

MEMORANDUM FOR THE RECORD

Event: Interview with Eric Dinallo

Type of Event: Interview

Date of Event: Friday, June 4, 2010

Team Leader: Chris Seefer

Location: 70 West 40th Street, New York, NY (Dinallo for Attorney General Campaign Headquarters)

Participants - Non-Commission:

- Eric Dinallo, former Superintendent, New York State Insurance Department (NYSID)
- John Kenny, Dinallo Campaign Manager (and former Special Counsel at the NYSID)
- Martha Lees, Deputy Superintendent and General Counsel, NYSID

Participants - Commission:

- Chris Seefer
- Dixie Noonan
- Kim Shafer
- Mike Easterly (by phone)

MFR Prepared by: Dixie Noonan

Date of MFR: June 8, 2010

Summary of the Interview or Submission:

This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted as such.

Kenny: The lead life insurance states (Texas, New York, Arizona, Tennessee) met with AIG in early 2007 and started looking at its securities lending business. New York took the lead. AIG had not fully disclosed the way its securities lending business worked to state regulators. In September 2007, the regulators determined that AIG's securities lending business needed to be wound down, and directed AIG to reduce the scope of its program. By September 12, 2008, the balance of AIG's securities lending portfolio was down to \$58 billion (this represented a 25% decrease from the program's peak almost a year earlier). By September 30, 2008, the balance was down to \$34 billion.

A high percentage of invested assets (65%) were in residential mortgage backed securities (RMBS) that were triple-A rated up to the financial crisis. Kenny doesn't think there's been much actual loss (as opposed to mark to market loss) on the portfolio [now in Maiden Lane II and being managed by Blackrock].

The NYSID also looked at the securities lending businesses of 25 other insurance companies.

Securities lending programs work by the company lending out securities it owns (e.g., municipal bonds) and receiving in return cash collateral (ranging from 95% - 102% of the amount of the security, usually closer to 102%). The company then takes the cash collateral it receives from lending the security and invests the cash in something else, for example, treasuries with the same duration as the securities lending transaction (in this example, there is a perfect timing match). Variables include what the company chooses to invest in, including the yield on the asset it invests in and whether there is a timing match between when the borrower will return the security and when the company can liquefy what it's invested in with the cash.

The "beauty" of the transactions is that they are not classified as sales and repurchases for accounting purposes and no gain or loss is recorded.

The problems with AIG's securities lending business were two-fold: (1) there was no market for the securities AIG had invested in (RMBS), partially because AIG's program was too big; and (2) no one wanted anything to do with AIG because of the problems at the Financial Products unit (FP).

Dinallo: Dinallo doesn't think AIG's securities lending investments were any more aggressive than others'.

Hank Greenberg uniquely ran AIG. AIG took advantage of regulatory gaps, including: (1) choosing the OTS as its regulator¹; and (2) creating and running its securities lending business at the holding company level, which meant that none of the state insurance regulators had exclusive oversight because the assets from the securities lending businesses run out of the various state insurance subsidiaries were pooled at the holding company level. New York had jurisdiction over only 8.5% of the securities lending assets. Texas probably had the highest percentage, and then California.

The Financial Products unit (FP) was akin to an undercapitalized monoline. Other monolines were regulated and had capital requirements, but not FP.

Jim Corcoran, who was the NYSID Superintendent for 20 years, saw [companies] monetizing their triple-A rating and selling financial guarantee insurance (FGI), for example, Ambac and MBIA. Article 6900 of the New York State Insurance Law, adopted in the 1980s, is the law

¹ Dinallo has no knowledge that Greenberg was personally involved in this decision.

applicable to financial guarantee insurance companies, and [provides that they have no access to state guarantee funds].

Accelerated by the repeal of Glass-Steagall and the Commodities Futures Modernization Act (CFMA), FP ran an unregulated, non-capitalized monoline.

The NYSID issued an opinion letter in 2000 that stated that credit default swaps (CDS) are not insurance as long as there is no requirement that the payment on the contract be conditioned upon actual losses.

It is an interesting question whether CDS is insurance without an insurable interest.

Monolines didn't technically write CDS. The way it worked was that a monoline would write an insurance policy to a special purpose entity (a "transformer"), which would in turn write CDS. The capital behind the CDS was based on the insurance policy one step removed. But the NYSID got comfortable with this arrangement because it knew there was ultimately capital behind the CDS obligation (unlike what was in place for FP).

Dinallo thinks that there was a misunderstanding in the marketplace about the accessibility of capital to the holding company. Insurance companies are the opposite of most other companies, in that the insurance subsidiaries actually control the holding company, rather than the other way around (because the insurance subsidiaries are regulated by the states and are required to maintain capital that is not accessible at will by the holding company). People relied on AIG FP's ability to access holding company's capital, when in fact they would be at the largesse of the holding company and all the state insurance regulators of the operating subsidiaries. Dinallo thinks the rating agencies and counterparties misunderstood this, and he did not understand why FP was rated triple-A.

With respect to the announcement in September 2008 that the NYSID and New York State would begin regulating "covered" CDS (i.e., where the counterparty actually had an interest in the security referenced by the CDS), but not "naked" CDS (i.e., where the counterparty did not have an interest in the security referenced by the CDS), Dinallo had a plan. People would then have to decide if they were engaged in an illegal insurance contract.

Dinallo was worried about more people pulling for firms and securities to fail than to succeed. E.g., the Spanish and French Armada, starting to hunt for failure. [?]

[Kim asked about the empty creditor hypothesis, and Dinallo said this was consistent with what he had been saying.]

The CFMA did not preempt the anti-fraud provisions regarding bucket shops, etc. It is a misnomer to say that states were preempted by the CFMA on regulating *insurance*.

In August or September of 2007 Dinallo began thinking about CDS, and seeing it as an alternative insurance product.

Dinallo thinks that he coined the phrase “naked CDS” in May 2008 on Melissa Frances’s show on CNBC. They have only found one earlier reference to the phrase, in London in 2003.

Dinallo thinks that the credit markets were completely ignored, in contrast to the heavily regulated equities markets.

(In early 2008) Dinallo tried to get Wall Street to help the bond insurers, since the Wall Street firms’ trading books were triple-A because of them, but Dinallo found that some on Wall Street had actually gone long CDS on the monolines.

Dinallo observed that there was not enough debt to satisfy the \$63 trillion CDS market, meaning that a lot of it had to be naked CDS.

When asked why the NYSID didn’t go in and regulate FP, Dinallo said that the NYSID Superintending actually has to meet a high standard before it can go into an insurance company holding company. Section 1504(b) of the New York State Insurance Law gives the Superintendent the power to examine the holding company if he has cause to believe that its operations may materially affect the financial condition of an insurance subsidiary and the Superintendent is unable to get the relevant information from the regulated subsidiary. Dinallo said this provision is clearly in the law to stop the insurance regulator from harassing the holding company.

The NYSID had only as much information on the holding company of AIG as it was given by the Office of Thrift Supervision (OTS), AIG’s holding company regulator. The NYSID had annual meetings with the OTS in November. Dinallo did not attend these meetings; Moriarty did.

Dinallo suggested looking at the insurance law at Article 1001 (specifically section 1113). It lists other types of financial insurance, e.g., equity, currency, interest rate – all these are considered insurance and you can’t sell insurance on them. [?] But credit isn’t covered here – credit is done in the monolines. A covered CDS is basically an insurance policy of a monoline.

CDS was carved out here because it was covered by the CFTC, and in Dinallo’s mind, proper capital was being set aside until the CFMA. This is all about capital.

Section 1113 lists *kinds* of insurance, and then somewhere else in the insurance law it says you can’t do these kinds.

Section 1000 – defines “insurance contract”

Section 6500 – concerns the monolines

The CDS that Dinallo was exposed to were the ones the monolines were engaged in. Then he saw all these other CDS out there.

The September 2008 announcement (concerning regulating covered CDS starting January 2009) had an “out” for if the federal government got involved. Dinallo said that he wanted to motivate Tim Geithner.

To grab the issue, Dinallo would have had to start prosecuting, but this wouldn’t have helped. He put out a plan to *regulate*, which should have happened 10 years prior.

*Chris asked Martha Lees for any documents concerning whether the NYSID considered whether it should be regulating or prosecuting covered CDS after the 2000 opinion letter. Dinallo said we should ask for opinion letters and “desk drawer rules.”

Firms can already distinguish between naked and covered CDS. Auditors make traders account for CDS as hedges or trades based on whether they are naked or covered.

Dinallo thinks that the two most important causes of the financial crisis were Gramm-Leach Bliley (GLB) and the CFMA. Dinallo wrote two op-eds in the Financial Times setting forth his views. Fared Zakaria said it was the clearest piece he’d read on the financial crisis. Dinallo also did a 60 Minutes show on CDS.

There are only four buckets of financial products: (1) bank deposits; (2) insurance; (3) gambling/futures; and (4) investments/bonds/equity. The first three are guaranteed payments upon certain events. The fourth constitutes “mere aspirations.”

For 100 years we set capital correctly for these. The CFMA said – see these four buckets? If you can do it over here by derivatives instead, then there is no capital requirement anymore.

In 1907, there was a run on trusts (like shadow banks), and J.P. Morgan got the banks together and formed a central bank. The anti-bucket shop laws passed in 1909 came out of the 1907 crisis. According to Dinallo, we just did this all over again by the CFMA. We had it right, and in one fell swoop the CFMA annihilated it.

Hedge funds did OK during the crisis because they are Darwinian animals and they knew this game and figured out if their counterparties had adequate capital or not.

FP was a hedge fund in one sense but supposedly had the backing of the parent company. That’s what GLB did, it allowed financial supermarkets to be created.

Dinallo doesn’t believe that mortgages were the cause of the crisis. There were not enough mortgages to securitize without CDS because you couldn’t get the triple-A rating on RMBS without the CDS wrap. And you never would have had as much CDS if you had required capital behind them.

AIG sold a unique and very deadly form of guaranty insurance. NYSID would never have allowed. A hallmark of insurance is not having to post collateral, which the FP contracts required.

With respect to securities lending –

It's an open regulatory question whether securities lending is subject to mark to market accounting or statutory accounting. Dinallo doesn't know if the NYSID examinations were based on one basis or another.

Securities lending transactions with counterparties were from demand to 120 days, and mostly kept rolling. On the investment side, AIG bought longer term assets than the duration of the securities lending contracts in order to get a higher yield.

AIG's new CEO, Willumstad, came to see the NYSID in June 2008 when he became CEO, and said that he would be restructuring the company and announcing a plan to do so in September 2008. The plan that Willumstad put forth was very similar to what actually happened, but Willumstad was ousted two weeks before he was scheduled to release the plan (when the government bailout occurred on September 16, 2008).

Senior insurance people from AIG came into the NYSID the week before the bailout. (Dinallo wasn't at this meeting. Schreibe from AIG came. NYSID felt the insurance companies were protected.) People were starting to circle around FP. Dinallo said that the call he received on September 12, 2008 from AIG wasn't that surprising given the events of that week.

*There was a lengthy ProPublica interview of Dinallo regarding the securities lending business, for which he did extensive preparation. Dinallo suggested we revisit this prep and get the documents he used from the NYSID.

The National Association of Insurance Commissioners (NAIC) established a task force on AIG in late 2006 or early 2007. Based on the work of the task force, in September 2007 the task force directed AIG to unwind its securities lending program.

The task force was prompted because the NYSID was looking at AIG's securities lending disclosures and did not understand how it worked (think w/r/t it being run on a pooled basis at the holding company level). There was some report that the NYSID wasn't comfortable with. This prompted the NYSID to look at other securities lending businesses, which they determined were OK. AIG was somewhat unique because of its counterparty relationships.

Bailout weekend – AIG's commercial paper started not to roll on Thursday, more on Friday, and it was clear it wouldn't roll at all on Monday (September 15).

Causes of the Crisis –

Mortgages? Commercial banks and brokers did an unjustified amount of lending, and the loans were securitized and rated. The business assumed natural harvesting of mortgages, but it wasn't, it was created. This was on the trading book of all traders. Risk managers walked by and said if you want to rehypothecate out at a triple-A rating, you need insurance to protect against the downside. The insurance was CDS, and was really cheap. If they'd had to buy real insurance, they couldn't afford it.

OTS became AIG's regulator after it was determined that everyone had to have a consolidated supervisor after Nick Leeson's trades wiped out Barings Bank in the 1990s.

AIG went to the OTS. The investment banks went to the SEC under its consolidated supervised entity program. Dinallo was at Morgan Stanley during this time period. Morgan Stanley could have chosen the OTS because it had a thrift (Discover).

Dinallo has received favorable press in contrast to Geithner for getting the monolines' counterparties to accept 17 cents on the dollar, when the NY Fed paid 100 cents on the dollar to AIG's counterparties. Dinallo thinks the comparison is unfair to Geithner. FGIC was a sickly monoline, and the NYSID commuted its obligations with counterparties. If this didn't happen, the monolines would be bankrupt. So Wall Street took an average of 12-18%.

The AIG bailout wasn't about AIG, it was about the counterparties.

Dinallo said in a New York Times article that 80% of CDS is speculative. This was a back of the envelope calculation based on how much CDS existed and how much corporate debt existed. (If you put all equities and bonds together, you would get 20% of the \$63 trillion in CDS notional amount.)

Dinallo thinks that we should look at insurance regulation as a model for what was done right in the financial crisis (responding to criticism from Volcker about failures in state regulation). Fifteen or so insurance companies received TARP money. The TARP money that went into insurance companies went into the holding company or "bolted on" trading units. They took no TARP that went down to the operating companies at the insurance level.

The CFMA left insurance untouched, it did not preempt state regulation of insurance.

Lehman's failure caused the Fed to reevaluate AIG, which it had not been focused on bailing out before. After Lehman failed, e.g., there were rumors that GE's commercial paper wouldn't roll. This was unbelievable, and led the Fed to reevaluate the AIG situation. It's unclear whether AIG would have been bailed out if Lehman had been saved on the prior weekend.

Dinallo thinks the Fed may have been able to structure the AIG bailout differently than it did, for example, by guaranteeing AIG's obligations.