIG's balance sheet via derivatives and other instruments – across the regulated entities.
- Firms and regulators must end their excessive reliance on rating agencies. Outsourcing due-diligence to third parties undermines market discipline and companies can be seduced into inaction by the false comfort of high ratings. These ratings can change, however, and by building ratings triggers into the swaps contracts at AIG FP, for example, the company essentially handed its liquidity situation to a third party.
- Regulators must develop resources to challenge firms' modeling of exposures and potential liquidity demands. Credit risk modeling must be explicitly recognized as simply a tool and by no means a determinative presentation of a company's true risk.
- Regulators must understand that capital and earnings, however important, are of virtually no assistance to a firm caught in a full-blown liquidity crisis. Bolstering the liquidity framework – particularly understanding and reducing firms' exposure to catastrophic counterparty demands – is already a priority of both domestic and international regulators, not to mention the firms remaining in the marketplace.
- Notwithstanding the corrosive impact of what happened in late-2008, taxpayer guarantees should be explicit and enumerated beforehand. Firms without a public guarantee should fail through an orderly and unsubsidized process. Public money should not underwrite private risk.
- Finally, in the run up to AIG's crisis, nearly every instrument of national policy was directed at enhancing the value of a single asset: housing. AIG was not alone in attempting to capitalize on

what was, by near consensus, an important national goal. The unintended consequences of this policy have been profound and prolonged.

Thank you again for the opportunity to appear today and share my experience. I look forward to your questions.