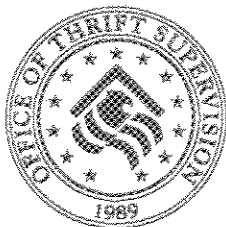


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Statement of

Scott M. Polakoff
Acting Director, Office of Thrift Supervision

regarding

**American International Group:
Examining what went wrong, government intervention, and
implications for future regulation**

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

March 5, 2009

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I. Introduction

Good morning, Chairman Dodd, Ranking Member Shelby and members of the Committee. Thank you for inviting me to testify regarding the Office of Thrift Supervision's (OTS) examination and supervisory program and its oversight of American International Group, Inc. (AIG). I appreciate the opportunity to familiarize the Committee with the complex, international operations of AIG as well as the steps the OTS took to oversee the company.

At the Committee's request, in my testimony today, I will discuss the complicated set of circumstances that led to the government intervention in AIG. I will provide details on our role as the consolidated supervisor of AIG, the nature and extent of AIG's operations, the risk exposure that it accepted, and the excessive concentration by one of its companies in particularly intricate, new, and unregulated financial instruments. I will also outline the Agency's supervisory and enforcement activities.

I will describe some lessons learned from the rise and fall of AIG, and offer my opinion, in hindsight, on what we might have done differently. Finally, I will outline some needed changes that could prevent similar financial companies from repeating

AIG's errors in managing its risk, as well as actions Congress might consider in the realm of regulatory reform.

II. History of AIG

AIG is a huge international conglomerate that operates in 130 countries worldwide. As of year-end 2007, 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 various 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.

My testimony will focus primarily on AIG, the holding company, and AIG Financial Products (AIGFP). Many of the initial problems in the AIG group were centered in AIGFP and AIG's Securities Lending Business.

It is critically 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 (CDS) associated with collateralized debt obligations (CDO), backed primarily by U.S. subprime mortgage securities and (2) AIG's securities lending commitments. While 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., 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 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 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 1990's and operated independently from AIG's regulated insurance entities and insured depository institution. AIGFP's

\$100 billion in assets comprises 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 AAA rating for market transactions and counterparty negotiations.

AIGFP's CDS provide 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 on the safest portion of the security from a credit perspective. In fact, even today, there have not been credit losses on the AAA risk layer.

AIGFP made an internal decision to stop origination of these derivatives in December 2005 based on their general observation that underwriting standards for mortgages backing securities were declining. At this time, however, AIGFP already had \$80 billion of CDS 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.

III. OTS's Supervisory Role and Actions

Supervisory Responsibilities

Mr. Chairman, I would like next to provide an overview of OTS' responsibilities in supervising a savings and loan holding company (SLHC). In doing so, I will describe many of the criticisms and corrective actions OTS directed to AIG management and its board of directors, especially after the most recent examinations conducted in 2005, 2006 and 2007.

As you will see, our actions reveal a progressive level of severity in our supervisory criticism of AIG's corporate governance. OTS criticisms addressed AIG's risk management, corporate oversight, and financial reporting, culminating in the Supervisory Letter issued by OTS in March 2008, which downgraded AIG's examination rating.

You will also see that where OTS fell short, as did others, was in the failure to recognize in time the extent of the liquidity risk to AIG of the "super senior" credit default swaps in AIGFP's portfolio. In hindsight, we focused too narrowly on the perceived creditworthiness of the underlying securities and did not sufficiently assess the susceptibility of highly illiquid, complex instruments (both CDS and CDOs) to downgrades in the ratings of the company or the underlying securities, and to declines in the market value of the securities. No one predicted, including OTS, the amount of funds that would be required to meet collateral calls and cash demands on the credit default swap transactions. In retrospect, if we had identified the absolute magnitude of AIGFP's CDS exposures as a liquidity risk, we could have requested that AIGFP reduce its exposure to this concentration.

OTS' interaction with AIG began in 1999 when the conglomerate applied to form a federal savings bank (FSB). AIG received approval in 2000, and the AIG FSB commenced operations on May 15, 2000. OTS is the consolidated supervisor of AIG, which is a savings and loan holding company by virtue of its ownership of AIG Federal Savings Bank.

OTS supervises savings associations and their holding companies to maintain their safety, soundness, and compliance with consumer laws, and to encourage a competitive industry that meets America's financial services needs. As the primary federal regulator of savings and loan holding companies, OTS has the authority to supervise and examine each holding company enterprise, but relies on the specific functional regulators for information and findings regarding the specific entity for which the functional regulator is responsible.

Once created, a holding company is subject to ongoing monitoring and examination. Managerial resources, financial resources and future prospects continue to be evaluated through the CORE holding company examination components (*i.e.*, Capital, Organizational Structure, Risk Management and Earnings). The OTS holding company examination assesses capital and earnings in relation to the unique organizational structure and risk profile of each holding company. During OTS's review of capital adequacy, OTS considers the risk inherent in an enterprise's activities and the ability of the enterprise's capital to absorb unanticipated losses, support the level and composition of the parent company's and subsidiaries' debt, and support business plans and strategies.

The focus of this authority is the consolidated health and stability of the holding company enterprise and its effect on the subsidiary savings association. OTS oversees the enterprise to identify systemic issues or weaknesses, as well as ensure compliance with regulations that govern permissible activities and transactions. 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 AIG's is vastly deeper and more resource-intensive than what would be required for a less complex holding company.

OTS Supervisory Actions

OTS's approach to holding company supervision has continually evolved to address new developments in the financial services industry and supervisory best practices. At the time AIG became a savings and loan holding company in 2000, OTS focused primarily on the impact of the holding company enterprise on the subsidiary savings association. With the passage of Gramm-Leach Bliley, not long before AIG became a savings and loan holding company, OTS recognized that large corporate enterprises, made up of a number of different companies or legal entities, were changing the way such enterprises operated and would need to be supervised. These companies, commonly called conglomerates, began operating differently from traditional holding companies and in a more integrated fashion, requiring a more enterprise-wide review of their operations. In short, these companies shifted from managing along legal entity lines to managing along functional lines.

Consistent with changing business practices and how conglomerates then were managed, in late 2003 OTS embraced a more enterprise-wide approach to supervising conglomerates. This shift aligned well with core supervisory principles adopted by the Basel Committee and with requirements adopted by European Union (EU) regulators that took effect in 2005, which required supplemental regulatory supervision at the conglomerate level. OTS was recognized as an equivalent regulator for the purposes of AIG consolidated supervision within the EU, a process that was finalized with a determination of equivalence by the French regulator, Commission Bancaire.

Under OTS's approach of classifying holding companies by complexity, as well as the EU's definition of a financial conglomerate, AIG was supervised, and assessed, as a conglomerate. OTS exercises its supervisory responsibilities with respect to complex holding companies by communicating with other functional regulators and supervisors who share jurisdiction over portions of these entities and through our own set of specialized procedures. With respect to communication, OTS is committed to the framework of functional supervision Congress established in Gramm-Leach Bliley. Under Gramm-Leach Bliley, the consolidated supervisors are required to consult on an ongoing basis with other functional regulators to ensure those findings and competencies are appropriately integrated into our own assessment of the consolidated enterprise and, by extension, the insured depository institution we regulate.

Consistent with this commitment and as part of its comprehensive, consolidated supervisory program for AIG, OTS began in 2005 to convene annual supervisory college meetings. Key foreign supervisory agencies, as well as U.S. state insurance regulators, participated in these conferences. During the part of the meetings devoted to presentations from the company, supervisors have an opportunity to question the company about any supervisory or risk issues. Approximately 85 percent of AIG, as measured by allocated capital, is contained within entities regulated or licensed by other supervisors. Another part of the meeting includes a "supervisors-only" session, which provides a venue for participants to ask questions of each other and to discuss issues of common concern regarding AIG. OTS also uses the occasion of the college meetings to arrange one-on-one side meetings with foreign regulators to discuss in more depth significant risk in their home jurisdictions.

As OTS began its early supervision of AIG as a conglomerate, our first step was to better understand its organizational structure and to identify the interested regulators throughout the world. In this regard, AIG had a multitude of regulators in over 100

countries involved in supervising pieces of the AIG corporate family. OTS established relationships with these regulators, executed information sharing agreements where appropriate, and obtained these regulators' assessments and concerns for the segment of the organization regulated.

As OTS gained experience supervising AIG and other conglomerates, we recognized that a dedicated examination team and continuous onsite presence was essential to overseeing the dynamic and often fast paced changes that occur in these complex structures. In 2006, OTS formally adopted a risk-focused continuous supervision program for the oversight of large and complex holding companies. This program combines on- and off-site planning, monitoring, communication, and analysis into an ongoing examination process. OTS's continuous supervision and examination program comprises development and maintenance of a comprehensive risk assessment, which consists of: an annual supervisory plan; risk-focused targeted reviews; coordination with other domestic and foreign regulators; an annual examination process and reporting framework; routine management meetings; and an annual board of directors meeting.

OTS conducted continuous consolidated supervision of the AIG group, including an on-site examination team at AIG headquarters in New York. Through frequent, ongoing dialogue with company management, OTS maintained a contemporaneous understanding of all material parts of the AIG group, including their domestic and cross-border operations.

OTS's primary point of contact with the holding company was through AIG departments that dealt with corporate control functions, such as Enterprise Risk Management (ERM), Internal Audit, Legal/Compliance, Comptroller, and Treasury. OTS held monthly meetings with AIG's Regulatory and Compliance Group, Internal

Audit Director and external auditors. In addition, OTS held quarterly meetings with the Chief Risk Officer, the Treasury Group and senior management, and annually with the board of directors. OTS reviewed and monitored risk concentrations, intra-group transactions, and consolidated capital at AIG, and also directed corrective actions against AIG's Enterprise Risk Management. OTS also met regularly with Price Waterhouse Coopers (PwC), the company's independent auditor.

Key to the continuous supervision process is the risk assessment, resulting supervisory plan, and targeted areas of review for each year. OTS focused on the corporate governance, risk management, and internal control centers within the company and completed targeted reviews of non-functionally regulated affiliates within the holding company structure.

In 2005, OTS conducted several targeted, risk-focused reviews of various lines of business, including AIGFP, and made numerous recommendations to AIG senior management and the board 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.

Our report of examination also identified weaknesses related to American General Finance (AGF), another non-functionally regulated subsidiary in the AIG family that is a major provider of consumer finance products in the U.S. These weakness included

deficiencies regarding accounting for repurchased loans, evaluation of the allowance for loan losses, Credit Strategy Policy Committee reporting, information system data fields, and failure to forward copies of state examination reports and management response to the Internal Audit Division.

The examination report also noted weaknesses in AIG's management and internal relationships, especially with the Corporate Legal Compliance Group and the Internal Audit Division, as well as its anti-money laundering program

In 2006 OTS noted nominal progress on implementing corrective measures on the weaknesses noted in the prior examination; however, the Agency identified additional weaknesses requiring the board of directors to take corrective action. Most notably, OTS required the board to establish timely and accurate accounting and reconciliation processes, enhance and validate business line capital models, address compliance-related matters, adopt mortgage loan industry best practices, and assess the adequacy of its fraud detection and remediation processes.

During 2007, when there were signs of deterioration in the U.S. mortgage finance markets, OTS increased surveillance of AGF and AIGFP. OTS selected AGF for review because of its significant size and scope of consumer operations, and to follow-up on the problems noted in prior examinations.

OTS also has supervisory responsibility for AIG Federal Savings Bank. OTS took action against AIG FSB in June, 2007, in the form of a Supervisory Agreement for its failure to manage and control in a safe and sound manner the loan origination services outsourced to its affiliate, Wilmington Finance, Inc. (WFI). The Agreement addressed loan origination activities and required AIG FSB to identify and provide timely assistance to borrowers who were at risk of losing their homes because of the thrift's loan

origination and lending practices. OTS also required a \$128 million reserve to be established to cover costs associated with providing affordable loans to borrowers.

Later, in light of AIG's growing liquidity needs to support its collateral obligations, OTS took action in September 2008 at the FSB level to ensure that depositors and the insurance fund were not placed at risk. OTS actions precluded the bank 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 attendant risks related thereto. AIG FSB continues to be well capitalized and maintains adequate levels of liquidity.

After a 2007 targeted review of AIGFP, OTS instructed the company to revisit its modeling assumptions in light of deteriorating sub-prime market conditions. In the summer of 2007, after continued market deterioration, OTS questioned AIG about the valuation of CDS backed by subprime mortgages. In the last quarter of 2007, OTS increased the frequency of meetings with AIG's risk managers and PwC. Due to the Agency's progressive concern with corporate oversight and risk management, in October 2007 we required AIG's Board to:

- Monitor remediation efforts with respect to certain material control weaknesses and deficiencies;
- Ensure implementation of a long-term approach to solving organizational weaknesses and increasing resources dedicated to solving identified deficiencies;
- Monitor the continued improvement of corporate control group ability to identify and monitor risk;

- Complete the holding company level risk assessment, risk metrics, and reporting initiatives and fully develop risk reporting;
- Increase involvement in the oversight of the firm's overall risk appetite and profile and be fully informed as to AIG Catastrophic Risk exposures, on a full-spectrum (credit, market, insurance, and operational) basis; and
- Ensure the prompt, thorough, and accountable development of the Global Compliance program, a critical risk control function where organizational structure impediments have delayed program enhancements.

OTS further emphasized to AIG management and the board that it should give the highest priority to the financial reporting process remediation and the related long-term solution to financial reporting weaknesses. In connection with the 2007 annual examination, the Organizational Structure component of the CORE rating was downgraded to reflect identified weakness in the company's control environment.

Shortly after OTS issued the 2007 report, AIG disclosed its third quarter 2007 financial results, which indicated for the first time a material problem in the Multi Sector CDS portfolio evidenced by a \$352 million valuation charge to earnings and the disclosure that collateral was being posted with various counterparties to address further market value erosion in the CDS portfolio.

As PwC was about to issue the accounting opinions on the 2007 financial statements, the independent auditor concluded that a material control weakness existed in AIGFP's valuation processes and that a significant control deficiency existed with Enterprise Risk Management's access to AIGFP's valuation models and assumptions. Due to intense pressure from PwC, in February 2008, AIG filed an SEC Form 8K announcing the presence of the material weakness. AIG pledged to implement complete remediation efforts immediately.

OTS's subsequent supervisory review and discussions with PwC revealed that AIGFP was allowed to limit access of key risk control groups while material questions relating to the valuation of super senior CDS portfolio were mounting. As a result of this gap, corporate management did not obtain sufficient information to completely assess the valuation methodology. In response to these matters, AIG's Audit Committee commissioned an internal investigation headed by Special Counsel to the Audit Committee to review the facts and circumstances leading to the events disclosed in the SEC Form 8K. The Special Counsel worked with OTS to evaluate the breakdown in internal controls and financial reporting. Regulatory entities such as the Securities Exchange Commission and Department of Justice then also commenced inquiries.

The OTS met with AIG senior management on March 3, 2008, and communicated significant supervisory problems over the disclosures in the SEC Form 8K and the unsatisfactory handling of the Enterprise Risk Management relationship with AIGFP. OTS downgraded AIG's CORE ratings and communicated the OTS's view of the company's risk management failure in a letter to AIG's General Counsel on March 10, 2008.

As part of this remediation process and to bolster corporate liquidity and oversight, AIG successfully accessed the capital markets in May of 2008 and raised roughly \$20 billion in a combination of common equity and equity hybrid securities. This action coupled with existing liquidity at the AIG parent, provided management with reasonable comfort that it could fund the forecasted collateral needs of AIGFP. AIG also added a Liquidity Manager to its corporate Enterprise Risk Management unit to provide senior management with more timely stress scenario reporting and formed a liquidity monitoring committee composed of risk managers, corporate treasury personnel and business unit members to provide oversight.

On July 28, 2008, AIG submitted a final comprehensive remediation plan, which OTS reviewed and ultimately accepted on August 28, 2008. The AIG audit committee approved the company's remediation plan, which also was used by PwC to assess AIG's progress in resolving the material control weakness covering the valuation of the CDS portfolio and the significant control deficiency attributable to AIG's corporate risk oversight of AIGFP, AGF and International Lease Finance Corporation (ILFC). OTS continues to monitor these remediation efforts to this day, notwithstanding AIG's September 2008 liquidity crisis.

As AIG's liquidity position became more precarious, OTS initiated heightened communications with domestic and international financial regulators. Through constant communication, OTS monitored breaking events in geographic areas where AIG operates, kept regulators in those jurisdictions informed of events in the U.S. and clarified the nature of AIG's stresses. OTS's identification of AIGFP as the focal point of AIG's problems added perspective that allowed foreign regulators to more accurately assess the impact on their regulated entities and to make informed supervisory decisions.

In September 2008 the Federal Reserve Bank of New York (FRB-NY) extended an \$85 billion loan to AIG and the government took an 80 percent stake in AIG. On the closure of this transaction, Federal statute no longer defined AIG as a savings and loan holding company subject to regulation as such. This result would be true whether AIG had been a savings and loan holding or bank holding company subject to regulation by the Federal Reserve Board. Nonetheless, OTS has continued in the role of equivalent regulator for EU and international purposes. FRB-NY's intervention had no impact on OTS's continued regulation and supervision of AIG FSB.

Although OTS has scaled back some regulatory activities with regard to AIG, the Agency continues to meet regularly with key corporate control units and receive weekly reports on various exposures and committee activities. OTS closely monitors the activities at AIGFP to reduce risk, as well as the divestiture efforts of the holding company. OTS will continue to focus on Residential Mortgage Backed Securities exposures and the ultimate performance of underlying mortgage assets. OTS is tracking AIG's remediation efforts. Finally, OTS continues to work with global functional regulators to keep them apprised of conditions at the holding company, as well as to learn of emerging issues in local jurisdictions.

IV. Lessons Learned

Despite OTS's efforts to point out AIGFP's weaknesses to the company and to its Board of Directors, OTS did not foresee the extent of the risk concentration and the profound systemic impact CDS products caused within AIG. By the time AIGFP stopped originating these derivatives in December 2005, they already had \$65 billion on their books. These toxic products posed significant liquidity risk to the holding company.

Companies that are successful have greater opportunities for growth. AIG was successful in many regards for many years, but it had issues and challenges. OTS indentified many of these issues and attempted to initiate corrective actions, but these actions were not sufficient to avoid the September market collapse.

It is worth noting that AIGFP's role was not underwriting, securitizing or investing in subprime mortgages. Instead, AIGFP simply provided insurance-like

protection against declines in the values of underlying securities. Nevertheless, in hindsight, OTS should have directed the company to stop originating CDS products before December 2005. OTS should also have directed AIG to try to divest a portion of this portfolio. The pace of change and deterioration of the housing market outpaced our supervisory remediation measures for the company. By the time the extent of the CDS liquidity exposure was recognized, there was no orderly way to reduce or unwind these positions and the exposure was magnified due to the concentration level. The CDS market needs more consistent terms and conditions and greater depth in market participants to avoid future concentration risks similar to AIG.

I believe it is important for the Committee to understand the confluence of market factors that exposed the true risk of the CDS in AIGFP's portfolio. OTS saw breakdowns in market discipline, which was an important element of our supervisory assessment. Areas that we now know were flawed included: over reliance on financial models, rating agency influence on structured products, lack of due diligence in the packaging of asset-backed securities, underwriting weaknesses in originate-to-distribute models, and lack of controls over third party (brokers, conduits, wholesalers) loan originators.

Shortcomings in modeling CDS products camouflaged some of the risk. AIGFP underwrote its super senior CDS using proprietary modeling similar to that used by rating agencies for rating structured securities. AIGFP's procedures required modeling based on simulated periods of extended recessionary environments (i.e. ratings downgrade, default, loss, recovery). Up 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 mainstream assumptions that were generally acceptable to the rating agencies, PwC, and AIG.

Following a targeted review of AIGFP in early 2007, OTS recommended that the company revisit its modeling assumptions in light of deteriorating sub-prime market conditions. In hindsight, the banking industry, the rating agencies and prudential supervisors, including OTS, relied too heavily on stress parameters that were based on historical data. This led to an underestimation of the unprecedented economic shock and misjudgment of stress test parameters.

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 huge amounts of collateral for which it had insufficient funds. The holding company capital was frozen and AIGFP could not meet the calls.

V. Recommendations

From the lessons learned during our involvement with supervising AIG, we would like you to consider two suggestions in your future exploration of regulatory reform.

Systemic Risk Regulator

First, OTS endorses the establishment of a 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 to resolve 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 - Consistency and Transparency

CDS are financial products that are not regulated by any authority and impose serious challenges to the ability to supervise this risk proactively without any prudential derivatives regulator or standard market regulation. We are aware of and support the recent efforts by the Federal Reserve Bank of New York to develop a common global framework for cooperation. There is a need to fill the regulatory gaps the CDS market has exposed.

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. OTS believes standardization of CDS would provide more transparency to market participants and regulators.

In the case of AIG, there was heavy reliance on rating agencies and in-house models to assess the risks associated with these extremely complicated and unregulated products. I believe that Congress should consider legislation to bring CDS under regulatory oversight, considering the disruption these instruments caused in the marketplace. Prudential supervision is needed to promote a better understanding of the risks and best practices to manage these risks, enhance transparency, and standardization of contracts and settlements. More and better regulatory tools are needed to bring all potential instruments that could cause a recurrence of our present problems under appropriate oversight and legal authority.

A multiplicity of events led to the downfall of AIG. An understanding of the control weaknesses and events that transpired at AIG provides an opportunity to learn to identify weaknesses and strengthen regulatory oversight of complex financial products and companies. OTS has absorbed these lessons and has issued risk-focused guidance and policies to promote a more updated and responsive supervisory program.

VI. Closing

Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee, for the opportunity to testify on behalf of the OTS on the collapse of AIG.

We look forward to working with the Committee to ensure that, in these challenging times, thrifts and consolidated holding companies operate in a safe and sound manner.