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: Follow-up Questions for OTS

CIO Program

For institutions in the CIO program, to what extent does OTS management both in the regions and in Washington review supervisory plans, risk matrices, targeted examinations, and annual examinations? [Alex Luc]

Does OTS management (either in Washington or Jersey City) have a system or other means for tracking all examination findings and recommendations? Did OTS have system for tracking the exam findings for AIG from 2006-2008?

We tracked examination and targeted review recommendations through our continuous on-site supervisory program. All exam or targeted review findings that were communicated to management during the supervisory year were rolled into our annual report and brought to the attention of the AIG Board, via its Regulatory Committee. We have provided a complete "Supervisory History" which is located on the N drive, AIG/Supervisory History/Briefing Book

Does OTS have agency-wide planning documents that address areas of high risk both for thrifts, thrift holding companies, and complex international organizations? [Donna Deale]

How standard is the Risk Matrix approach for CIO institutions? How are the composite ratings for risks developed? How do examiners use the risk matrices after they are developed? [Alex Luc]

In the AIG workpapers, the risk matrix in the 2007 and 2008 supervisory plans lists 14 risk types, including systemic risk. What guidance were examiners provided to evaluate these risks at CIO institutions? Does OTS management review these risks across institutions? [Alex Luc]

In 2007's Supervisory Plan for AIG, OTS lists a caveat on its findings in the introduction:
"It should be recognized that there is no absolute assurance that OTS' evaluation of a firm will uncover all serious problems or deficiencies, which may exist. This is because the accuracy of the CORE ratings and overall rating of the firm are influenced by many factors, including: the amount, kind and quality of the firm information requested by OTS and provided by the firm; the openness and cooperation of firm personnel at all levels; the choice of business line for the targeted reviews; the openness and cooperation of the firm's functional regulators; the scope and quality of the examination approach; the knowledge and skill of our examiners and examination management; and the amount of resources made available for the task."
Is this a common disclosure for supervisory plans and could you comment about its implication regarding OTS' examination process at AIG? [Alex Luc] Jim C.

Background (internal purposes only). At the time the 2007 supervisory plan was being drafted by the AIG on-site examination team, and the 2007 work plan was being considered, the EIC over the prior two years had been permanently assigned elsewhere in the NE region during the fall 2006 roll-up examination, and the assistant EIC was overseas on reserve duty. No replacements or additional resources were being provided for additional leadership or examination work at that time. The acting EIC and one other examiner was all that remained for that time period. These two individuals felt that, as difficult as it is to supervise a \$1.0 trillion company with the limited resources previously provided, it would be even more difficult in 2007. The authors of the plan felt that it was therefore necessary to include the above language spelling out the limitations of such work.

That being said, while the language is not common for supervisory plans (or regulatory profiles as they were called for normal thrifts at the time), all the language is doing is spelling out the limitations of any third party review work. Language along these lines is not uncommon in industry third party reviews or even annual independent audits.

Are there any requirements for examiners to assess the adequacy of risk models as part of their review of institutions in the CIO program? Do examiners independently evaluate the results of any stress testing? What resources are available for them to do so? [Jim Christner]

Conglomerate examiners are required to follow established policies and procedures for conducting examinations of large and complex enterprises (Section 940 of the OTS Holding Company Handbook). This handbook indicated that:

An integral part of a good risk management program incorporates a system of internal controls that are sufficient to identify areas of weakness, particularly in financial reporting and accounting systems and records, and with regard to regulatory compliance. ?Examiners? will need to evaluate how the conglomerate ensures the integrity of its internal control structure, including controls over information technology (IT). You should begin your assessment by asking questions that include:

Does the conglomerate maintain an effective risk management program? Is the board and senior management actively engaged in risk management? Does the board approve risk management and other significant policies?

Do policies and procedures clearly delineate limits, activities, responsibilities, and authorities? Are policies and procedures updated on a timely basis for changes? Are policy and procedural changes communicated to employees?

Are management reports sufficient to identify and monitor significant risks to the conglomerate? Are these reports accurate and timely? Who reviews these reports and how often?

Does the conglomerate model its significant risks? If so, do they properly document the methodology, data, and assumptions employed? Do they back-test the results? Who reviews modeling results and how often?

Conglomerate examiners are not expected to independently validate risk models, but in accordance with the above examination guidance are expected to review internal controls over the risks management processes employed by the firm, including the firm?s model validation process, and to evaluate the results of the major risk models.

In conducting this work, examiners have available to them various regulatory issuance such as handbooks and information releases. Examples are OCC 2006-16 Risk Modeling and Model Validation and the First Quarter 2005 OTS Quarterly Review of IRR addressing risk models.

With respect to AIG and AIGFP, the examiners reviewed market and credit risk management reports and the internal control structures around risk management. Examination reviews also addressed AIGFP?s New Products Development Group processes and, along with PWC, indentified the need for group wide controls over model validation at he firm, which PWC added as an SD and OTS followed closely.

For institutions in the CIO program, how often does OTS senior management attend meetings with the institutions? Board of Directors or Audit Committee? [Mike Finn]

Is OTS taking any action to change the way it oversees the other CIO companies? [Mike Finn]

OTS seems to have devoted relatively few resources to AIG?s oversight compared with Washington Mutual. Could you comment on the difference? [Mike Finn]

AIG

What were the issuance dates of the supervisory plans for AIG in 2006, 2007, and 2008? When were these plans approved for use? [Tom O?Rourke and Manny Tisseverasinghe]

The supervisory plans are drafted by the onsite examination team, with input from DC/ regional specialists and senior managers during the fourth quarter of each year. Plans are discussed and approved in during the first quarter all hands meetings.

It should be noted that the plans are not meant to be rigid and static. The intent of the plan is to provide the conglomerate team with a broad frame to work with and one that allows for modifications based on emerging issues.

2006 and prior plans did not include a risk matrix. The risk matrix based planning was adopted in 2007. The supervisory plans for 2006-2008 can be located in the N drive, under CMLPX/AIG/under the respective annual folders

In 2006, were targeted reviews sent directly to Board and senior management? If not, when did that practice begin and what prompted it? [Tom O?Rourke and Manny Tisseverasinghe]

In 2006 Targeted Reviews were delivered to the senior manager or designated recipient of the reviewed unit or activity, with other copies provided to AIG Internal Audit, the AIG Examiner Liaison (Norma Vallejo at the time), Enterprise Risk and the General Counsel. In 2007, we continued to deliver targeted review to senior managers but included a recap of each targeted reviews findings in the annual roll up examination report and directed the board?s attention to that information.

In the examination materials we reviewed from 2006-2008, annual and targeted reports related to AIGFP often describe management as ?highly capable? and ?technically sophisticated and highly experienced individuals with significant tenure.? How were these assessments of AIGFP management and technical staff made? [Tom O?Rourke and Manny Tisseverasinghe] Jim

Correction: We do not recall any such 2008 reviews that described AIGFP management under any favorable terms.

Background (internal purposes only): This is somewhat of an unfortunate result of the pressure to arrive at a conclusion of the quality of management, despite the limitations of examination resources for a \$1.0 trillion company with a \$100 billion financial products division and questions even to this day regarding OTS authority (should we have treated AIGFP like a thrift and subjected them to regulatory expectations of a thrift even though there was nothing illegal about engaging in such transactions outside of a regulated financial services company, e.g. congress themselves decided to not have CDS transactions regulated). That being said a best effort was made to evaluate and conclude upon the quality of management. This is a qualitative assessment and is based on several factors. During the review examiners conduct interviews with senior and support management and review internal reports. The assessment takes into consideration the depth of knowledge of the products on balance sheet, the tenor and quality of experience, management and employee turnover or absence thereof, and performance to date. AIGFP had previously not experienced difficulties during period of past stress (e.g. Hedge funds and Asian currency crisis, Enron, dor.com bust, others).

In the summary of activities at AIG from 2005-2007 that the examiners put together, there is a point about capital model validation. Could you explain that reference, what was done to evaluate the model validation, and what was done to follow up on those findings? [Tom O'Rourke and Manny Tisseverasinghe]

During the 2005-2007, AIG was in the process of transitioning its capital allocation to a economic capital based capital allocation. Ecap computations require extensive reliance on models to analyze the impact of various risk factors. AIG elected to have the models reviewed and validated by external third party service providers. We reviewed the findings of the third party service providers. The third party validation certifications indicate that the assumptions used by the Company are conservative and at or above industry standards.

Our top down risk focused approach did not include a review of model integrity and the validity of assumptions. Rather the review was designed to assess governance and controls surrounding the transition to an economic capital frame work. The review included an assessment of Board and management oversight; internal capital assessment; internal assessment of risks; monitoring and reporting; and internal control review.

Our review indicates that the company has taken a comprehensive, disciplined approach and the Ecap process takes into consideration all material risks faced by the Company and is relevant to the current operating environment. Credit, insurance, operational, market, interest rate and liquidity risks, is considered and addressed in the capital assessment process.

AIG has suspended its Ecap Transition efforts due to its current condition.

Once AIG was downgraded to a ?3? in March 2008, what steps did OTS take? Are these consistent with the way OTS would approach downgrades in ratings at other holding companies? [Tom O'Rourke and Manny Tisseverasinghe]

Downgrade to a three implies that the company has material weaknesses that need to be addressed and corrected. As part of the downgrade OTS required the Company to certain corrective actions. 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.

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.

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 divesture 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.

Yes this is consistent with how OTS would approach downgrades in ratings at other holding companies.