

Testimony of
Robert E. Lewis
Before the
Financial Crisis Inquiry Commission
June 30, 2010

Chairman Angelides, Vice Chairman Thomas, and members of the Commission, I am pleased to help in any way I can in the Commission's efforts to learn about AIG and the complex derivative financial instruments that I understand to be the subject of today's hearing.

I am the Chief Risk Officer of AIG. I joined AIG in 1993 as the company's Chief Credit Officer, and in 2004 was appointed the company's first Chief Risk Officer by then-CEO M.R. Greenberg. As Chief Risk Officer, I established, and continue to be responsible for, the AIG corporate-level risk management function known as "Enterprise Risk Management" or "ERM."

As an insurance company, AIG is in the business of taking on risk. AIG's basic approach is that responsibility and accountability for the risks assumed by the various AIG business units actually reside within the business units themselves. My role as Chief Risk Officer, supported by Enterprise Risk Management, is to assist the businesses in identifying, evaluating, and managing aspects of their risks.

I understand that the focus of today's hearing is on complex financial derivatives and, in particular, on the credit default swaps sold by AIG's financial products division known as "FP." Let me then get right to that subject.

An important aspect of the management of the risk from FP's sale of credit default swaps involved the CDO structure of the assets underlying the swaps themselves. Basically, as I believe the Commission now very much understands, a CDO consists of a "tower" of loans with the uppermost level, known as the "super-senior" level, having the first right to the entire tower's cash flow in the event of defaults and consequent losses above an agreed-upon level. FP's approach to the management of its risk was to structure the credit default swaps so that they would only be triggered if the underlying losses were severe enough to rise to the highest levels in the tower, a risk that FP determined to be exceedingly unlikely even under severe economic scenarios.

FP's analysis of the risk was supported by significant risk management resources residing within FP itself and reporting to its CEO. While neither FP's CEO nor its risk personnel reported to me, I understood FP's analysis of the risk to include quantitative modeling developed by a leading finance professor at Wharton which assumed features of the worst economic conditions that have existed at any time since World War II. This statistical analysis

demonstrated to a 99.85% confidence level that the upper-level portion of a CDO tower insured by an FP credit default swap would not suffer credit losses.

FP sold its first default swap in 1998, and for years things worked as FP's models had predicted. However, in the latter part of 2005, ERM at the corporate level began to get concerned based on increasingly aggressive bank lending practices and a housing market that was unduly heating up. In early 2006, my Chief Credit Officer discussed these concerns with FP's CEO in London who responded that FP's own risk analysis was identifying the same concerns and that he had decided it was time to shut down.

At that point, commitments were already in place so it was not realistic to terminate the business instantaneously. However (with one exception), FP decided to end its business of new credit default swap sales involving subprime exposure. As to those swaps already on the books, the judgment was that they would continue to perform satisfactorily given the safety of the tower structure and the fact that those swaps covered earlier mortgages, provided at a time of more conservative lending practices.

As it turned out, we were wrong about how bad things could get. What ended up happening was so extreme that it was beyond anything we had planned for. The CDO tower structure nonetheless did provide significant protection to AIG because those investors at the top of the tower were legally

protected by their superior rights to the tower's cash flow. But the market's apparent anticipation of further cash flow declines, combined with an extraordinary erosion in market liquidity generally, resulted in a collapse of "fair values" thereby triggering collateral calls.

AIG's liquidity was thus depleted notwithstanding that credit losses to AIG were not actually occurring and, given more time, the values would have been expected to come back. As the credit crisis reached its peak, AIG's ability to maintain its liquidity declined precipitously as credit markets froze, other liquidity issues developed, and FP could not make good on all collateral call demands. It was at that point that the federal government stepped in with taxpayer assistance.

I would be pleased to answer any questions.

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