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Statement of

Michael E. Finn
Northeast Region Director, Office of Thrift Supervision

regarding

American International Group

before the

Congressional Oversight Panel

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I. Introduction

Chair Warren and members of the Congressional Oversight Panel, thank you for the opportunity to testify today on OTS supervision of American International Group, or AIG.

I am Michael Finn, Regional Director of the OTS Northeast Region. From January 2004 to August 2004, I served as OTS Assistant Managing Director in Washington, D.C., for the newly formed Complex and International Organizations (CIO) unit with responsibility for developing programs for coordinating the supervision of internationally active OTS-regulated holding companies subject to the European Union's Conglomerate Directive, including AIG. The CIO unit continued to manage the supervision of AIG from Washington after my departure until July 2008, when responsibility for CIO was transferred to the OTS Northeast Region, where I was serving as Regional Director. My responsibility for AIG supervision ended two months later, when the federal government invested in AIG in September 2008. The Northeast Region continues to supervise AIG's thrift subsidiary, AIG Federal Savings Bank (AIG FSB), which has $1.1 billion in total assets.

In my testimony today, I will discuss the legislative history of OTS supervision of savings and loan holding companies (SLHCs), the OTS program for supervising holding companies, the history of AIG, OTS supervision of AIG and OTS recommendations for holding company regulation in the future.

Before I begin that discussion, I would like to clarify four points about AIG's collapse.

First, AIG Financial Products, or AIGFP – the subsidiary of AIG that originated the credit default swaps (DCS) that were central to AIG's problems – was operating long before the OTS became AIG's holding company supervisor in 2000.

Second, credit default swaps were, and continue to be, unregulated and lacking in transparency, although Congress is considering proposals to require regulation of such derivative products and to improve transparency.

Third, AIG Financial Products never had business dealings with the OTS-regulated AIG FSB and had no relation to it beyond sharing the same corporate parent.

Fourth, the legal framework for OTS authority to regulate holding companies was not primarily designed to protect holding companies from problems, but to ensure the safety and soundness of the underlying thrift institutions, to assess the impact of the holding company activities on the thrift and to prevent holding company actions from harming the thrift and its depositors. Although a consensus has developed that the United States needs a systemic risk regulator to assess the impact of systemically important and interrelated companies on the economy, the OTS has never had that authority or those aspirations. That supervisory authority will not exist unless Congress establishes it. The OTS strongly supports proposals in Congress to establish a systemic risk regulator.

II. Legislative History

The statutory approach to savings and loan holding companies has always been premised on preserving the safety and soundness of the subsidiary thrift. Congress passed the first SLHC legislation, known as the Spence Act, in 1959.[1] Although largely

[1] Pub. L. 86-374, 73 Stat. 691 (1959).

intended as “stopgap legislation,” the Spence Act contained provisions prohibiting savings associations from investing in, or in any way having an interest in, the securities of the holding company or its subsidiaries.[2] Similarly, savings associations were prohibited from extending credit to their holding companies or their subsidiaries.[3]

Seven years after enactment of the Spence Act, Congress revisited SLHC regulation by enacting the Savings and Loan Holding Company Amendments of 1967[4], which came to be known as the Savings and Loan Holding Company Act (SLHCA).[5] Unlike the Spence Act, which was limited in its scope, the SLHCA provided a comprehensive statutory framework for the registration, examination and regulation of SLHCs. Among other things, this comprehensive law was designed to preserve the safety and soundness of the subsidiary thrift by protecting holding company subsidiary institutions from overreaching by affiliates in a holding company structure. In the Senate Banking Committee hearings for this legislation, Federal Home Loan Bank Board Chairman Horne noted that with most business enterprises, there is no public concern how a parent company chooses to use its subsidiary, “[b]ut when one of those subsidiaries has the bulk of its liabilities in the form of savings entrusted to it by the public and when those liabilities are insured by a public agency, then there is a very strong reason for public concern over the purposes which that company is made to serve and over dealings of any sort that are not conducted at arm’s length.”[6]

Congress next amended the SLHCA as part of the Competitive Equality Banking Act of 1987 (CEBA).[7] The amendments did not alter the fundamental purpose of the SLHCA—to protect the safety and soundness of the subsidiary thrift.

Two years after the enactment of CEBA, Congress again amended the SLHCA as part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989

[2] *Id.*
[3] *Id.*
[4] Pub. L. 90-225 (1968).
[5] The SLHCA is now section 10 of the Home Owners’ Loan Act. 12 U.S.C. 1467a.
[6] Savings and Loan Holding Companies: Hearings on S. 1542 Before the Senate Committee on Banking and Currency,” 90th Cong., 1st Sess. at 27 (1967) (Statement of John E. Horne).
[7] Pub. L. 100-86, 100 Stat. 552 (1987).

(FIRREA).[8] The FIRREA amendments were premised on preserving the safety and soundness of the subsidiary institution. For example, FIRREA provided the OTS with an expedited enforcement remedy against holding companies whose activities endangered the financial stability or safety and soundness of their subsidiary thrift.[9] Savings institutions were generally made subject to Sections 23A, 23B and 22(h) of the Federal Reserve Act, in the same manner and to the same extent as those sections apply to Federal Reserve member banks.[10]

Ten years after FIRREA, Congress passed the Gramm-Leach-Bliley Act of 1999 (GLBA).[11] The GLBA facilitates affiliations among banks, securities firms and insurance companies. So long as certain conditions are met, a bank holding company can qualify as a financial company and engage in a wide variety of services that are financial in nature.[12]

In the GLBA, Congress instituted special provisions with respect to the OTS and the Board of Governors of the Federal Reserve System (Board) supervision of functionally regulated subsidiaries of holding companies, such as insurance companies. Generally, these provisions require coordination with the functional regulator and require the OTS and the Board to predicate certain actions on the safety and soundness of the subsidiary depository institution. The GLBA also amended the SLHCA to prohibit new unitary SLHCs from engaging in nonfinancial activities or affiliating with nonfinancial organizations.[13] Existing unitary holding companies were "grandfathered." The restrictions, however, continued to allow financial activities to be conducted by the savings and loan holding company, to the same extent as a bank holding company, including insurance activities.

[8] Pub. L. 100-73, 103 Stat. 183 (1989).
[9] 12 U.S.C. 1467a(p)(1).
[10] 12 U.S.C. 1468
[11] Pub. L. 106-102, 113 Stat. 1338.
[12] 12 U.S.C. 1843(l)(1).
[13] *Id.* at § 401.

III. OTS Holding Company Supervision Program

AIG's chief line of business was insurance. The range of other OTS-supervised holding companies is diverse, including some large publicly held insurance companies, large and small mutual insurance companies, privately held companies and fraternal organizations. Collectively, these holding companies own insurance subsidiaries in almost every state, offering insurance and banking products to U.S. consumers. Some have insurance operations in foreign countries as well. These holding companies provide products across the sectors of the insurance industry, including life insurance, annuities, title and property and casualty insurance for consumers and businesses of all sizes. Along with their savings association subsidiaries, these holding companies are able to offer a full range of financial products.

OTS also regulates approximately 39 other holding companies that engage in insurance activities to a lesser degree, but are not considered predominantly insurance companies.

Once a company acquires or charters a thrift institution, as a SLHC it is subject to regulatory examination and monitoring by the OTS. As the primary federal regulator of savings and loan insurance holding companies, the OTS has the authority to examine each holding company, including its subsidiaries, subject to certain obligations under the GLBA to coordinate with the functional regulator[14]. We commonly refer to this overall entity as the holding company enterprise. In its examination and supervision of the enterprise, OTS uses a risk-focused approach that considers the combined risk profile of the holding company, its financial health and stability, and the interdependence of entities within the structure.

The primary objective of a risk-focused examination of a holding company predominantly engaged in insurance activities is to identify and examine the areas of the business that pose the greatest degree of risk to the condition of the overall enterprise and

[14] Pub.L. 106-102, 113 Stat. 1338.

to the thrift. The initial scope of the examination targets the areas that have higher than normal risk characteristics. Employing this approach requires examiners to use judgment in determining the level of review, testing and analysis necessary to assess the condition of the enterprise. Accordingly, the scope of each examination is specifically tailored to the risk associated with the enterprise and it is determined on a case-by-case basis. It may also change from year-to-year as the OTS sets different areas for targeted review.

The examination goal is consistent across all types of holding company enterprises; however, the level of review and amount of resources needed to assess a complex structure, such as a holding company engaged in extensive insurance activities, is far greater than what would be required for a less complex holding company.

Coordination with Other Regulators

Consultation with other regulators is essential to OTS's supervision of SLHCs. OTS seeks to achieve the legislative goal of reducing duplication by sharing information and working closely with other state and federal regulators. In conducting its review of an insurance holding company enterprise, the OTS relies on state insurance regulators and foreign regulators for information and findings regarding the entity for which they are functionally responsible. To limit regulatory duplication, the OTS has entered into regulatory cooperation agreements with all but two state insurance regulators, as well as other jurisdictions overseas.

As a first source, OTS examiners use readily available information about an insurance company in the holding company enterprise by obtaining and reviewing reports the company submits to its primary regulator, information that it reports publicly and externally audited financial statements.

OTS may also request examination information directly from the company if the insurance regulator cannot provide it. It is important to note that OTS may only seek information directly from the company if that information meets certain conditions. Specifically, the information can only be requested if it is needed to assess: (1) a material risk to a thrift or holding company; (2) compliance with a federal law that OTS has specific authority to enforce against the functionally-regulated entity, or (3) the systems for monitoring and controlling the financial and operational risks that may threaten the safety and soundness of a thrift.

Examination Components

Examination of holding companies is an important part of OTS's supervisory program. OTS examiners assess the condition of the holding company enterprise and help ensure that the operations of the holding company do not harm the thrift affiliate.

In carrying out its regulatory function regarding holding companies, the OTS evaluates four components, collectively known by the acronym "CORE."

The "C" in the CORE rating stands for "Capital." In its review of a SLHC's capital adequacy, the OTS considers the risk inherent in the enterprise's activities and the ability of capital to absorb unanticipated losses, support the level and composition of debt of the parent company and subsidiaries, and support business plans and strategies.

"O" is for "Organizational Structure." This component involves identifying the organizational structure and ownership, and assessing any changes. This part of the examination also includes an assessment of: (1) lines of business and activities, and the inherent risks they pose; (2) concentrations of risk; and (3) the nature and volume of intra-group transactions and significant intercompany relationships.

"R" represents "Risk Management," which involves the ability of the board and executive management to identify, measure, monitor and control risk within the holding company enterprise. Managing risk is fundamental to the success of any business venture. OTS expects holding companies to have adequate risk management practices, including strong corporate governance and a system of internal controls. Such risk management practices should be commensurate with the size and complexity of the holding company enterprise.

“E” represents “Earnings/Liquidity,” which involves the overall financial performance of the consolidated holding company enterprise, including the quality of consolidated earnings, profitability and liquidity. This includes the holding company’s earnings trends and cash flow, as well as the relative contributions and dividend payout ratios of significant subsidiaries, and the current and prospective effects on subsidiaries, including the thrift.

Once OTS examiners have completed their review of the CORE components, they develop a composite rating, which is the overall assessment of the holding company enterprise, as reflected by consolidated risk management and consolidated financial strength. Examiners exercise judgment in determining the relative importance of each CORE component to the safe and sound operation of the holding company.

IV. History of AIG

AIG is a large international conglomerate that operates in 130 countries worldwide. As of year-end 2007 – the last full year before the federal government’s investment in AIG – the combined assets of the AIG group were $1 trillion. The AIG group’s primary business is insurance. AIG’s core business segments fall under four general categories (*e.g.*, General Insurance, Life Insurance and Retirement Services, Financial Services and Asset Management)**.** AIG’s core business of insurance is functionally regulated by U.S. state regulators, with the lead role assumed by the New York and Pennsylvania departments of insurance, and by foreign regulators throughout the 130 countries in which AIG operates.

It is important to note that AIG’s crisis was caused by liquidity problems, not capital inadequacy. AIG’s liquidity was impaired as a result of two of AIG’s business lines: (1) AIGFP’s “super senior” credit default swaps associated with collateralized debt obligations (CDO), backed primarily by U.S. subprime mortgage securities and (2) AIG’s securities lending commitments. Although much of AIG’s liquidity problems were the result of the collateral call requirements on the CDS transactions, the cash requirements of the company's securities lending program also were a significant factor.

AIG's securities lending activities began prior to 2000. Its securities lending portfolio is owned pro-rata by its participating, regulated insurance companies. At its highest point, the portfolio's $90 billion in assets comprised approximately nine percent of the group's total assets. AIG Securities Lending Corp. (AIG SLC), a registered broker-dealer in the U.S., managed the much larger, domestic piece of the securities lending program as agent for the insurance companies in accordance with investment agreements approved by the insurance companies and their functional regulators.

The securities lending program was designed to provide the opportunity to earn an incremental yield on the securities housed in the investment portfolios of AIG's insurance entities. These entities, through AIG SLC, loaned their securities to various third parties, in return for cash collateral, most of which AIG was obligated to repay or roll over every two weeks, on average. While a typical securities lending program reinvests its cash in short duration investments, such as treasuries and commercial paper, AIG's insurance entities invested much of their cash collateral in AAA-rated residential mortgage-backed securities with longer durations.

Similar to the declines in market value of AIGFP's credit default swaps, AIG's residential mortgage-backed security investments declined sharply with the turmoil in the housing and mortgage markets. Eventually, this created a tremendous shortfall in the program's assets relative to its liabilities. Requirements by the securities lending program's counterparties to meet margin requirements and return the cash AIG had received as collateral then placed tremendous stress on AIG's liquidity.

AIGFP had been in operation since the early 1990s and operated independently from AIG's regulated insurance entities and insured depository institution. AIGFP's

$100 billion in assets comprised approximately 10 percent of the AIG group's total assets of $1 trillion.

AIGFP's CDS portfolio was largely originated in the 2003-to-2005 period and was facilitated by AIG's full and unconditional guarantee (extended to all AIGFP transactions since its creation), which enabled AIGFP to assume the AIG parent's AAA rating for market transactions and counterparty negotiations.

AIGFP's CDS provided credit protection to counterparties on designated portfolios of loans or debt securities. AIGFP provided such credit protection on a ''second loss'' basis, under which it repeatedly reported and disclosed that its payment obligations would arise only after credit losses in the designated portfolio exceeded a specified threshold amount or level of ''first losses.'' Also known as "super senior," AIGFP provided protection on the layer of credit risk senior to the AAA risk layer. The AIGFP CDS were considered to be on the safest portion of the security from a credit perspective.

AIGFP made an internal decision to stop origination of these derivatives in December 2005, based on the company's general observation that mortgage underwriting standards were declining for loans packaged for securitization. At this time, however, AIGFP already had $80 billion of CDS obligations and commitments. The housing market began to unravel starting with subprime defaults in 2007, triggering a chain of events that eventually led to government intervention in AIG.

V. OTS Supervision of AIG

The OTS granted a federal savings bank charter to AIG in 1999, and the bank opened for business in 2000. The OTS continues to be the primary federal regulator for the $1.1 billion insured depository institution – AIG FSB – and the OTS was the consolidated regulator for the savings and loan holding company. In January 2007, the OTS was informed that its holding company supervision was deemed to have "equivalency status" by the Coordinator under the European Union's Financial Conglomerates Directive. It is important to point out that this designation bestowed no additional authority or powers on the OTS for supervising AIG. Any limitations on existing authority and power in U.S. law continued to prevail.

On September 16, 2008, the Federal Reserve Bank of New York extended an $85 billion loan to AIG and the government took an 80 percent ownership stake in AIG. On the closure of this transaction, the OTS no longer supervised the AIG holding company because by operation of law, AIG was no longer a savings and loan holding company, as defined by federal statute.

OTS supervision of the AIG holding company included annual examinations of the holding company, targeted reviews of its subsidiaries, reports on the findings of those supervisory activities and follow-up with AIG's management and Board of Directors to address OTS concerns cited in the reports.

OTS actions show increasing supervisory criticism of AIG's risk management, financial reporting and corporate governance, including its oversight of AIGFP. The criticisms culminated in a Supervisory Letter in March 2008 that downgraded AIG's holding company rating.

A key element of OTS's role as AIG's consolidated regulator was to coordinate with the company's other regulators in the U.S. and abroad. Approximately 85 percent of AIG, as measured by allocated capital, was contained within entities regulated or licensed by other supervisors.

A multitude of regulators in more than 100 countries were involved in supervising pieces of the AIG corporate family. The OTS established relationships with the most relevant regulators for AIG, executed information sharing agreements where appropriate, and requested regulators' assessments and concerns for the segment of the organization that each one regulated.

In 2006, the OTS began to convene annual supervisory college meetings with foreign supervisory agencies and U.S. state insurance regulators. During the part of the meetings devoted to presentations from the company, supervisors had opportunities to question the company about supervisory concerns and risk issues. Another part of the meeting contained a "supervisors-only" session, providing a venue for participants to ask questions of each other and to discuss issues of common concern regarding AIG. Also during the college meetings, the OTS arranged one-on-one side meetings with foreign regulators for in-depth discussions about significant risks in their home jurisdictions.

Beginning in 2004, the OTS conducted several targeted, risk-focused reviews of various lines of business at AIG, including AIGFP, and made numerous recommendations to AIG's senior management and the Board of Directors with respect to risk management oversight, financial reporting transparency and corporate governance. The findings, recommendations and corrective action points of the 2005 examination were communicated in a report to the AIG Board in March 2006. With respect to AIGFP, OTS identified and reported to AIG's board weaknesses in AIGFP's documentation of complex structures transactions, in policies and procedures regarding accounting, in stress testing, in communication of risk tolerances, and in the company's outline of lines of authority, credit risk management and measurement.

Following another targeted review of AIGFP in early 2007, OTS recommended that the company revisit its financial modeling assumptions in light of deteriorating sub-prime market conditions. AIG relied too heavily on such models and shortcomings in modeling of credit default swap products camouflaged some of their risk. Until June 2007, the results of the AIGFP models indicated that the risk of loss was a remote possibility, even under worst-case scenarios. The model used market-derived assumptions that were generally acceptable to the rating agencies, AIG and its external auditor.

As previously discussed, the OTS's primary focus regarding AIG was on AIG's thrift institution, AIG Federal Savings Bank. OTS took a formal enforcement action against AIG FSB in June 2007 in the form of a Supervisory Agreement for its failure to manage and effectively control loan origination services outsourced to its affiliate, Wilmington Finance, Inc. The Agreement required AIG FSB to identify and provide remedies for borrowers who were at risk of losing their homes because of the thrift's loan origination and lending practices. OTS also required AIG to establish a $128 million reserve to cover costs associated with providing affordable loans to borrowers and to reimburse borrowers who had paid excessive loan origination fees.

In September 2008, when problems at the AIG holding company were mounting, the OTS took action to ensure that depositors at the federal savings bank and the federal deposit insurance fund were not placed at risk. The OTS precluded AIG FSB from engaging in transactions with affiliates without OTS knowledge and lack of objection; restricted capital distributions; required maintenance of minimum liquidity and borrowing capacity sensitive to the unfolding situation; and required retention of counsel to advise the board in matters involving corporate reorganization and related risks.

Approximately six months after OTS's March 2008 downgrade of AIG's examination rating, the credit rating agencies also downgraded AIG on September 15, 2008. That precipitated calls that required AIGFP to post significant amounts of collateral for which it had insufficient funds or borrowing capacity. The holding company capital was frozen and AIGFP could not meet the calls.

VI. Recommendations

Based on lessons learned from the collapse of AIG and the broader financial crisis, the OTS has three recommendations for regulatory reform.

Systemic Risk Regulator

The OTS strongly endorses efforts by Congress to establish a single systemic risk regulator with broad authority, including regular monitoring, over companies that if, due to the size or interconnected nature of their activities, their actions, or their failure would pose a risk to the financial stability of the country. Such a regulator should be able to access funds, which would present options for the orderly resolution of problems at these institutions. The systemic risk regulator should have the ability and the responsibility for monitoring all data about markets and companies, including but not limited to companies involved in banking, securities and insurance.

Regulation of Credit Default Swaps

Credit default swaps are financial products that are not regulated by any authority. Without a prudential derivatives regulator, standard market regulation or central clearinghouse, these products lack transparency and pose serious challenges and risks. The OTS strongly supports efforts to regulate CDS.

We have also learned there is a need for consistency and transparency in CDS contracts. The complexity of CDS contracts masked risks and weaknesses in the program that led to one type of CDS performing extremely poorly. The current regulatory means of measuring off-balance sheet risks do not fully capture the inherent risks of CDS. The OTS believes standardization of CDS would provide more transparency to market participants and regulators.

Supervision of Holding Companies Predominantly Engaged in Insurance

The OTS recommends that Congress enhance the consolidated supervision of holding companies that are predominantly engaged in insurance activities. Such a holding company should be supervised by a federal regulator that concentrates on the core activity and related risks in the primary business of the enterprise. We think it is prudent to align the regulatory authority with the holding company enterprise's primary activities.

The authority to supervise such a consolidated holding company could be housed within a federal insurance regulator, if Congress chose to create one. We believe that, at a minimum, a federal consolidated regulator should be established for holding companies predominantly engaged in insurance activities.

A fundamental requirement for prudent risk management of a holding company is effective oversight and enforcement authority over the entire organization. A holding company regulator should have authority to monitor and exercise full enforcement authority over non-functionally regulated affiliates and to implement information-sharing arrangements between entities in the holding company structure and their functional regulators. The regulator should have the authority to impose capital requirements, restrict activities and otherwise regulate the operations of the holding company and the non-functionally regulated affiliates.

VII. Closing

Thank you again for the opportunity to share OTS's recommendations for a stronger framework for systemic risk regulation, derivative products and insurance holding company supervision. We look forward to working with you on these important issues in the future. I am happy to respond to your questions.