TESTIMONY OF ANDREW FORSTER
BEFORE THE FINANCIAL CRISIS INQUIRY COMMISSION

JULY 1, 2010

Chairman Angelides, Vice Chairman Thomas, and distinguished members of the Commission, my name is Andrew Forster. I submit this testimony to the Commission regarding the financial problems at American International Group, Inc. ("AIG"), including the role complex financial derivatives played in the financial problems at the company.

I am currently an Executive Vice President and I supervise the Asset Desk at AIG Financial Products ("AIGFP"), a subsidiary of AIG, although I am employed directly by Banque AIG, a French subsidiary of AIG. The Asset Desk manages AIGFP's cash investment book and undertakes trading and investing activities on AIGFP's behalf. During 2007, I was one of approximately 13 executive vice presidents of AIGFP who reported directly to Mr. Cassano.

I graduated from Oxford in 1992 with a degree in history and economics. I was employed by JP Morgan in various capacities from 1992 until 1998. Thereafter, I moved to Banque AIG, beginning on the Asset Desk. I became head of the Asset Desk in 2003, a position I have held ever since. I have always worked in the London offices of AIGFP and am a citizen of the United Kingdom.

The Commission has requested that I address the following issues related to AIGFP's multi-sector credit default swap ("MSCDS") portfolio.

1. The Increase in the Size of the Multi-Sector CDS Portfolio in 2005

I had limited involvement in marketing or soliciting MSCDS deals, but my understanding at the time was that the increase in MSCDS transactions was in large part due to an increase in the overall size of the market for multi-sector CDOs in 2005. The size of the overall CDS market grew substantially in notional amount in 2005. This increase in AIGFP's position did not arise out of a change in AIGFP policy, but merely reflected the increased demand in the market for such structured products.

2. Approval and Monitoring of Multi-Sector CDS Portfolio Transactions

Because I was based in AIGFP's London office and the vast majority of MSCDS transactions making up AIGFP's multi-sector portfolio originated in the United States, I was generally not directly involved in the origination process.[1]

The first line of approval for new deals in the multi-sector portfolio at AIGFP came from those individuals who originated the deals, particularly Alan Frost and Gary Gorton, in Wilton,

---

[1] Eleven out of approximately 117 trades in the MSCDS portfolio originated in Europe and for those trades I was more aware of and involved in the origination process because they were being handled directly by individuals who worked in our London office. These trades were handled out of the London office for a variety of reasons, including the fact that in many cases the counterparties were European investment banks.

Connecticut. That team would negotiate the terms of the deals and would also obtain information from the counterparties concerning the reference obligations underlying each CDO upon which AIGFP was to write protection. That information was then analyzed using AIGFP's proprietary in-house model which had been created by Gary Gorton, a former professor at the Wharton School of Business at the University of Pennsylvania (the "Gorton Model").

In simple terms, the Gorton Model evaluated the risk of losses on the super senior portion of the CDO bonds; the Gorton Model did not measure the market value of the super senior portion of the CDO bonds, only the risk or likelihood of a default of each of the underlying reference obligations. The Gorton Model used the ratings of the underlying bonds from the three major rating agencies: Moody's, Standard & Poor's and Fitch Ratings as inputs, to which a number of conservative assumptions were made (for example, reducing certain of these ratings and employing significantly lower recovery rates). The default rates in the Gorton Model were based upon severe recessionary market scenarios that were modeled to be worse than the worst post World War II recession.

From the Gorton Model, AIGFP determined the attachment point for the super senior tranche of the CDO, *i.e.*, the point where the model determined that there was sufficient subordination to adequately protect against credit losses, with an additional cushion built in for more protection. AIGFP would only write protection on deals where the Gorton Model showed that the risk of credit losses above this attachment point would be remote. At the time, the Gorton Model gave us confidence that there was an extremely small risk that any of our positions in the MSCDS portfolio would ever experience any sort of losses.

My understanding was that the approval process was transparent in terms of providing sufficient information up the chain to members of AIG's Credit Risk Committee ("CRC") so that they could adequately evaluate the credit risk of the transactions. The final approval for the MSCDS transactions was made by AIG's Credit Risk Committee. The Wilton team primarily prepared the analysis underlying the Credit Approval Memos sent to the CRC for each transaction. It was also my understanding that Mr. Cassano was provided with these memos. I received many of the Credit Approval Memos, particularly in 2005, although in general I was only forwarded the memos once they had already been sent to the CRC for approval. I was rarely involved in the preparation of the memos.

Nevertheless, it was my belief that the Credit Approval Memos were comprehensive and provided the CRC with sufficient information to evaluate the financial risk of the MSCDS transactions to both AIGFP and AIG. Attached to each of these Credit Approval Memos, there was typically a spreadsheet which detailed each reference bond making up the CDO in question, the dollar amount of that bond, the type of asset (RMBS, CMBS, Home Equity, etc.), the weighted average life of each reference bond, and the rating given to each bond by Moody's, S&P or Fitch Ratings. Similarly, the Credit Approval Memos typically included a table which summarized the percentage of the existing portfolio that belonged to different asset classes including RMBS. The Credit Approval Memos also detailed the proposed capital structure of the CDO, the subordination which protected the Super Senior portion, the risk when analyzed through the Gorton Model and the conservative assumptions which accompanied the application of that model.

3. Exit from the Business

In all of our lines of business, as part of our normal practice, we periodically re-evaluated the markets we were involved in and our assumptions about those markets. In the summer of 2005, I began thinking more and asking more questions about the MSCDS portfolio, and tried to take a more active role in evaluating the book. Specifically, in July 2005, I questioned whether in our modeling we needed to consider additional analysis of deals containing large amounts of interest-only loans, deals that were biased toward low FICO scores, and deals that were heavily concentrated in particular geographic regions. Further, I asked whether we should strengthen the process used to evaluate the CDO managers who were in charge of these deals, particularly in non-static deals where the managers had the ability to add and remove collateral within certain limits.

Towards the end of 2005 and continuing through early 2006, a number of individuals at AIGFP and AIG discussed similar questions regarding the MSCDS portfolio. This was a fluid process with debate over several months. My chief concern about the subprime market going forward, which other participants in the discussion shared, was that the underwriting standards for new mortgage loans were declining. We conducted due diligence in this regard, including communicating with several investment banks. This process of internal evaluation eventually resulted in a consensus decision to pull out of the subprime MSCDS market. It is important to recognize that the decision to pull out of that part of the subprime market was based upon an evaluation of the market *going forward*, and we remained confident that any risk of loss on our existing subprime exposure was remote.

With hindsight, it would have been prudent to have hedged the multi-sector portfolio in early 2006. However, at the time we viewed the risk to the portfolio as so remote that implementing hedging would have been counter to the credit risk analysis upon which AIGFP's business was based.

4. Disputes Regarding Collateral Calls

Beginning in or around July 2007, various CDS counterparties made, or stated that they intended to make, collateral calls against AIGFP on the basis of the counterparty's belief that the value of the reference obligations (i.e., the super senior tranches of the CDOs) had declined in value. The largest collateral call, and the collateral call which AIGFP spent the greatest amount of effort attempting to resolve, was made by Goldman Sachs. Over the next several months, additional collateral calls were received from the Bank of Montreal, Barclays, Calyon, CIBC, HSBC, Merrill Lynch, the Royal Bank of Scotland, Societe Generale, UBS, and others.

Our internal process for responding to collateral calls involved different business units within AIGFP. First, AIGFP had an internal collateral group which received formal collateral calls and arranged for collateral to be posted when required. Officially, collateral calls were to be made directly to the collateral group. However, our counterparties would often notify the AIGFP traders with whom they had a relationship before (or even instead of) making a formal call. Mr. Cassano and I also became involved in some of the discussions with the counterparties when disagreements persisted. In my view, these collateral calls were treated as business disputes to be negotiated between AIGFP and its counterparties rather than as legal disputes. No counterparty demanded immediate posting of collateral and most appeared willing to discuss settlements of collateral calls at amounts other than the initial amount of the call.

Persistent disagreements, however, arose from differing views about the market valuation of the reference obligations. These differing views about valuation became more and more difficult to resolve through the fall of 2007. As drafted, the CSAs provided for, among other things, dealer polls as a means of resolving disagreements about market values. But the problem that we at AIGFP and indeed many of our counterparties faced is the simple fact that by the fall of 2007, there was no longer an existing market, much less a liquid market, for the instruments we were trying to price.

Ultimately, AIGFP posted some of the requested collateral. In many cases, AIGFP and the counterparties agreed to disagree on the amount of the total valuation, but settled on a compromise amount to be posted under the CSA. In December of 2007, after months of work developing our own variation of the BET valuation model and various pricing inputs, our views with respect to collateral calls were also informed by the valuations produced by our internal model results.

In early 2008, as the number and size of collateral calls grew, my role decreased dramatically as AIG Corporate became more involved.