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4
5 Hearing on "The Role of Derivatives
6 in the Financial Crisis."

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11 **COMMISSIONERS**

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22 PAGES 1 - 376

1 Session 1: Overview of Derivatives
2 MICHAEL GREENBERGER, Professor,
3 University of Maryland School of Law
4 STEVE KOHLHAGEN, former Professor of
5 International Finance, University of California
6 at Berkeley and former Wall Street derivatives
7 executive.
8 ALBERT "PETE" KYLE, Charles E. Smith Chair Professor of
9 Finance, University of Maryland
10 MICHAEL MASTERS, Chief Executive Officer, Masters Capital
11 Management, LLC
12 Session 2: American International Group, Inc., and
13 Derivatives
14 JOSEPH J. CASSANO, Former Chief Executive Officer,
15 American International Group, Inc. Financial
16 Products.
17 ROBERT E. LEWIS, Senior Vice President and Chief
18 Risk Officer, American International Group, Inc.
19 MARTIN J. SULLIVAN, Former Chief Executive Officer
20 American International Group, Inc.
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23
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1 Session 3: Goldman Sachs Group, Inc. and Derivatives

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3 CRAIG BRODERICK, Managing Director, Head of Credit,
4 Market and Operational Risk, Goldman Sachs Group,
5 Inc.

6 GARY D. COHN, President and Chief Operating Officer,
7 Goldman Sachs Group, Inc.

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P R O C E E D I N G S

(9:06 a.m.)

CHAIRMAN ANGELIDES: Good morning. Welcome to the hearing of the Financial Crisis Inquiry Commission on "The Role of Derivatives in the Financial Crisis." I want to welcome everyone here today. I am going to start off with a brief opening statement, and I will be followed by Vice Chairman Thomas.

Good morning. As always, as we start the hearing this morning I would like to thank Vice Chairman Thomas for his partnership and his cooperative work with me and my fellow Commissioners. Today I want to particularly single out and thank Commissioners Born, Hennessey, Thompson, and Wallison for taking the lead on this hearing.

Today we will be examining the role of derivatives in the financial crisis. I must say that, despite 30 years in housing, finance and investment in both the public and private sectors, I had little appreciation of the tremendous leverage, risk, and speculation that was growing in the dark world of derivatives.

Neither, apparently, did the captains of finance nor leaders in Washington.

The sheer size of the derivatives market is as stunning as its growth. The notional value of over-the-counter derivatives grew from \$88 trillion in 1999 to \$684

1 trillion in 2008. That is more than 10 times the size of
2 the gross domestic product of all nations.

3 Credit derivatives grew from less than a trillion
4 dollars at the beginning of this decade to a peak of \$58
5 trillion by 2007. These derivatives multiplied throughout
6 our financial markets unseen and unregulated.

7 As I have explored this world, I feel a little
8 like I've walked into a bank, opened a door, and seen a
9 casino as big as New York, New York. Unlike Claude Rains in
10 Casablanca, however, we should be shocked, shocked that
11 gambling is going on.

12 As the financial crisis came to a head in the
13 fall of 2008, no one knew what kind of derivative-related
14 liabilities the other guys had. Our free markets work when
15 participants have good information. When clarity mattered
16 most, Wall Street and Washington were flying blind.

17 To be fair, derivatives have a legitimate purpose
18 to help hedge against risk, but much of what has been traded
19 in recent years, especially synthetic securities, is just
20 bet, upon bet, upon bet. They don't build a factory. They
21 don't start a business. They don't add a job. These
22 securities may have been synthetic, but they destroyed real
23 people's real life-savings.

24 One might think that financial reform legislation
25 will take care of all of this, but it would be naive to

1 believe that a signature on a law, in and of itself, marks
2 the completion of financial reform. In fact, it is only the
3 beginning.

4 It took a good decade for New Deal reforms to be
5 put into action. The real nitty gritty of financial reform
6 will be worked out in regulations. No wonder lobbyists are
7 already lining up to help write the rules. Real reform
8 depends on the will to make it happen, of regulators, of the
9 public officials who appoint them, and of the financial
10 leaders who must live by them.

11 This Commission has already seen plenty of
12 instances of sensible regulations that went unenforced.
13 Sadly, we know that, while the soul may be willing, the
14 flesh is often weak. All of us who want to avoid another
15 financial crisis need to understand how we got into this
16 one. That's the purpose of this Commission.

17 In the case of derivatives, my fellow
18 Commissioners and I have seen something we've seen many
19 times in our investigation: Risk, leverage, and early-
20 warning signs being ignored.

21 In this instance, there were the reddest of red
22 flags. In 1994, Orange County, California, goes bankrupt in
23 a derivatives deal gone bad. In 1998, Long-Term Capital
24 Management causes a near financial crisis. And in 2001,
25 Enron, knee deep in derivatives, explodes causing what is at

1 the time the largest bankruptcy in U.S. history.

2 It's not as if no one warned us. Back in the
3 1990s, Commissioner Born, then Chair of the Commodities
4 Futures Trading Commission, saw the looming crisis and
5 argued strenuously for transparency and common-sense
6 regulation of derivatives. Her prescience and tenacity
7 earned her the John F. Kennedy Profile in Courage Award. If
8 she had prevailed, I believe we would have had a safer
9 financial system.

10 And so today we will look at derivatives and the
11 financial crisis through the prism of two companies:
12 Goldman Sachs and AIG. The two were linked through
13 derivatives, as indeed was all of Wall Street.

14 In June 2008, Goldman's derivatives book had a
15 notional value of \$53 trillion, with over 1.2 million
16 contracts. We will ask Gary Cohn, Goldman's President and
17 Chief Operating Officer, how his firm's derivatives'
18 dealings may or may not have contributed to the financial
19 crisis, and the economic crisis that followed.

20 We will ask how it came to be that AIG, a once-
21 respected company that Americans looked to for traditional
22 insurance needs, found itself on the losing side of many
23 derivatives' transactions with Goldman and other companies
24 and had to be bailed out with a commitment of \$182 billion
25 in taxpayers' assistance.

1 We will have questions for AIG's former CEO
2 Martin Sullivan, as well as the former head of its Financial
3 Products Group, Joseph Cassano, who is testifying for the
4 first time since the crisis. And we will explore the
5 Goldman-AIG connection, a multi-billion dollar strategic
6 relationship that ultimately turned contentious.

7 We will examine how the two financial giants
8 struggled over derivatives in the fateful weeks and months
9 leading up to the financial crisis, and whether their fight
10 fueled this crisis. Hopefully, over the next two days we
11 can shine a light on this dark world of derivatives.

12 And with that, I now turn the microphone over to
13 my colleague, Vice Chairman Bill Thomas.

14 VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman.

15 I do want to note for the record the absence of
16 two Commissioners. And frankly I'm surprised that we've
17 been able to maintain the full complement of the Commission
18 for as long as we have, given the resumes of the individuals
19 on the Commission. So I want to note the absence of
20 Commissioner Murren and Commissioner Thompson, who I know
21 would want to be here. And I wanted to make public note of
22 this because we've been so pleased at the sacrifices the
23 Commissioners have made so that we could be in attendance.
24 But frankly, the real world sometimes cannot be overcome and
25 you've got to do what you've got to do. So I want to

1 recognize them for their ongoing contribution, and they will
2 be with us at another time.

3 I also want to thank all of the witnesses once
4 again, and I want to underscore, Mr. Chairman, as you
5 mentioned we have two particular firms here. And as we have
6 done in the past, it isn't to focus on them and hold them
7 responsible, but rather to use them in an attempt to look at
8 some case studies. And you would turn to the biggest
9 players so that you have a better understanding of the way
10 in which relationships occurred, and I think by any standard
11 AIG and Goldman would be at least two of the principal
12 nominees in that discussion.

13 You mentioned the movie Casablanca. The movie
14 that I think of when we talk about derivatives, having begun
15 my Congressional career on the Agriculture Committee, is the
16 movie Trading Places with Dan Aykroyd and Eddie Murphy, and
17 their attempt to corner the orange juice futures market.
18 Because most people will think about derivatives in terms of
19 the classic pork belly, or oil, and the rest.

20 And so the frankly interesting history of how
21 derivatives came into play, at least in most people's
22 opinion, but especially the spinoffs of derivatives, a
23 significant role in what we have been statutorily charged
24 with investigating, the financial and the resultant economic
25 crisis, is one that most people do not understand. And the

1 more I listen to folk and read, apparently some of the
2 people who were the major players did not understand what it
3 was that they were dealing with, and especially the more
4 complicated financial aspects of being on one side or the
5 other of the derivatives.

6 So I mean even as late as today, in The New York
7 Times we continue to find out things that are behind-the-
8 scenes' exposes of what went on. And as we go forward, we
9 will probably get more of that. But today's hearing,
10 especially the first panel, I think will give us a quality
11 grounding in just exactly what we are talking about.

12 And I do hope--and I am going to try to keep my
13 eye on our primary statutory mission--and that is not get lost
14 in some of the intriguing stories, but to focus on what we
15 can do to determine the causes of the financial crisis and
16 the resulting economic crisis, and the role that the various
17 institutions and activities of those institutions played in
18 the resultant financial crisis.

19 So I look forward to today's testimony. And I
20 want to thank, once again, all the witnesses and look
21 forward to the hearing.

22 Thank you, Mr. Chairman.

23 CHAIRMAN ANGELIDES: Thank you, Mr. Vice
24 Chairman. Now we will begin the first session, and we have
25 four panels with us, four witnesses with us. This first

1 session is "An Overview of Derivatives" designed to give
2 both the Commission and the public a large-scale view of
3 this issue.

4 What I would like to do is ask if the witnesses
5 would please all rise and raise your right hand to do what
6 we customarily do, which is swear in all our witnesses in
7 our public hearings. So again, if you would raise your
8 right hand. I will read the oath and you will affirm.

9 Do you solemnly swear or affirm under penalty of
10 perjury that the testimony you are about to provide the
11 Commission will be the truth, the whole truth, and nothing
12 but the truth, to the best of your knowledge?

13 MR. GREENBERGER: I do.

14 MT. KOHLHAGEN: I do.

15 MR. KYLE: I do.

16 MR. MASTERS: I do.

17 (Witnesses sworn.)

18 CHAIRMAN ANGELIDES: Thank you, very much.

19 Gentlemen, we have received your written
20 testimony and we appreciate that. We are going to ask each
21 of you to provide an oral statement of no more than five
22 minutes so that we can reserve the balance of the time, in
23 excess really of two hours, for questions and answers.

24 So I would ask you also to not just repeat your
25 written testimony, because we are good readers on this

1 Commission. You have in front of you a device that at one
2 minute the yellow light will go on. So that is your signal
3 that you have one minute to wrap up.

4 We will start and just go down in order with Mr.
5 Greenberger. We will end with Mr. Masters. And, Mr.
6 Greenberger, if you will commence your testimony, terrific.

7 WITNESS GREENBERGER: Thank you, Mr. Chairman,
8 and thank you Members of the Commission:

9 I think Commissioner Thomas hit the nail on the
10 head. We often think of these products as being pork
11 bellies, or red wheat, and even in the regulated futures
12 market by the mid- to late-'90s it had expanded across a
13 wide array of instruments, financial instruments,
14 complicated financial instruments, that are part of the
15 derivatives package.

16 There will be much discussion when you deal with
17 this over the term "swaps," which is essentially what it's
18 called, an over-the-counter derivative, as a result of the
19 Commodities Futures Modernization Act, an unregulated
20 product.

21 Just quickly, the most common swap is a plain-
22 vanilla swap, interest rate swap. Someone has a loan.
23 They've committed to pay an adjustable rate. They're
24 worried that the adjustable rate will go above the fixed
25 rate. So they enter into a swap agreement with a swap

1 dealer--and there are five major swap dealers, major banks,
2 where the swap dealer will pay it the adjusted rate, or take
3 care of the adjusted rate, and it will pay the swap dealer
4 the fixed rate.

5 So it has swapped its adjustable exposure for
6 fixed exposure.

7 Now of course the swaps dealers don't do that pro
8 bono. They pay a very hefty fee to put themselves at risk,
9 and they themselves then lay off that risk with other swaps'
10 parties.

11 The most classic thing I think we will be
12 discussing is the credit default swap, which many believe--
13 including myself--was a major culprit in causing the
14 financial crisis.

15 That swap is the swap of a premium for the
16 guarantee in this case of an investment. Theoretically
17 somebody owns a collateralized debt obligation, which is
18 essentially an investment, that subprime mortgages to
19 non-creditworthy individuals will be paid off and won't
20 default.

21 They want an insurance against the very high risk
22 that people who can't afford a mortgage will not pay the
23 mortgage. The calculus--I know, Mr. Chairman, you used the
24 word \$58 trillion, because this is a private, bilateral
25 opaque market I think estimates are just educated guesses.

1 The figures I put in my testimony is the credit default swap
2 market was at a minimum \$35 trillion, a maximum \$65 trillion
3 notional value.

4 And I've made clear in my testimony the
5 difference between notional value and amount at risk, and
6 I'm happy to discuss that.

7 We had an opportunity at one point where we
8 reached a fork in the road. Will these swaps' products that
9 look like futures--many people argued they were futures--
10 would they be regulated as regulated futures? Or would they
11 be completely unregulated?

12 By virtue of the Commodity Exchange Act, if they
13 were futures they would be cleared--that is to say, some
14 strong financial institution would make sure that the
15 commitments were backed by adequate capital through the
16 collection of margin, and you wouldn't have situations like
17 September 15th, 16th, where AIG wakes up finding out all of
18 a sudden it owes \$80 billion on its credit default swap
19 book. That's the clearing aspect.

20 And if it were regulated, it would be exchange
21 traded. That is to say, transparent. The market would
22 know. The regulators would know what is out there, and
23 there would be a market-driven price mechanism associated to
24 these products.

25 We had a fork. We could have either done that,

1 or we could do what Congress did in 2000, which was to
2 decide for their reasons that this market would be
3 completely unregulated.

4 That is to say, no clearing. No exchange
5 trading. Preemption of state laws. Especially state gaming
6 laws were preempted because of an understanding that this
7 was going to be a highly speculative market. And the
8 states, if they applied gambling laws, would interfere with
9 the market.

10 Not only was federal regulation what then-
11 Chairman Christopher Cox said, a regulatory black hole
12 overseeing this market, but the statute itself had a
13 provision in it that, to the extent the swaps violated the
14 statutes, they could not be rescinded or unenforceable.

15 In the end, what you have is a \$600 trillion
16 notional value market that is completely unregulated and
17 dark. Therefore, regulators don't know what's happening out
18 there. Market observers don't know what's happening out
19 there. And that led to a belief that we needed to rescue
20 the entire market in the fall of 2008.

21 CHAIRMAN ANGELIDES: Thank you very much, Mr.
22 Greenberg--Greenberger, sorry, I just cut off that "er."
23 Mr. Kohlhagen. Dr. Kohlhagen. For all of you who have
24 Doctorates, I apologize.

25 WITNESS KOHLHAGEN: "Mister" is fine.

1 Good morning and thank you for inviting me here
2 and for letting me share my opinions with you. I have five
3 basic points I want to make.

4 The first is that interest rate derivatives,
5 currency derivatives, equity derivatives, and commodity
6 derivatives in my opinion did not cause, amplify, or
7 marginally spread--or materially spread the financial
8 crisis. In fact, they offered hedging opportunities to the
9 international community, corporations, and investors and
10 individuals, and were an enhanced global resource allocation
11 efficiency and had absolutely no material effect whatsoever
12 on the financial crisis.

13 Over-the-counter on credit derivatives, in
14 general, and credit default swaps in particular, had
15 absolutely no role whatsoever in causing the financial
16 crisis.

17 My second point is that credit derivatives in
18 general, and credit default swaps in particular, definitely
19 enabled the continuation of the bubble starting in March of
20 2005 when AIGFP sold a staggeringly large amount of credit
21 default swaps over about a 15-month period into the
22 marketplace.

23 The bubble started before that, and the crisis
24 would have happened if they had not done that. The crisis
25 would have come sooner if AIGFP had not been involved in

1 that market. And it would have been--the crisis would have
2 been somewhat less severe, but it still would have happened.

3 The causes--my third point is, the cause of the
4 financial crisis was quite simply the commitment by the
5 United States Government to bring home ownership to the next
6 group of people who previously had not been able to own
7 their own homes.

8 That did not necessarily have to lead to a
9 crisis. There would be some cost to U.S. taxpayers, the
10 subsidies and guarantees, and was unknown. The way that
11 that government program was implemented and the conduct of
12 the government-created, government-sponsored, and
13 government-managed program led to much higher costs than
14 people thought.

15 In order for--my fourth point would be, the
16 amplification and spreading required enablers. And those
17 enablers, later when it turned into a bubble, what I call
18 "bubble enablers," included essentially everybody: lending
19 officers, lending institutions, the government's open-ended
20 and poorly supervised subsidies and guarantees of Fannie Mae
21 and Freddie Mac, those institutions that sold products that
22 were worth less than they were selling them to be, the
23 rating agencies, the Federal Regulators Liberalization and
24 Forbearance, and the Federal Reserve's easy monetary policy
25 in the face of it, and the BIS Capital Adequacy Rules that

1 gave an incentive to institutions and the whole AAA
2 securities invariant to their quality.

3 The fifth point that I want to make, and that I
4 would like to emphasize, that I have not seen anywhere in
5 the press or anywhere, is that the largest cause of the
6 over-valuation of the CDOs was miscommunication within the
7 firms on Wall Street that were creating them.

8 It takes two kinds of professional employees to
9 create the CDOs that led to the crisis. The first are
10 mathematicians and technical experts that actually create
11 the models, that develop the models and develop the pricing.
12 Those people professionally have no concept whatsoever of
13 what's going on in the credit markets. They have no idea
14 what's happening to underwriting standards in the credit
15 world.

16 The second type of employee who does pay
17 attention to what's going on in the credit markets in
18 general had no knowledge at all of how these instruments are
19 priced. And in terms of corporate management, those two
20 silos did not communicate with each other. And so that the
21 credit guys were not telling the derivatives guys, if you
22 will, what was going on in the market. And so the pricing,
23 I believe unknowingly, was off.

24 The financial institutions that figured it out
25 basically began hedging and began not underwriting these

1 securities. But there were a set of organizations in the
2 middle of this that were fully equipped, that had both
3 skills and should have caught this, and those were the
4 rating agencies. They also had access to nonpublic
5 information and an obligation for discovery.

6 When hedge funds and institutional investors
7 discovered the problem, they came to AIG. And as all of you
8 know, it takes two to create a market: buyers and sellers.
9 And AIG basically sold into this market because they were a
10 credible market participant.

11 I would like to add one thing, if I may please.
12 I believe that the writing of \$80 billion of naked, unhedged
13 CDSs by AIGFP was an act of incredible corporate
14 irresponsibility on three grounds: that AIG executives did
15 not appropriately manage their subsidiary; that AIGFP
16 executives went beyond their culture and their corporate
17 culture and did this activity; and thirdly, those
18 institutions who bought from them who never asked the
19 question, or at least didn't ask the question in time: Wait
20 a minute. If they're selling me this quantity, what are
21 they selling to other people?

22 CHAIRMAN ANGELIDES: Thank you, very much.
23 Professor Kyle.

24 WITNESS KYLE: Thank you for inviting me here
25 today.

1 There are many, many culprits that have been
2 identified in causing the financial crisis. OTC
3 derivatives trading is one culprit that has been proposed.
4 Its relatives: short-selling and the securitization and
5 tranching of risks are others.

6 The list goes on. It includes: Poor risk
7 management at banks; the originate and distribute model of
8 banking; the credit rating agencies; the executive
9 compensation practices of large financial institutions which
10 allowed large bonuses to be paid; government mandates for
11 home ownership, and in particular mandates that Fannie Mae
12 and Freddie Mac purchase mortgages--backedby mortgages to
13 low-income home owners; and finally, unscrupulous banking
14 practices and greed.

15 I want to propose that there are different causes
16 of the financial crisis. That list that I just went through
17 includes many things that are interesting to talk about in
18 the context of the crisis, but two other factors were the
19 most important ones and the ones that we should keep in
20 mind.

21 The first of these is what I call "risk
22 shifting." The banks were playing with their own money as
23 long as they were making profits. Banks were playing with
24 taxpayer money when they were making losses.

25 So the what I call "risk shifting" is this idea

1 that a levered financial institution gets to keep the upside
2 but gets to dump the losses on taxpayers if it loses money.
3 Risk shifting was a big factor in the, lying behind the behavior of the
4 large
5 banks.

6 The second factor I want to identify is what I
7 would call "irrational exuberance." It's a belief that
8 housing is a good investment and that everybody should own a
9 home, not only because they need a place to live but because
10 it's a good investment to own a home.

11 History shows that home ownership is not that
12 great of an investment, and it is very risky. So it is
13 perfectly reasonable for people to be renters.

14 Now when you think about risk shifting and
15 irrational exuberance as being the causes of the financial
16 crisis, I think the solution to the problem is relatively
17 straightforward. We need much higher capital requirements
18 for banks. If we have much higher capital requirements for
19 banks, then banks will be playing with their own money and
20 not playing with taxpayers' money.

21 And, we need less emphasis on home ownership as
22 an intrinsically desirable social goal undertaken for its
23 own sake.

24 So to explore risk shifting a little further, and
25 also to put derivatives into perspective, let's take a look
26 at three different, I'll call them case studies, but three

1 different situations that occurred during the financial
2 crisis which I think are very similar even though they look
3 different. And I'll call them "Bear Stearns," but what I
4 say about Bear Stearns probably applies to Lehman Brothers,
5 and I'll refer to Citigroup, and I'll refer to AIG.

6 Bear Stearns failed because--not because it had
7 huge losses on its derivatives book, but rather it just
8 owned huge quantities of mortgages that it financed with a
9 huge amount of leverage. And it was allowed to do this
10 because the SEC/CSE program, which was supposed to regulate
11 the investment banks, did not have really high capital
12 requirements and did not have a really strong liquidity
13 requirement that was good enough to keep Bear Stearns in
14 business.

15 Bear Stearns collapsed when they were not able to
16 finance their inventories of mortgages and securities backed
17 by mortgages in the market because the market lost faith in
18 the company.

19 The same thing happened to Lehman Brothers. Yes,
20 Bear Stearns had a derivatives book, but the main reason it
21 failed was because of its highly levered risky mortgage
22 positions.

23 Citigroup, it set up off-balance-sheet entities
24 which invested in very safe, seemingly safe securities
25 backed by mortgages. Citigroup was given almost an infinite

1 ability to leverage these investments because capital
2 requirements were so low. And even though they were making,
3 or thought they were making a few basis points on the
4 transactions, those few basis points shows up as a really
5 high return on capital when it can be leveraged as much as
6 Citigroup was leveraging it. When it turned out these
7 investments were not so safe, Citigroup essentially
8 collapsed.

9 And then there's AIG. AIG did the same thing,
10 but they used derivatives contracts. They used credit
11 default swaps essentially to insure very safe securities,
12 and they were only making a few basis points on the
13 transactions they thought. But because of the leverage,
14 they thought that they could make a lot of money on this.

15 In all three cases, the use of this leverage was
16 irresponsible and ultimately led to the collapse of the
17 institutions. But I don't think they would have done it--
18 particularly Bear Stearns and Citigroup--if they hadn't been
19 playing with taxpayer money. If they had been playing with
20 their own money, they would have engaged in better risk
21 management, which I may return to later.

22 CHAIRMAN ANGELIDES: Thank you very much,
23 Professor Kyle. Mr. Masters.

24 WITNESS MASTERS: Good morning, Chairman, Vice
25 Chairman Thomas, and Members of the Commission:

1 I welcome the opportunity to appear before you
2 today to testify on the very important topic of the role
3 played by over-the-counter derivatives in the financial
4 crisis.

5 Although a combination of factors caused the
6 financial crisis, unregulated derivatives played an
7 essential and uniquely dangerous role. Their impact was
8 two-fold.

9 First, unregulated credit derivatives were
10 largely responsible for creating systemic risk that turned
11 isolated problems into a system-wide crisis.

12 Second, speculation ignited by unregulated
13 commodity derivatives sparked excessive volatility in
14 commodities prices which further harmed an already stressed
15 economy.

16 Both of these problems could have been
17 significantly mitigated by requiring OTC derivatives to
18 clear through a central counterparty with novation and daily
19 margin. This would have created transparency and precluded
20 the systemic risk inherent in a marketplace comprised of
21 opaque webs of interconnected and overleveraged
22 counterparties.

23 Central clearing would have also made it possible
24 to enforce the aggregate speculative position limits which I
25 have proposed in previous Congressional testimony.

1 I will first discuss how derivatives created
2 systemic risk. Then I will talk about their role in
3 fostering excessive price volatility.

4 Unregulated derivatives set the following three
5 fundamental preconditions for the system wide financial
6 crisis.

7 First, a lack of transparency in derivatives'
8 markets made it difficult for counterparties to see when
9 individual firms were taking excessive risk before the
10 crisis, or to distinguish creditworthy firms from risky ones
11 once the crisis started.

12 Second, the interlocking web of very large
13 exposures between the major swaps' dealers created the
14 potential for a domino effect wherein the failure of one
15 dealer could lead to the failure of all dealers.

16 Third, losses do not have to be very high in
17 order to force the first domino to fall due to the extreme
18 leverage that characterized those positions. This leverage
19 was the result of requiring little or no margin collateral
20 to be posted to ensure other dealers bets.

21 Together, these three factors formed the
22 preconditions for a contagion between institutions as well
23 as between markets. The large volume of trading between
24 swaps' dealers spawned an interlocking web of very large
25 exposures among the 20 or so largest dealers.

1 When the supposedly highly credit-worthy Lehman
2 Brothers defaulted, swaps' customers, plus many of their
3 swaps' counterparties, immediately lost large sums of money.
4 Swaps dealers were forced to radically re-evaluate the
5 creditworthiness of all their counterparties, and question
6 who might be the next to fail.

7 The OTC derivatives markets came to a grinding
8 halt, jeopardizing the viability of every participant
9 regardless of their direct exposure to subprime mortgage-
10 backed securities.

11 Furthermore, when the OTC derivatives markets
12 collapsed, participants reacted by liquidating their
13 positions in other assets those swaps were designed to
14 hedge.

15 Markets witnessed a sell-off across all asset
16 classes. The sell-off even extended to commodities, a
17 market historically uncorrelated with financial assets prior
18 to the deregulation of OTC derivatives markets.

19 This brings me to the topic of excessive
20 volatility arising from the intrusion of OTC derivatives
21 into commodities markets.

22 Unregulated derivatives directly distort
23 commodity prices by facilitating excessive speculation.
24 Index speculation in particular is an especially dangerous
25 source of volatility. It is worth emphasizing that

1 derivatives' dealers thrive on volatility, while the rest of
2 the economy suffers because of it.

3 In my testimony before the Senate Agriculture
4 Committee last year I explained how the devastation caused
5 by the rapid deterioration of our credit markets, which
6 pushed our financial system to the brink, was greatly
7 exacerbated by the 2008 derivatives' driven rise and
8 collapse in food and energy prices.

9 In conclusion, I would like to reiterate that
10 during this crisis one single factor stood out in its
11 potential to destroy the financial system as a whole: The
12 massive interlocking web of over-the-counter derivatives'
13 exposures among the biggest Wall Street swaps dealers.

14 Many financial institutions might have gone
15 bankrupt or suffered severe losses from the crisis, but the
16 system as a whole would not have been imperiled were it not
17 for the propagation of unregulated derivatives' markets.

18 Thank you.

19 CHAIRMAN ANGELIDES: Thank you very much,
20 gentlemen, and we are now going to begin Commissioner
21 questioning. And as is the custom, I will begin as Chair,
22 and then the Vice Chair will follow me, and then the
23 Commissioners who led this investigation and hearing will
24 then follow.

25 Let me start with a couple of questions. I am

1 going to take a few of my questions now, and then defer the
2 balance to after the balance of the Commissioners have
3 spoken.

4 I want to ask a couple of you about the role that
5 derivatives played in accelerating, or perhaps enlarging,
6 amplifying, the creation, the issuance, the marketing of
7 synthetic collateralized debt obligations backed by
8 mortgage-backed securities?

9 Some have posed the fact that by the very nature
10 of having these derivatives, it accelerated the market, it
11 enabled the market. And therefore obviously in the end it
12 amplified both the boom and the bust.

13 So I would like to ask a couple of you to comment
14 on that. I'll start with you, Mr. Greenberger, if you would
15 comment on that: the extent to which credit default swaps
16 amplified, accelerated the market. And I am going to ask a
17 couple of others the same question.

18 WITNESS GREENBERGER: Well let me break it down
19 into two answers.

20 First of all, you have credit default swap
21 insuring real risk. That is, people hold and investment in
22 the subprime market and want to get insurance.

23 Just like we drive cars with comfort, even though
24 we may get into an accident, our insurance policy gives us
25 that comfort. People were investing in the proposition that

1 people without credit, or adequate credit, would pay their
2 mortgages.

3 That investment became much easier if you could
4 say, hey, I've got an insurance policy. And, by the way, it
5 wasn't just AIG. All these institutions were issuing credit
6 default swap. Read "House of Cards" by William Cohan, or most
7 importantly read "A Colossal Failure of Common Sense" by
8 Lawrence McDonald, a trader and officer within Lehman, who
9 blames credit default swaps for bringing Lehman down.

10 So, yes, if I've got insurance I'm going to take
11 more risk. They didn't understand that, unlike most
12 insurance policies, no collateral or capital had to be
13 posted. But the real villain of the piece here is, as Eric
14 Dinallo has said, and I know he will be before you, his
15 analysis of MBIA, the monoline which he was in charge of
16 trying to rescue, and AIG, was that for every real insurance
17 policy insuring risk, there were three to four that were a
18 gamble.

19 In other words, you could buy insurance on
20 somebody else's car, on somebody else's life, or in this
21 case on somebody else's CDO. In the SEC case against
22 Goldman, leaving aside fraud--I don't want to talk about
23 fraud--but just look at that transaction. John Paulson
24 played fantasy CDO. He went across a range of CDOs and
25 picked out the most dangerous tranches. He bet a billion

1 dollars those tranches would fail.

2 Some poor schnooks on the other side who thought
3 housing prices would always go up, took the opposite end of
4 that bet. John Paulson made a billion dollars. The
5 counterparties lost the billion. Many of them needed to be
6 rescued with taxpayer funds.

7 So the problem here is only in a small sense the
8 mortgage default. The real problem here is all the
9 gambling--don't forget, state gaming laws are preempted--all
10 the gambling on whether the defaults would occur, that had
11 nothing to do with the real economy. As you said, no
12 warehouses got built. No manufacturing capability. No
13 medicines got discovered. It was just Mr. Paulson, and he
14 could do it legally, bet that non-creditworthy individuals
15 would not pay their mortgages.

16 That blew a hole in the economy. Because of no
17 clearing requirements, the AIGs of this world never had to
18 post margin. And they woke up on September 16th \$80 billion
19 in the hole.

20 CHAIRMAN ANGELIDES: All right. Mr. Kohlhagen,
21 would you comment on my question, and perhaps pick up on--

22 WITNESS KOHLHAGEN: I'm sympathetic to what Mr.
23 Greenberger said, and I agree with your contention--

24 CHAIRMAN ANGELIDES: "Question," but that's okay.

25 WITNESS KOHLHAGEN: I took it as a contention.

1 Okay. Then let me state what I believe.

2 I believe that credit default swaps did enhance
3 the bubble. They were a bubble enabler. I think that the
4 bubble started before credit default swaps.

5 I think one of the things people need to step
6 back from and realize is that in order for a market to work
7 you have to have sellers and buyers. And once the credit
8 default swaps, once people figured out how to use credit
9 default swaps, there now was a new source of sellers that
10 hadn't existed before. There was no way to actually sell or
11 short the market.

12 With the development and the rapid growth of
13 credit default swaps starting late in the bubble, there was
14 a whole new source of sellers, and there could be a whole
15 new source of buyers. And so he's right that there were
16 people making and losing money. If you go back to the cause
17 of this, what was going on in the United States' housing
18 industry and the subsidization of the guarantees by the
19 Federal Government of creating a whole new set of home
20 ownership, there were certain costs to the U.S. taxpayers
21 for that.

22 Nobody knew what it was going to be going in.
23 But once the bubble started, once you had enabled the
24 bubble--and I am agreeing with you that CDOs, synthetic CDOs
25 and credit default swaps enhanced the bubble in the latter

1 stage--you now not only have the cost to the U.S. Taxpayers
2 of the subsidies, but you now had gains and losses, as
3 Mr. Greenberger said, from the market.

4 So add to the cost to the U.S. Taxpayers the
5 losses the people saw. And people see that as the cost and
6 ignore the billions in gains that he talked about.

7 CHAIRMAN ANGELIDES: All right. Actually let me
8 pick up on this, and actually, Professor Kyle, I'm going to
9 pick up on your comments about what seems to be a common
10 thread.

11 No matter what device was chosen by the
12 institutions that failed, each device had extraordinary, or
13 each strategy, or lack thereof, had extraordinary leverage
14 associated with it.

15 What we have just heard these two gentlemen lay
16 on the table is in essence that you had this large betting
17 parlor. You know, in my opening remarks I referred to the
18 fact that I'm someone who spent 30-plus years of my life in
19 the fields of housing, and investment as a practitioner, and
20 I was quite stunned to see the level of, in a sense,
21 leverage going on and betting going on with respect to these
22 securities.

23 To what extent do you believe, or not believe
24 that these instruments allowed for the inflation of this
25 bubble? In other words, it may not have been the sole

1 cause, but were they the device-du-jour that allowed this
2 bubble to be amplified significantly?

3 WITNESS KYLE: So I think my view is the opposite
4 of the other panelists on this. I think that one of the
5 reasons we have derivatives and particular credit default
6 swaps is to allow short sellers to bet that a security is
7 overvalued by selling it short, and then profit if it goes
8 down.

9 There weren't really good vehicles for taking
10 short positions in mortgages or other securities backed by
11 housing finance instruments in the early stages of the
12 bubble. But as the bubble progressed, you started getting
13 more and more synthetic CDOs and credit default swap type
14 instruments that could be shorted in very significant
15 quantities.

16 If you don't have short sellers in a market,
17 there is a danger that asset prices will be over-valued;
18 that innocent, or unsophisticated investors will pay more
19 for a security than it's worth. Because without short-
20 selling, only the people with bullish, or optimistic
21 opinions are heard. It's kind of like I'm not allowing the
22 opinions, the negative opinions to be heard in the
23 marketplace.

24 So as instruments for shorting, subprime
25 mortgages developed and became more commonplace in 2006 and

1 2007. My opinion is that the short sellers essentially came
2 into the party and turned off the lights a bit earlier than
3 the lights would have been turned off otherwise.

4 In other words, they helped prevent the bubble
5 from getting worse than it would otherwise have gotten by
6 damping down the values of these securities.

7 CHAIRMAN ANGELIDES: I am going to challenge that
8 a little in this sense. The fact is that because you
9 essentially had these highly levered bets, you know, the
10 CDS, as Professor Greenberger said, you had the ability for
11 example on all the Goldman Abacus deals for there to be, you
12 know, in a lot of these deals there might have been a \$2
13 billion synthetic CDO where maybe there was \$100 to \$200 in
14 real money up. And of course that was just a bet because it
15 was, you know, without being pejorative, it wasn't on a real
16 asset; it was referencing securities. But you had perhaps
17 \$1.9 billion that was extraordinarily levered.

18 You know, in essence Goldman, for example, paying
19 AIG \$2.1 million a year on a bet that they could ultimately
20 win \$1.7 billion.

21 Isn't the fact that there was this enormous
22 leverage available, didn't that just pump up the balloon?
23 And I will credit my Vice Chair with a question, which is,
24 instead of the balloon being filled with air, was it being
25 filled with helium?

1 WITNESS KYLE: Well, the big leverage of course
2 is the homeowner who buys a home with no money down.

3 CHAIRMAN ANGELIDES: Well, there are two points
4 of leverage, correct? I mean, you've got the homeowner
5 doing that, eroding lending standards, but now you have an
6 almost 100 percent bet on that bet.

7 WITNESS KYLE: Yes. So you have the homeowner
8 who is buying the home with essentially infinite leverage.
9 Then you have investors, or traders in the marketplace using
10 derivatives, and the derivatives are structured to
11 incorporate the ability to undertake a lot of leverage. And
12 the tranching of the mortgage-backed securities, and in
13 particular some of the tranches that went into the Abacus
14 deal that you're going to be hearing about today, those
15 tranches were designed to package a lot of risk into a
16 small investment.

17 And this enabled buyers of the collateralized
18 debt obligations to take on a lot of exposure to the
19 mortgages with a small amount of money. The synthetic part
20 of it--and the synthetic part of it, let me make it clear,
21 is the derivatives part of it--the synthetic part of it
22 serves the purpose of allowing a trader to take a short
23 position, and to take a short position as Mr. Paulson did
24 with a great deal of leverage.

25 So that synthetic portion, by allowing traders to

1 take a short position, tends to push the price of the asset
2 down rather than up. So I think that the creation of
3 synthetic CDOs had the effect of dampening down a
4 speculative binge that otherwise was propagating itself with
5 long positions, highly levered long positions, by investment
6 banks and hedge funds and even individual home owners that
7 had gotten out of control.

8 CHAIRMAN ANGELIDES: All right, go ahead
9 Kohlhagen, and then we will move on.

10 WITNESS KOHLHAGEN: Are we allowed to comment on
11 that?

12 CHAIRMAN ANGELIDES: I will allow you to comment.
13 Would you, please, and then I have one observation to make.

14 WITNESS KOHLHAGEN: The existence of leverage
15 that you both were discussing about, or both discussing,
16 does not necessarily lead to this outcome. I mean, currency
17 derivatives, interest rate derivatives, decades of
18 experience with highly leveraged books, of hedged books by
19 derivatives desks have never led to these kinds of problems.

20 So it's not a necessary outcome. It's not a
21 necessary outcome of the leverage.

22 WITNESS GREENBERGER: If I could take fifteen
23 minutes, Mr. Chairman, I would just--

24 CHAIRMAN ANGELIDES: Fifteen "minutes"?

25 WITNESS GREENBERGER: Fifteen seconds.

1 CHAIRMAN ANGELIDES: I only have thirteen minutes
2 left.

3 WITNESS GREENBERGER: Fifteen seconds.

4 (Laughter.)

5 WITNESS GREENBERGER: Like billions and millions,
6 I get confused between minutes. There's nothing wrong with
7 short selling. You just have to have--the other side of the
8 bet has to have the capital to pay it off.

9 If it were in a clearinghouse, you would short
10 sell and know that AIG had the money to pay the bet off.
11 The American Taxpayer paid these bets off. That's what's
12 wrong with that short sale.

13 CHAIRMAN ANGELIDES: And that's one of the things
14 that strikes me, is that on a lot of these transactions
15 there was no skin in the game. At the end of the day, the
16 only skin came off the back of the Taxpayers.

17 You have these people who say it's a zero sum
18 game, but there were clear winners here and losers, and I
19 don't think it takes a math genius to know who the losers
20 were because of the bills that were paid.

21 WITNESS KOHLHAGEN: AIGFP had 20 years of
22 experience of running derivatives books, hedged derivatives
23 books with never a problem. It was doing these credit
24 default swaps that they did with no hedging at all, just
25 writing them naked, that led to their problem.

1 CHAIRMAN ANGELIDES: Right. The Vice Chair would
2 like to ask a question. Go ahead.

3 VICE CHAIRMAN THOMAS: Thank you. On that point,
4 Dr. Kyle, I understand your argument about the need for
5 short sellers, but I guess my biggest problem is in this
6 poker game I kind of like to watch it on TV because I always
7 get to see what everybody else has, and then watch the fool
8 get burned because he didn't know what the other guy had.

9 My worry is this whole business of transparency,
10 and an understanding of exactly what we thought were
11 sophisticated participants not being as sophisticated or
12 knowledgeable as we thought they were.

13 And I understand the clearinghouse concept, which
14 kind of helps it clean up, but in the situation we found
15 ourselves did you still think that short was good? Or were
16 they simply betting on a hunch without having similar
17 information? And was there a preponderance of information
18 in one group, or one group thought they had a preponderance
19 of information and therefore did more because they thought
20 they could control the situation?

21 It's this business of knowing and the failure of
22 transparency on both sides of this game that frankly has
23 just amazed me in terms of the bets they put down.

24 CHAIRMAN ANGELIDES: And by the way, just a
25 technical matter here, Mr. Vice Chair, I'm actually done

1 with my time, so you can now roll.

2 VICE CHAIRMAN THOMAS: Okay, I used some of his,
3 so now I'm on my time.

4 WITNESS KYLE: Okay, so--so I think I agree with
5 you. I believe that if you put more derivatives on
6 organized exchanges, if you standardized the contracts, if
7 you traded them in transparent markets, if you published
8 information about the positions that various parties have,
9 even if you encouraged discussion of how they're priced
10 which is helped by having the prices transparent, the people
11 who are going long and the people who are going short might
12 come to understand why they were disagreeing.

13 VICE CHAIRMAN THOMAS: Or especially those people
14 who were going short with no chips on the table.

15 WITNESS KYLE: Well I think the people that went
16 short did have chips on the table. Mr. Paulson I think had a
17 billion dollars worth of chips on the table that he turned
18 into a large profit.

19 But the people that bought the--took the long
20 positions--

21 VICE CHAIRMAN THOMAS: Did you state that
22 accurately? He couldn't have had a billion dollars of chips
23 on the table going short, and then walk away with a billion
24 dollars.

25 CHAIRMAN ANGELIDES: Could I make--

1 VICE CHAIRMAN THOMAS: Sure, on my time, you go
2 ahead.

3 CHAIRMAN ANGELIDES: On your time, my
4 understanding is, I believe from the work of our staff, is
5 that I think Mr. Paulson paid about a \$15 million annual
6 payment, and I assume it was over probably about a two-year
7 period or so, or three-year period, until payoff. So that
8 was the ratio of leverage essentially.

9 VICE CHAIRMAN THOMAS: And the other concern, and
10 I'm jumping in the middle on a specific question, and
11 I'll go back to a broader approach in a second, was the idea
12 of leverage and the possibility that insurers--maybe AIG in
13 particular--didn't even understand the mechanism in terms of
14 their responsibility to put up real money if there's a
15 change in relationship of the value.

16 I mean that's a pretty fundamental rule of the
17 game that you would think insurance companies would
18 understand what it was that they were insuring against. And
19 how the consequences of that policy would operate.

20 WITNESS KYLE: Okay, so let me make two points.

21 Many people think that short selling is extremely
22 dangerous because your upside losses are kind of unlimited
23 if the price of the asset skyrockets.

24 VICE CHAIRMAN THOMAS: It depends on what you
25 know and when you know it.

1 WITNESS KYLE: It does depend on what you know
2 and when you know it. And this is true in particular if
3 you're talking about individual stocks. But if you're
4 talking about taking a short position in a security that
5 everybody else deems to be AAA, or extremely safe, and it's-
6 -

7 VICE CHAIRMAN THOMAS: Well we'll get to that
8 later about what AAA means.

9 WITNESS KYLE: --but if everybody thinks it's
10 AAA, the potential losses on taking a short position on such
11 a security are very small.

12 I mean, how much is the price of a security that
13 everybody trades if it's AAA going to rise and move against
14 you if you've taken a short position?

15 VICE CHAIRMAN THOMAS: If everyone thought it was
16 going to be a good bet, there would have been more with Mr.
17 Paulson, wouldn't there?

18 WITNESS KYLE: You would have thought so. So Mr.
19 Paulson in taking his position in credit default swaps was
20 not posing a risk to Taxpayers that he might lose money. He
21 was paying a fee to buy insurance. That was his money
22 coming out of his pocket, or his hedge fund's pocket. And
23 he stood to lose the money that he was paying for the
24 insurance. But he stood to make a great deal if a
25 catastrophe occurred in the debt markets for those

1 instruments, which indeed it did occur.

2 So I don't think he posed a risk to Taxpayers.

3 But certainly the people on the other side of the

4 transaction did pose a risk to Taxpayers.

5 CHAIRMAN ANGELIDES: Well, and again we're doing
6 a little duo here this morning. We both said we came and
7 we'd read all our materials. There was so much, and so
8 interesting, we were unscripted because there was so much we
9 wanted to see where this goes, but that's a key point there.

10 That of course Mr. Paulson was not systemically
11 important. On the other side of the bet, you ended up
12 having institutions that turned out to be. And therefore
13 the size of the bets, the size of the betting does matter in
14 the end. And who does it matters in the end.

15 WITNESS KYLE: Yes. And bond markets are
16 different from commodity markets in the sense that typically
17 in a commodity market when the price of the commodity starts
18 rising, things start getting more risky and more volatile.
19 When prices fall, typically things calm down.

20 In bond markets, it is just the opposite: When
21 prices rise, bonds become safer; things calm down. When
22 prices fall, things go haywire.

23 So in the case of the other side of Mr. Paulson's
24 bet, as prices fell volatility increased. These
25 collateralized debt obligations were structured in such a

1 way--

2 VICE CHAIRMAN THOMAS: Margins.

3 WITNESS KYLE: --as to magnify the volatility if
4 prices fell. And Mr. Paulson knew that and was hoping to
5 profit from that as prices fell.

6 But back to your earlier question, there was
7 fundamental disagreement in the market between those who
8 thought that housing prices would go up forever and those,
9 like Mr. Paulson, who thought that housing prices would come
10 down.

11 And my experience, having debated with people
12 during the bubble, during this period, was that you could
13 share your opinions with people, but people would not change
14 their mind. There was some fundamental disagreement among
15 the various participants in the market, and this
16 disagreement occurred on Wall Street. It also occurred on
17 Main Street as you talked to people who thought it was a
18 good idea to buy a much bigger house than they needed
19 because it was a good investment.

20 VICE CHAIRMAN THOMAS: Just to respond to that,
21 you know economists are fond of saying that all of the
22 things being equal, and if the mortgage market looked like
23 it used to, 20 percent down, you get a statement of income,
24 what you've done, the rest of it, it wouldn't have been what
25 it was.

1 And so to a certain extent, there were people
2 assuming certain things. They didn't do their due
3 diligence. And what it was that they had as a AAA-rated, it
4 isn't what it used to be, but people were given assurances
5 that it was. So to a certain extent, to me there was a
6 great deal of ignorance on people who should not have been
7 ignorant about the level of participation.

8 And I would be much more concerned about those
9 poker games I watch if my money was staking one of those
10 guys who keeps doing what he's doing and he ain't gonna be
11 at the table long. Reaction?

12 WITNESS KOHLHAGEN: Mr. Vice Chairman, I don't
13 want to comment on the poker game analogy, but I do want to
14 go back to something about two-and-a-half minutes--

15 VICE CHAIRMAN THOMAS: What gambling type would
16 you prefer that I use? Roulette wheel?

17 WITNESS KOHLHAGEN: I'll let you do the
18 analogies.

19 (Laughter.)

20 VICE CHAIRMAN THOMAS: Okay.

21 WITNESS KOHLHAGEN: A couple of minutes ago you
22 asked a question. I want to make an important
23 clarification, if it's not understood by everyone. AIG is
24 an insurance company. It was in fact the strongest, most
25 financially secure, best-run insurance company maybe in the

1 history of the world.

2 VICE CHAIRMAN THOMAS: Somebody you wanted on the
3 other side of your deal.

4 WITNESS KOHLHAGEN: Yes. AIGFP had nothing to do
5 with insurance. They were a derivative subsidiary. They
6 still are a derivative subsidiary. And the people who
7 managed and ran AIGFP and worked at AIGFP knew nothing about
8 insurance.

9 So it would be a mistake to view AIGFP as an
10 insurance entity. The executives who ran AIG were
11 responsible for managing the subsidiary, and clearly in this
12 case they failed.

13 VICE CHAIRMAN THOMAS: Okay. And that brings up
14 another whole series of questions about how it was handled
15 after the fact, and that particular segment. Could it have
16 been severed, and a whole bunch of other questions, which we
17 may get to.

18 Let me now start my time in terms of what I
19 usually do on my time. First of all, thank you for already
20 being fairly frank and allowing us to get some degree of
21 different answers which will help us better understand and
22 we will do more of it.

23 What I would ask of you is, not to stand but to
24 simply please say 'yes' to the question: If we have
25 information based upon your testimony, or we discover other

1 information as we continue to go forward, would you be
2 willing to respond to questions that we would put to you in
3 writing following this hearing?

4 (The witnesses nod affirmatively.)

5 VICE CHAIRMAN THOMAS: She can't record head
6 nods.

7 WITNESS GREENBERGER: Yes.

8 WITNESS KOHLHAGEN: Yes.

9 WITNESS KYLE: Yes.

10 WITNESS MASTERS: Yes.

11 VICE CHAIRMAN THOMAS: Thank you very much. You
12 know, some of us really did think if the rules of the game
13 would remain the same that house prices would go up. I'm a
14 creature of Southern California, and frankly no one who
15 didn't have to pay rent paid rent. And it paid off for a
16 long time.

17 And anyone looking at the Tax Code, if you had
18 the ability to buy a place that you could reasonably afford
19 and it fit into your three-times income, all of those little
20 calculations that people used to use, that it was usually
21 very, very rich people who didn't worry about trying to
22 build a nest egg in a way that seemed to be reasonable who
23 would rent.

24 So to what extent did the Tax Code play a role in
25 moving us in the direction that we eventually went? Since

1 you mentioned renting versus buying?

2 WITNESS KYLE: I think that the deductibility of
3 interest and property tax payments encourages people to buy
4 homes. It does make the rent/buy calculus favor home
5 ownership.

6 On the other hand, if you compare the United
7 States with other countries, we have very high property
8 taxes. So I view the deductibility of interest as being
9 largely offset by the high property taxes that we have in
10 the United States and therefore view it as a kind of neutral
11 as to rent versus buy.

12 Like you, I used to live in California and I
13 talked to people a lot about the rent versus buy calculus.
14 So I went online a few years ago in the middle of the
15 bubble--I think it was about 2005 and 2006--and downloaded
16 about 40 or 50 rent versus buy calculators, and I learned
17 two things from those calculators, or three things.

18 First of all, they all gave a different answer.
19 Second of all, they all said you should buy a home. And
20 third of all, all of them were wrong.

21 VICE CHAIRMAN THOMAS: And they were all
22 sponsored by realtors.

23 (Laughter.)

24 WITNESS KYLE: Most of them were sponsored by
25 realtors, and realtors generally tell you to buy a home. My

1 experience sitting down with homeowners and actually trying
2 to get homeowners to go over the numbers was that homeowners
3 really hadn't figured out whether it was valuable for them
4 to rent or to buy. And in particular, in California rent
5 yields traditionally--at least back in the 1980s--in many
6 periods have been very low. So it's an easy decision to
7 rent.

8 VICE CHAIRMAN THOMAS: And you also haven't
9 touched on the Tax Code provision, which concerned me from
10 the time that we didn't clear it up, having been on the
11 committee, was when we decided to not allow the deduction of
12 consumer interest; that we didn't insulate, isolate, and
13 protect the equity in your home from cleverly, and sometimes
14 not so cleverly, being utilized for consumer interest rather
15 than building up equity in the home.

16 WITNESS KYLE: I personally feel that the
17 decision to allow interest deductibility of home mortgage
18 interest but not allow the deductibility of credit card debt
19 interest undermined the integrity of the housing market.

20 VICE CHAIRMAN THOMAS: It certainly did, in terms
21 of producing a check for the equity that you gained every
22 month so that you could spend it, leaving people with no
23 margin after having lived in their home for years, of
24 protection that you would have thought ordinarily would have
25 been in the home.

1 WITNESS KYLE: And not only that, it of course
2 encouraged people to take their credit card debts and kind
3 of transfer them over to their mortgage effectively so that
4 they--

5 VICE CHAIRMAN THOMAS: Sure, or the RV, or the--

6 WITNESS KYLE: --so that they could get the
7 interest deductibility.

8 VICE CHAIRMAN THOMAS: That was the problem.

9 WITNESS KYLE: And it also encouraged banks to
10 think of home mortgages kind of like credit card debt, which
11 implies that the incentives to get let's say a good
12 appraisal on a house are undermined at the level of the
13 bank, because the bank is really in some sense making
14 something akin to a credit card loan to the homeowner and
15 not something that's your traditional mortgage that you
16 referred to earlier where the homeowner makes a 20 percent
17 down payment based on a legitimate appraisal and
18 verification of income.

19 VICE CHAIRMAN THOMAS: Well, and we'll go into in
20 some detail what my colleague from Las Vegas indicated to me
21 that there have now been 123 indictments in Las Vegas for
22 mortgage fraud. In even my own town we have several cases
23 that are clearly indicated. And obviously the discussion
24 that we had from the '80s simply seems like petty
25 misdemeanor based upon what occurred toward the end of the

1 session.

2 I am going to reserve my time because I want to
3 make sure that some of those who are very interested in the
4 narrow issue, which is the one in front of us, derivatives,
5 have maximum amounts of time to pursue that. But I do want
6 to come back near the end, Mr. Chairman, and ask this panel
7 if they would be willing to answer some questions based on
8 the fundamental concern we have, which is what are the
9 fundamental underlying causes of the financial crisis. And
10 maybe we'll get to vote on some of them. Thank you. I
11 reserve my time.

12 CHAIRMAN ANGELIDES: Thank you. And I am going
13 to, as I said, reserve the balance of my time for the end.

14 Ms. Born.

15 COMMISSIONER BORN: Thank you very much, Mr.
16 Chair. I appreciate all four of you appearing today to help
17 us explore the role of over-the-counter derivatives in the
18 financial crisis.

19 We have experienced the most, and are
20 experiencing the most significant financial crisis since the
21 Great Depression, and it appears that regulatory gaps,
22 including the failure to regulate over-the-counter
23 derivatives may have played an important role in the crisis.

24 As a result of pressures from a number of the
25 country's largest financial institutions who are and were

1 our largest derivatives dealers, Congress passed a statute
2 in 2000 called The Commodity Futures Modernization Act that
3 eliminated virtually all regulation over the over-the-
4 counter derivatives market.

5 Because of that statute, no federal or state
6 regulator currently has oversight responsibilities or
7 regulatory powers over that market. The market is opaque
8 and is often referred to as "the dark market."

9 It is enormous. As of December of last year, the
10 reported size of the market was almost \$615 trillion in
11 notional amount, still more than 10 times the gross domestic
12 product of all the nations in the world.

13 While over-the-counter derivatives have been
14 justified as vehicles to manage risk, they in practice can
15 spread and multiply risk as well. Lack of transparency,
16 lack of price discovery, excessive leverage, lack of
17 adequate capital and prudential controls, and a web of
18 interconnections among counterparties have made this market
19 dangerous, and we will be examining the role that the market
20 has played in the financial crisis.

21 Warren Buffett has appropriately dubbed over-the-
22 counter derivatives "financial weapons of mass destruction."
23 And in a recent Commission hearing he said the time bomb is
24 still ticking.

25 Congress has just taken an historic and important

1 step toward closing this regulatory gap when the Conference
2 Committee on Financial Regulatory Reform decided on a bill
3 that would impose comprehensive federal regulation on
4 derivatives, including the requirement that most derivatives
5 must be traded on exchange and centrally cleared.

6 I look forward to its passage into law and its
7 full implementation in order to protect the public from the
8 systemic dangers posed by the market.

9 And as my first question I would like to direct
10 it initially to Professor Greenberger, and it concerns the
11 deregulation of these markets. In your view, did
12 deregulation of the over-the-counter derivatives market in
13 any way contribute to the financial crisis? And if so,
14 would you explain how?

15 WITNESS GREENBERGER: I believe it certainly did.
16 And just to go back to the AIG example, or the person who
17 took the opposite end of Mr. Paulson's bet--by the way, Mr.
18 Paulson made that bet with \$15 million. He got \$1 billion.
19 If he had lost the bet, he would have lost \$15 million. He
20 had absolutely no risk. AIG had complete risk.

21 Now let's take AIG. Suppose we had had
22 traditional market controls. We have heard that the
23 management of AIG didn't understand what was happening. If
24 we had had traditional market controls, the subsidiary would
25 have had to go to the holding company and say I've got to

1 put collateral down. \$80 billion probably would have been
2 \$7 billion in collateral.

3 And when the adults in AIG understood that they
4 were insuring mortgages by non-creditworthy individuals, my
5 confidence is that they would have said: Are you kidding?
6 We're not giving you \$7 billion to run the risk of \$80
7 billion.

8 Then, Vice Chairman Thomas said, well, you know,
9 there's no transparency here. If the exchange trading had
10 been involved, the regulators would have known that AIG was
11 buying these positions like crazy. The Fed, the Treasury,
12 the CFTC, and probably state insurance regulators would have
13 said: What are they doing here? They're running up this
14 phenomenal risk.

15 But we didn't have clearing. So they never had
16 to post anything. They're AAA rating. They could make
17 these bets of \$80 billion without putting a shekel on the
18 table.

19 The holding company didn't know what was going
20 on. When AIG failed, there was \$20 billion in reserves of
21 all the regulated insurance subsidiaries, and on September
22 16th there was an \$80 billion hole with the FP subsidiary.

23 So if you have regulation, you have--as the value
24 of that bet declined minute by minute, AIG would have been
25 called up by its clearinghouse, post margin. Post margin.

1 And not wake up one day and find they were \$80 billion in
2 debt.

3 And if they hadn't posted margin, the deal would
4 have been shut out. If it was on an exchange, everybody
5 would have seen what was happening. The regulators would
6 have seen this phenomenal risk taking that was going on, and
7 I'm confident that somebody would have said: Holy cow!
8 Holy cow! And finally, we're not in the Lehman bankruptcy.
9 There are major fights over what the value of these
10 instruments are.

11 The creditors are saying they're worth a billion.
12 Lehman's saying they're worth \$500 million. If you're on an
13 exchange, the market prices these things minute by minute.
14 You don't have these disputes. We couldn't rescue or buy
15 the TARP assets because we didn't know what the price was.

16 So if there was regulation, my view is these
17 crazy bets on bus drivers paying off \$400,000 mortgages
18 would have never happened. If they had happened, the
19 collateral that would have been called would have dampened
20 this market substantially. The transparency of the exchange
21 would have alerted not only regulators but market observers
22 that craziness was going on here. Let's head it off.

23 And finally, we would have prices and not debates
24 over prices.

25 COMMISSIONER BORN: So one of the things we are

1 going to be looking at later today with AIG and Goldman
2 Sachs is the price disputes that they entered into about the
3 value of the underlying reference assets, or synthetic
4 assets for the CDS. And also, the need for AIG suddenly to
5 post enormous amounts of money.

6 What I am hearing you say is that, if this had
7 been trading on an exchange, there would have been price
8 discovery that showed what the values were, and what one
9 party would owe to another. Is that right?

10 WITNESS GREENBERGER: That's exactly right. We
11 can't have a debate over what the worth of an IBM stock is.
12 I can't tell you it's worth a billion, and you can't argue
13 with me that it's \$500 million. The market tells us minute
14 by minute what an IBM stock is worth.

15 The same is true with pork bellies that are sold
16 on exchanges. We can't argue over what the price is. The
17 market tells you minute by minute what the price is.

18 Because these were opaque, off-exchange, private
19 bilateral transactions, the only methodology for determining
20 a price is using crazy mathematical algorithms. That's
21 called mark-to-model.

22 So you get in these phenomenal disputes that
23 Lehman in its bankruptcy is now having with its creditors.
24 By the way, Lehman entered into 930,000 unregulated over-
25 the-counter derivatives; 6,000 of its creditors are in

1 disputes with it. One of the creditors is claiming its
2 claim is worth a billion, and Lehman has sued them saying
3 it's an exaggeration by hundreds of millions of dollars.

4 If you exchange trade, the free market tells you
5 what the value is and you end all these disputes.

6 COMMISSIONER BORN: Well, and I also think I
7 understand you are saying that once the price is adequately
8 discovered through exchange trading, there is no big buildup
9 of indebtedness by one side of the contract to the other
10 because of the clearing mechanism?

11 WITNESS GREENBERGER: Absolutely. When AIG
12 entered into these bets, it didn't all of a sudden become a
13 bad bet. It gradually--as the housing market became more
14 risky, that bet became a more risky bet. The value of it
15 declined.

16 And in a clearing situation, the clearinghouse
17 twice a day would have gone back to AIG and said, hey, you
18 lost a million dollars today. Post the margin. Maybe at
19 noon they would have done that. At five o'clock, another
20 million.

21 And again, the adult supervision at AIG would see
22 all this margin going out. Why? Because the contract was
23 losing money. Not all at one time. Day by day. This
24 crisis didn't build up overnight. And instead, because they
25 had to post no collateral, you get into these arguments

1 between Goldman and AIG. All of a sudden Goldman is saying,
2 post collateral. How much collateral? We don't know. And
3 you have a fight over that.

4 In a clearinghouse, twice a day, based on the
5 minute-by-minute pricing, the clearinghouse tells you how
6 the market is going against you. And by the way, if you
7 can't pay the margin, the clearinghouse closes you out right
8 then and there.

9 The best thing that could have happened to AIG
10 was a couple of days into this crazy process they were
11 closed out by their clearinghouse.

12 COMMISSIONER BORN: Mr. Masters, can I ask you to
13 explain further your statement. You have said that you
14 thought over-the-counter derivatives, particularly credit
15 default swaps, played a role in creating systemic risk that
16 made the financial crisis worse, and it indeed extended it
17 systemically.

18 And as I understand it, you described the
19 interconnections between the large over-the-counter
20 derivatives dealers and other big financial institutions.
21 In fact, you have quite a wonderful chart in your testimony
22 that everybody should take a look at that illustrates maybe
23 just a few of the interconnections, since I believe there
24 were millions and millions of contracts outstanding.

25 Could you describe how these interconnections

1 created systemic risk?

2 WITNESS MASTERS: Sure. So the interconnections,
3 the problem with the interconnections not having these
4 trades on a clearinghouse of some form where everybody--the
5 clearinghouse was standing, to what Michael was saying, in
6 the middle of all these trades, was that no one really knew
7 who had what.

8 And so once you had one domino fall, which I was
9 describing in my testimony, all the dominos could fall.
10 Because suddenly if you had CDS on let's say with Lehman
11 Brothers, and let's say you had CDS on a mortgage bond, or
12 you had it on some other bank's portfolio that you had
13 hedged, suddenly you didn't know if that CDS was good
14 anymore. Because embedded in every CDS contract is a credit
15 counterparty part of the contract.

16 So there's the bet. And then there's the credit
17 counterparty. And the problem with that is that--

18 COMMISSIONER BORN: So when you say "credit
19 counterparty," you mean there's a credit risk as well that
20 the counterparty might not be able to pay you?

21 WITNESS MASTERS: Correct. And I think for a
22 long time people just sort of ignored this. They said,
23 well, you know, I've got this on with Goldman, or with
24 Lehman, or with AIG, or whatnot. And suddenly when Lehman
25 went down, people said, wait a minute. I've got all of

1 these over-the-counter credit default swaps on. I've got
2 over-the-counter other instruments on. I want it all back.
3 I want to unwind all my bets.

4 And the whole problem with that, having this
5 interconnectedness if you will, is it's the worry of what
6 does the other person have? And so when everybody is
7 worried about what everybody else has, what they do is they
8 say, oh, well I just want all my chips back.

9 And everybody collectively said: I want all my
10 chips back. And so you saw correlations in the markets go
11 to one. You had the very situation you had. And that's how
12 systemic risk was transferred. It went from one, to the
13 other, but it was the fear of everybody's bets were bad.

14 Because if Lehman wasn't going to pay off, then
15 what about AIG? And in my view that was one of the reasons
16 why AIG was toppling a few days later. Because if you
17 couldn't trust AIG, now what do you have to do? And it is
18 further my belief that I think Treasury was going to let AIG
19 go until they realized that if AIG went, you know, everybody
20 else was going to go. And literally it was like dominos.

21 COMMISSIONER BORN: So it was partly the
22 counterparty credit risk. That is, that if AIG defaulted on
23 its CDS, then its counterparties would be in a vulnerable
24 financial position themselves might then default on
25 their derivatives' obligations and even fail themselves, as

1 AIG did. Is that right?

2 CHAIRMAN ANGELIDES: Before you answer, I'll
3 yield five minutes.

4 COMMISSIONER BORN: Thank you.

5 WITNESS MASTERS: That's right, Commissioner.

6 And so what you had was again this embedded credit bet,
7 within every bet one makes, when one is making a bet in the
8 over-the-counter market. Because if your counterparty
9 fails, what do you really have?

10 And so there was a massive switch after Lehman
11 Brothers went down to go to other counterparties to try to
12 replicate what other folks have, or to just take your bets
13 off overall. And we've talked to institutions about this--
14 pension funds and others. And suddenly they said, well, we
15 want all our bets back.

16 Well so now you've got a commodity index swap on.
17 And that's been fully collateralized, and you've got that on
18 with Goldman, or AIG, or whoever, and you say, well, I want
19 it back. Well as soon as you say I want it back, now
20 there's a chain reaction. Goldman has to sell the
21 commodities that were in it. You get your money back.
22 Suddenly there's this huge disruption in the commodity
23 markets that's coming from the derivatives markets, really
24 the credit counterparty of the derivative markets.

25 And again, that's how you saw the contagion from

1 one market to other markets.

2 COMMISSIONER BORN: So it's partly--this
3 uncertainty and fear of exposure to your counterparties led
4 to pulling out of contracts. Did the derivatives market
5 freeze up?

6 WITNESS MASTERS: The over-the-counter
7 derivatives markets freezed up. One interesting thing is
8 the exchanges didn't. The exchanges where one had a
9 counterparty centralized. There was no problem with the
10 exchanges. The only problem was with the over-the-counter
11 market where you didn't know who your counterparty--you knew
12 them, but you didn't know if they were good anymore. And
13 that's the real difference.

14 COMMISSIONER BORN: We had a hearing on the
15 shadow banking system and how there was essentially a run on
16 the investment banks through repo markets, through
17 commercial paper markets. Was part of the run on the big
18 investment banks also a derivatives market run--a
19 derivatives counterparty run?

20 WITNESS MASTERS: I don't think there's any
21 question that that was part of it. I mean, I knew plenty of
22 hedge funds that were, you know, trading with that, knowing
23 that, you know, if you had, you know, a \$50 trillion
24 derivatives book that you didn't know if the counterparty was
25 good anymore. I mean, you know, nobody has \$50 trillion of

1 capital. And so it causes all sorts of other fears.

2 I mean, people that own Goldman Sachs stock
3 suddenly say, you know what, I don't want to own it anymore.
4 I don't think there's any question that there was fear, and
5 legitimate fear, because I believe that had Treasury not
6 stepped in to save AIG, we would have lost all the
7 investment banks in a matter of time.

8 COMMISSIONER BORN: So you think there would have
9 been a cascading of failures throughout the financial
10 system. What would the effect of that on the financial
11 system itself have been?

12 WITNESS MASTERS: Well you would have had--you lost
13 the shadow banking system, and to a large part that hasn't
14 come back to any extent. I mean, we've lost a lot of facets
15 of that part. But you would have--the shadow banking leverage
16 that was out there would have come back to affect the
17 regulated financial system. And you would have had many
18 more bank failures. You would have had many other financial
19 participants that would have gotten hurt, more so over a
20 period of time because the derivatives counterparty issue
21 was so much larger than the regulated area that it had a
22 very significant effect.

23 So that is how the systemic contagion started
24 with derivatives, and then led to markets really around the
25 world--not just here in the U.S. but in other countries.

1 COMMISSIONER BORN: Does this suggest that, or do
2 you feel that lack of regulation of the over-the-counter
3 derivatives market played any role in establishing a
4 fragility in the system that let it play this role in the
5 financial crisis?

6 WITNESS MASTERS: I don't think there's any
7 question. I mean, lack of regulation was one of the key
8 issues. I mean, not having clearing--you know, you'd ask
9 regulators what--for instance, a few years ago people said
10 what's the value of commodity derivatives out there? Well
11 they couldn't tell you. And they couldn't tell you because
12 they couldn't see the market.

13 In my view, with the benefit of hindsight the
14 Commodity Futures Modernization Act was an unmitigated
15 disaster. It is one of the worst pieces of legislation that
16 I've ever seen with regard to the economy. And, you know,
17 today we are trying to fix a big problem, but it's a long
18 battle.

19 I mean, it opened up all sorts of issues. Not
20 having regulation in these markets is just not acceptable.

21 CHAIRMAN ANGELIDES: Ms. Born, a couple more
22 minutes, or--

23 COMMISSIONER BORN: Sure.

24 CHAIRMAN ANGELIDES: Okay, and then we'll--

25 COMMISSIONER BORN: Let me ask you. Another area

1 that you touched on that the other witnesses did not is the
2 impact of derivatives on the commodity bubbles, or the role
3 that they caused in the energy and food bubbles in 2008
4 where, you know, the price of oil skyrocketed to over \$140,
5 and then came back down to \$33.

6 Could you comment on how derivatives, perhaps on
7 exchange derivatives, perhaps off-exchange over-the-counter
8 derivatives, played a role there?

9 WITNESS MASTERS: Well, so really for the last
10 decade, really, since 2003, commodities became sort of an
11 accepted, quote/unquote, "asset class" for institutional
12 investors.

13 And the way many of the large institutional
14 investors decided to allocate into commodities was via
15 commodity index swaps, or some other kind of commodity swap,
16 which allowed them--

17 COMMISSIONER BORN: Let me ask you, who sold
18 those commodity index swaps?

19 WITNESS MASTERS: The large dealers: Goldman,
20 AIG, JPMorgan, Lehman Brothers.

21 And so when they marketed these, quote/unquote
22 "investments" to their clients, there was a significant
23 amount--I mean Wall Street, one thing they're pretty good at
24 is marketing--and there was a significant amount of money
25 flow that went into these derivative instruments that then

1 affected the price of these commodities. And markets
2 allocate via price.

3 So dollars went in and the price had to change to
4 account for that. And so you had a very significant rise
5 that was amplified by large institutional investors. You
6 know, commodities may have gone up, but they probably
7 wouldn't have gone up anywhere near the levels they achieved
8 without this amplification, this inflow of large investment
9 dollars from institutional investors.

10 And then, when you had the credit crisis, when
11 you had the Lehman blowup, then suddenly again the
12 counterparties were where people were worried. Money came
13 out. And prices came down just as fast.

14 CHAIRMAN ANGELIDES: Thank you.

15 COMMISSIONER BORN: Thank you.

16 WITNESS KOHLHAGEN: Can I--

17 CHAIRMAN ANGELIDES: Well, actually let's do
18 this. Mr. Vice Chairman would like to make a comment.

19 VICE CHAIRMAN THOMAS: Thank you. One of the
20 advantages of having a panel of experts is the interaction
21 between the panel of experts. And if there is a significant
22 delay in time in response, it kind of loses the purpose.

23 However, Commissioners control their own time.
24 And so I will, if necessary, periodically, since I saw him
25 being antsy out there, he wanted to say something, and it's

1 your time.

2 WITNESS KOHLHAGEN: Okay, thank you. Very
3 briefly, I would like to take the other side of what he just
4 said.

5 VICE CHAIRMAN THOMAS: Yes, but not in the same
6 period of time.

7 (Laughter.)

8 WITNESS KOHLHAGEN: No.

9 VICE CHAIRMAN THOMAS: Okay.

10 WITNESS KOHLHAGEN: First of all, everything you
11 say about the--both you and Commissioner Born say about the
12 commodity markets is correct, but it did not contribute to
13 the financial crisis. It did what it did, but it did not
14 contribute, (a).

15 (b) To your point about the over-the-counter
16 derivatives market, I'm sorry I respectfully disagree. It
17 did not freeze up. Those are speculative projections on
18 your part. I agree with you and Secretary Born that if the
19 government had not bailed out AIG that the over-the-counter
20 derivatives markets would have failed and crashed. But the
21 government did bail out AIG, and the over-the-counter
22 markets did not crash and they did not stop functioning.

23 WITNESS MASTERS: I would just make the answer to
24 that that--

25 VICE CHAIRMAN THOMAS: Mr. Chairman, on somebody

1 else's time he can answer. I was just trying to get a
2 balance. But if we're willing to take a common pot, this
3 kind of an exchange can be helpful if it's advancing our
4 understanding rather than pushing an argument for the sake
5 of an argument.

6 CHAIRMAN ANGELIDES: If there is something
7 extraordinarily compelling, why don't we just, on common
8 time, just literally 15 seconds each, quick comments. Mr.
9 Kyle? Mr. Masters, yes.

10 WITNESS KYLE: A quick comment,, which I
11 agree that it is important for the CFTC or the government to
12 have good information about what is going on. And they need
13 that information in real time. And even if a large number
14 of derivatives contracts move to organized exchanges where
15 the information in principle could be made available in real
16 time, the government and the public needs information about
17 what is going on in the OTC markets that hasn't gone to the
18 organized exchanges.

19 So it is very important to get that information
20 collected. It is very important to get that information
21 stored and processed in a common form. And it is very
22 important for regulators to have access to it, and it is
23 very important for market participants to have access to
24 that part of it that is not too proprietary. And the Office
25 of Financial Research, which is part of the new bill,

1 actually is going to accomplish a lot of that.

2 But I don't think of it as a regulatory agency.

3 I think of it as an information collection agency. It's not
4 going to be telling people how to run their business; it's
5 going to be providing information and transparency.

6 CHAIRMAN ANGELIDES: Mr. Masters, literally just
7 quick.

8 WITNESS MASTERS: Sure. I would just answer, you
9 know, two issues with regard to commodities. You know, in
10 my view a speculative bubble in commodities has significant
11 consequences for the American public, and had significant
12 consequences with regard to furthering the financial crisis.

13 And then second, with regard to the derivatives
14 markets not freezing up, I was there during the period. If
15 it didn't--you know, had we lost AIG, it would have totally
16 stopped. But there was palpable fear out there. And it was
17 as close as I would want to come to the markets freezing up.

18 CHAIRMAN ANGELIDES: All right. Thank you. Mr.
19 Hennessey.

20 COMMISSIONER HENNESSEY: Thank you, Mr. Chairman.

21 I want to see if I can try to clarify a few
22 things that are confusing me, because there's been a lot of
23 language thrown around in this debate and I think the
24 language sometimes gets sloppy, not from the four of you but
25 generally, and I think that sloppiness in language really

1 detracts from understanding what the problems are.

2 I am going to try and tackle a few things. One
3 is, I think there is an assumption that math is evil,
4 because I think a lot of people don't understand it and
5 they're afraid of it.

6 Two, is I have heard a couple of you say that
7 derivatives or credit default swaps were culprits. And I
8 think that derivatives and credit default swap are things,
9 and things can't be culprits any more than a hammer used in
10 a murder can be a culprit. The person who uses the hammer,
11 or misuses the hammer is the culprit.

12 And I am concerned that in a lot of cases what we
13 may be doing is confusing form, or the instrument, with the
14 actor who is using that instrument. That is kind of what I
15 want to drill down into.

16 Another is we've heard that credit default swap
17 are or were the cause of the crisis, and I want to explore
18 that a little bit. And then I also want to, if I have time,
19 talk about the question of whether or not side bets are bad.

20 I would just like to say, as a general matter I
21 am in favor of the capital requirements that we are talking
22 about, and generally for pushing things onto exchanges, and
23 for greater transparency.

24 But as I look at the different problems, first I
25 want to start with CDOs, and then I want to go to the CDS

1 world. It seems to me that I can explain a lot of what
2 happened with some very simple assumptions.

3 So first, if we start with a collateralized debt
4 obligation, if I assume that two primary causes were, one,
5 people made a bad assumption about housing price declines.
6 And, two, people made really bad assumptions about the
7 correlation of housing price declines across different
8 regional markets.

9 It seems to me that those two errors can explain
10 all of the poor valuation of collateralized debt
11 obligations. Just general comments on that? Mr. Kyle?

12 WITNESS KYLE: Yes. I--

13 COMMISSIONER HENNESSEY: Setting aside hybrids,
14 which have CDS with them, which is a different--

15 WITNESS KYLE: I agree that overly optimistic
16 assumptions about housing prices and overly low assumptions
17 about correlation are important. But two other things are
18 also important.

19 One is, when do homeowners default on their
20 mortgage? Do they default when they're underwater 20
21 percent? 40 percent? 50 percent? And so forth. Those
22 kinds of assumptions are important in these valuations.

23 Another assumption that is important is what are
24 going to be the recoveries, given that a homeowner defaults?

25 That depends in part on the ease with which a

1 creditor can foreclose on a homeowner. If it takes a long
2 time and the homeowner trashes the house, the recovery is
3 going to be much lower.

4 So I would add to your list--

5 COMMISSIONER HENNESSEY: Okay, good. Now--

6 WITNESS KYLE: --these additional issues, which--

7

8 COMMISSIONER HENNESSEY: In both cases, though,
9 those are poor--those are incorrect assumptions about inputs
10 into a model.

11 WITNESS KYLE: Correct.

12 COMMISSIONER HENNESSEY: Right? It's not--Mr.
13 Kohlhagen said this in his testimony--it's not the model
14 itself, or the fact that you're using math or a spreadsheet
15 to turn a whole loan into a mathematically complex set of
16 financial products.

17 And I guess what I'm trying to understand here
18 is--Mr. Greenberger, Mr. Kohlhagen, Mr. Kyle--do any of you
19 believe that the process of turning a whole loan into a CDO
20 by itself changes the amount of risk that's involved? Or
21 somehow was a cause of the crisis? Setting aside the other
22 questions of what was done with that CDO, or the lack of
23 transparency with that CDO, is the creation of a CDO by
24 itself a bad thing, or was it a cause in this case?

25 WITNESS KOHLHAGEN: I'll go first. The kids who

1 priced those CDOs--and I managed a whole bunch of them then,
2 so I can call them kids--basically did not have a clue about
3 what was going on in the credit markets in the United
4 States.

5 So they were making forecasts--not necessarily
6 assumptions, but forecasts of probabilities of default,
7 probabilities of foreclosure and volatility of the markets in an
8 arena in which they simply did not know what was going on, I
9 used in my testimony, Peoria. They did not understand what
10 was going on in the real world.

11 COMMISSIONER HENNESSEY: Right. And you talked
12 about basically the management issue of the two different
13 silos, the credit guys not talking to the math guys.

14 WITNESS KOHLHAGEN: I don't think it--I think it
15 determined the magnitude of the crisis. I don't think it
16 caused the crisis. In other words, if they had made those
17 forecasts in the ether they were living in, and they'd only
18 been a little bit wrong, then the losses would have been
19 considerably smaller.

20 But they were staggeringly wrong because they
21 didn't know what was going on, and no one was telling them.
22 And so what it caused was a huge magnitude of crisis. It
23 didn't cause the crisis. There's still an amount of crisis.

24 COMMISSIONER HENNESSEY: Do you have a view?

25 WITNESS GREENBERGER: I basically agree. All I

1 would say is your point about being angry about math--

2 CHAIRMAN ANGELIDES: Would you turn on your
3 microphone?

4 WITNESS GREENBERGER: Your point about being
5 angry about math, I'm not angry about math.

6 COMMISSIONER HENNESSEY: Oh, I wasn't suggesting
7 you were.

8 WITNESS GREENBERGER: But I just don't want to
9 have a GM stock determined by an algorithm. I think it is
10 much preferable that the market determines that price. And
11 the market--these kids were determining the price. There
12 wasn't a vehicle, an exchange-trading vehicle, for the
13 market to determine the price.

14 The algorithms will never do as well as the
15 market.

16 COMMISSIONER HENNESSEY: Okay. I want to try and
17 turn to credit default swaps now. And in particular I want
18 to try to understand, were there problems with credit
19 default swaps themselves, the existence of credit default
20 swaps? Were they a cause? Or was it basically the lack of
21 a capital requirement, which meant that AIG could just keep
22 cranking these things out infinitely? And then the fact
23 that the risk itself that was created by those products was
24 concentrated?

25 It seems to me that if those credit default swaps

1 had not been sold by a single firm, but instead had been
2 spread out among 50 firms, if you hadn't had the
3 concentration of risk in a particular place, and we've
4 talked about the counterparty risk and the poor
5 understanding of it, it seems to me that those two factors
6 can explain everything that's going on. And the CDS is
7 basically a mechanism through which the underlying problems
8 of concentration of risk and poor understanding of
9 counterparty risk were the actual underlying causes. Comment?

10 WITNESS KOHLHAGEN: I agree with Commissioner
11 Born, and apparently everybody here, that increased capital
12 requirements are going to help. Increased regulation may
13 help. Better information and transparency may help.

14 But in the end, if people behave irresponsibly in
15 a very, very, very large way, they will have very, very
16 large consequences.

17 COMMISSIONER HENNESSEY: In the case of say
18 AIGFP, that irresponsible behavior was essentially taking
19 one side of very, very large bets--

20 WITNESS KOHLHAGEN: In an unhedged way. It's
21 stunning. It was a subsidiary that made billions of dollars
22 over 20 years on the economic and business philosophy of
23 selling and buying things on a hedged basis. And they sold
24 \$80 billion unhedged.

25 COMMISSIONER HENNESSEY: And so my core question

1 is: Understanding that the lack of capital requirements
2 made it easy--facilitated AIGFP's ability to do that, was
3 the problem itself the mechanism that they used to do it?
4 Or was it basically here were a bunch of guys who were
5 taking really bad, unhedged risks?

6 WITNESS KOHLHAGEN: The latter.

7 COMMISSIONER HENNESSEY: Okay. Other views?

8 WITNESS GREENBERGER: Well I think you also have
9 to add naked credit default swaps into this. That is,
10 people who had no risk who were able to bet. That
11 exponentially increased--when a mortgage failed, you had the
12 CDOs fail, and the insurance on the CDOs, but you also had
13 the bettors, who Mr. Dinallo says were three to four times
14 the size of the actual mortgage.

15 Convert that. It may very well have been, if
16 there had been no naked CDS, like you can't have naked
17 insurance--I can't insure your life or your car--this would
18 have been a much smaller problem. Maybe one-quarter the
19 size of the problem.

20 So for that reason, I would say--and by the way,
21 Germany has just banned German citizens being able to buy
22 naked CDS on sovereign defaults in Europe. That is where we
23 are going to head. I'm not advocating that, nor is
24 Congress, but when we get into these crises further, the
25 anger about the betting will be--

1 COMMISSIONER HENNESSEY: I'm going to interrupt
2 you. Just because the Germans did it doesn't mean that we
3 should do it. And just because people are angry about
4 something that a lot of them don't understand is not
5 sufficient justification for doing it.

6 But again I want to focus on the causes here of
7 the crisis. Because I am having a tough time understanding
8 why side bets--which is what a naked credit default swap is--
9 --why a side bet in and of itself is a bad thing.

10 WITNESS GREENBERGER: It's a fine thing if you do
11 it in Las Vegas, or Atlantic City, where it is fully
12 regulated for cheating, capital requirements, and everything
13 else. Having side bets--

14 COMMISSIONER HENNESSEY: Good. Good. Okay,
15 wait, but let me interrupt you here because my time is
16 limited. Is a properly capitalized, transparent, no-
17 collusion side bet in a financial market a bad thing?

18 WITNESS GREENBERGER: I would want to think about
19 that, but my short answer is no. It's just that it's a
20 Utopian consideration from where we were that it's hard to
21 go into the hypothesis.

22 COMMISSIONER HENNESSEY: Right.

23 WITNESS GREENBERGER: But we would have been a
24 lot better off if Las Vegas had handled these side bets.

25 COMMISSIONER HENNESSEY: I have no doubt that--

1 (Laughter.)

2 COMMISSIONER HENNESSEY: I have no doubt that the
3 existence of naked credit default swaps allowed these firms
4 that wanted to leverage up these bets to do so easily.

5 What I am trying to understand is: Was it the
6 lack of capitalization? The lack of transparency? And the
7 leverage and concentration of risk that was the actual
8 problem? Or was it the fact that there wasn't an underlying
9 security?

10 I mean, you can buy and sell puts, right? And
11 they're in effect a similar sort of risk-bearing mechanism
12 we don't have problems with.

13 WITNESS GREENBERGER: Mr. Hennessey, you are
14 positing a fully regulated system. I agree, if there was a
15 fully regulated system there wouldn't have been the problem.

16 COMMISSIONER HENNESSEY: Okay.

17 WITNESS KOHLHAGEN: My short and long answer to
18 your question is: No.

19 COMMISSIONER HENNESSEY: Okay.

20 CHAIRMAN ANGELIDES: Which question?

21 WITNESS KOHLHAGEN: Whether or not side bets
22 would be a problem.

23 CHAIRMAN ANGELIDES: Whether what?

24 WITNESS KOHLHAGEN: Whether or not side bets are
25 bad.

1 VICE CHAIRMAN THOMAS: Either way?

2 WITNESS KOHLHAGEN: No, the way he stated the
3 question. Right.

4 WITNESS KYLE: I want to make--

5 COMMISSIONER HENNESSEY: Please.

6 WITNESS KYLE: I want to make two points related
7 to this.

8 The first is, the financial crisis was caused by
9 the concentration of risks in levered financial institutions
10 which, when they started suffering losses like Citigroup, or
11 AIG, or Bear Stearns, or Lehman, had to de-lever their
12 positions. They had to kind of shrink the size of their
13 book.

14 So when big banks lose a lot of money, it is bad
15 for the macro economy and it takes a long time to recover.
16 That's where "depressions" as opposed to "recessions" come
17 from. It is interesting to compare the financial crisis we
18 have now, which is the type I just described, with the dot
19 com bubble. In the dot com bubble there was a whole lot
20 more risk being moved around. Trillions of dollars worth of
21 stocks, which exposed trillions--

22 COMMISSIONER HENNESSEY: But it was dispersed.

23 WITNESS KYLE: --of dollars of risk on various
24 people, but these dot com stocks were owned by dispersed
25 investors, and largely not owned by banks. So when the dot

1 com bubble collapsed, the losses from the collapse were
2 enormous. But because the stocks were not held in levered
3 portfolios, the spillovers through the banking--and
4 particularly not held by banks--the spillovers into the
5 economy resulted in a recession that we recovered from very
6 quickly.

7 COMMISSIONER HENNESSEY: Okay, so sort of the
8 tentative conclusions that I come to, setting aside Mr.
9 Masters' concern about energy and food prices, is that, to
10 say derivatives is too broad. To say over-the-counter
11 derivatives as a cause is in fact too broad. That we should
12 be looking at the subset of over-the-counter derivatives
13 which are over-the-counter credit derivatives; and that
14 specifically the actual underlying problems were not the
15 over-the-counter credit default swaps themselves, it was the
16 lack of capital requirements, and then the concentration of
17 risk and the leveraging up that was done with those.

18 Comments from the two of you?

19 WITNESS KYLE: Yes, leveraging up in the banking
20 system.

21 COMMISSIONER HENNESSEY: In the banking system,
22 right.

23 WITNESS KYLE: And that would include the shadow
24 banking.

25 COMMISSIONER HENNESSEY: Right. It was the fact

1 basically--I simplify this as a bunch of people made the
2 same bad bets on housing prices. They happened to do this
3 through this complex mathematical instrument that a lot of
4 people are scared of. But then what really happened was,
5 then they also took those bad bets. They all concentrated
6 them in large institutions, and then their counterparties
7 weren't figuring out that they were exposed to counterparty
8 risk.

9 WITNESS KOHLHAGEN: And add "too big to fail" as
10 a problem. I mean, basically if these were little tiny
11 community banks, then we wouldn't be here today.

12 COMMISSIONER HENNESSEY: Okay. Good.

13 One other thing is, just again trying to add some
14 clarity here, the \$58 trillion number that gets thrown
15 around--and I know that you all are careful when you say \$58
16 trillion in nominal exposure, but then the reality is that
17 the net exposure is smaller.

18 I want to see if I can do an example here. Doug,
19 I will sell you a trillion dollars of credit default swaps
20 on General Electric. And then I want to buy a trillion
21 dollars of credit default swaps from you on General
22 Electric. Do we have a deal?

23 COMMISSIONER HOLTZ-EAKIN: Yes.

24 COMMISSIONER HENNESSEY: Okay. We have, as I
25 understand it we have just increased the notional amount of-

1 -

2 VICE CHAIRMAN THOMAS: Excuse me? Could I get
3 the commission for this?

4 (Laughter.)

5 COMMISSIONER HENNESSEY: Absolutely. Just a
6 couple basis points.

7 As I understand it, Doug and I have just
8 increased the notional value of the over-the-counter
9 derivatives market by \$2 trillion, even though there is not
10 in fact any real increase in risk that exists. Do I have
11 that basically right, Mr. Kyle?

12 WITNESS KYLE: Absolutely right. And when the
13 credit events occur that result in the credit default swaps
14 paying off, they hold these auctions. And the auctions
15 allow the net exposures, which would be zero in the case of
16 your transaction because you're both long and short a
17 trillion dollars, it kind of allows the net exposure to come to the
18 market.

19 My understanding is that the experience is that a
20 huge fraction of the notional exposure has been netted out
21 by the time the contracts wind down, and maybe you are
22 looking at one percent, or some fraction of one percent of
23 the notional amounts that people throw around as
24 representing true exposure.

25 COMMISSIONER HENNESSEY: Good. My time is

1 expiring, but--

2 VICE CHAIRMAN THOMAS: Do you want more time?

3 COMMISSIONER HENNESSEY: Twenty seconds.

4 VICE CHAIRMAN THOMAS: Two minutes.

5 COMMISSIONER HENNESSEY: Twenty seconds.

6 VICE CHAIRMAN THOMAS: And we'll pay it in
7 notional dollars.

8 CHAIRMAN ANGELIDES: Why don't you guys talk for
9 a minute and forty about the twenty seconds.

10 (Laughter.)

11 COMMISSIONER HENNESSEY: One of the problems that
12 I heard described in the OTC derivatives markets back in '05
13 and '06--Tim Geithner was worried about this when he was up
14 at the New York Fed--was the question of resolving the CDS
15 when a firm in fact failed.

16 All right, and he and the New York Fed were
17 pushing hard saying, look, you guys have got to figure out
18 how you are going to deal with all these overlapping
19 commitments and counterparty risk.

20 I don't know if his push worked. I understand
21 that it's in fact still not even complete, but he's
22 generally getting good reviews of it, but as best I can tell
23 that problem that they were concerned with did not actually
24 rear its head in sort of disorderly resolution of the CDS.
25 Right?

1 When Lehman failed, there were concerns about
2 counterparty risk, and counterparty exposure to Lehman, but
3 everybody who owed everybody else money actually basically
4 ended up paying? No?

5 WITNESS GREENBERGER: No. I mean, what's
6 confused is the CDS that guaranteed a Lehman default got
7 netted out to \$6 billion, and everybody went hurrah!. Look
8 at the Lehman bankruptcy. Look at the lawsuit Lehman is
9 bringing against one of its 6000 creditors, Nomura.

10 Nomura is debating not the credit default swap on
11 Lehman's viability but Lehman entered into interest rate
12 swaps, currency swaps, foreign exchange swaps, natural gas
13 swaps, energy swaps, with Nomura. Nomura says because
14 there's no market price they owe us a billion. Lehman is
15 saying we owe \$500 million; it's outrageous.

16 COMMISSIONER HENNESSEY: Okay. Good. Then let
17 me try and be a little more precise.

18 I'm not suggesting that the resolution mechanisms
19 are fixed or in fact working well. I guess what I'm
20 suggesting is that I was hearing arguments several years ago
21 that the difficulties in resolving these contracts was a
22 systemic risk. And what I'm hearing is, there are still
23 legal disputes about the appropriate valuation. Great.
24 Lawyers and economists go figure this out. But you didn't
25 have Lehman's default. Because I remember when, the day

1 before Lehman was going under we were all saying, okay, are
2 we worried about this as a triggering event? I think the
3 same was true with Bear. And everyone was sort of
4 pleasantly surprised that the default and the resolution of
5 it didn't cause other institutions to suddenly fail.

6 WITNESS GREENBERGER: It didn't cause other
7 institutions to suddenly fail because the American Taxpayer
8 was the lender of last resort to the holes that those
9 institutions had.

10 COMMISSIONER HENNESSEY: But not for Lehman.

11 WITNESS GREENBERGER: No, not for Lehman.

12 VICE CHAIRMAN THOMAS: Does the gentleman feel he
13 needs an additional 20 seconds?

14 COMMISSIONER HENNESSEY: Yes, please.

15 (Laughter.)

16 COMMISSIONER HENNESSEY: To round out that two
17 minutes.

18 WITNESS GREENBERGER: Not for Lehman, because
19 Lehman is now going through a bankruptcy process that is
20 disorderly. What Secretary Paulson, Chair Bernanke, New
21 York Fed President Geithner said, is: Hey, we can't have
22 this kind of bankruptcy institution by institution. We're
23 just not going to let it happen.

24 Why did it not happen? Because we bailed those
25 institutions out. They are thriving today because of that.

1 That's why there's no disruption. And by the way, the
2 interconnectedness is not just CDS; the interconnectedness
3 is interest rate swaps, currency swaps, foreign exchange
4 swaps, energy swaps, agriculture swaps.

5 So when you say, oh, CDS caused the crisis, that
6 may be true; but the interconnectedness crisis that led the
7 American Taxpayer to have to bail everybody out, because as
8 Michael Masters said, if these institutions failed there
9 would have been cascading effect.

10 And while the derivatives market locked up
11 immediately, Mr. Kohlhagen is right, it didn't lock up
12 completely, why? Because the American Taxpayer threw
13 trillions of dollars at it.

14 COMMISSIONER HENNESSEY: All right.

15 VICE CHAIRMAN THOMAS: Mr. Chairman, on my 20
16 seconds, do we all agree on the expert panel with that last
17 statement by Dr. Greenberger?

18 WITNESS KOHLHAGEN: No, I don't.

19 CHAIRMAN ANGELIDES: What about the part where he
20 agreed with you?

21 WITNESS KOHLHAGEN: I don't agree with that,
22 either.

23 (Laughter.)

24 CHAIRMAN ANGELIDES: All right, any other
25 comments?

1 VICE CHAIRMAN THOMAS: My concern is the
2 cascading aspect. And if there's disagreement that it
3 didn't have that cascading effect, then you've got to come
4 up with another explanation.

5 WITNESS KOHLHAGEN: I agree that there was the
6 fear of it, and I agree that, had we performed the
7 experiment of let's see what happens if we let AIG go under,
8 that we would have had systematic failure. I agree with
9 that.

10 I do not agree with Lehman. I agree with
11 Commissioner Hennessey that that's arguing among lawyers
12 about a contract value.

13 VICE CHAIRMAN THOMAS: Okay.

14 WITNESS KYLE: May I?

15 VICE CHAIRMAN THOMAS: Yes.

16 WITNESS KYLE: I think that in addition to the
17 OTC derivatives market we need to look at the repo market.
18 And the repo market did not function very well after Lehman
19 failed, especially in the UK as opposed to the U.S.

20 COMMISSIONER HENNESSEY: As a source of
21 interconnectedness, you mean?

22 WITNESS KYLE: Yes, yes. The repo market is a
23 huge source of interconnectedness because the various banks
24 are borrowing and lending money from one another, and
25 they're borrowing and lending securities from one another,

1 and the same arguments about the value of derivatives
2 contracts occur in arguing about the collateral value
3 underlying the repo contracts.

4 WITNESS KOHLHAGEN: I absolutely agree with Mr.
5 Kyle on that.

6 CHAIRMAN ANGELIDES: All right. Good. Thank
7 you. Now just on--Mr. Vice Chair?

8 VICE CHAIRMAN THOMAS: I'm out of time, but that
9 gets back to my function of Wall Street and all the banks.
10 Was it bees in a beehive, or a praying mantis with their
11 mate? And that I have not been able to figure out yet.

12 WITNESS KOHLHAGEN: It was praying mantis
13 playing Texas Hold 'Em.

14 (Laughter.)

15 VICE CHAIRMAN THOMAS: There you go.

16 CHAIRMAN ANGELIDES: All right. On my time, some
17 of my remaining time, I do want to ask one question before
18 we go to senator Graham. And this is on the, I think the
19 very good line of questioning that Mr. Hennessey pursued
20 about side bets.

21 I think he put down some markers with respect to
22 those side bets in terms of collateral, and honest, open
23 market, but I do have a fundamental question.

24 Doesn't it also matter who is participating in
25 the side bet market, and to what extent? I mean, at the end

1 of the day, taking away theory, there were winners and
2 losers. Some people say, look, it's a big zero sum game.
3 But having actually done pretty well in math, the math is
4 pretty simple here.

5 The losers, at least temporarily, and I think for
6 decades to come, will have been the American Taxpayers who
7 did step in to cover the side bets gone bad. And so
8 shouldn't we also be concerned about who participates in
9 side bets, and to what extent? Systemically important
10 institutions? Should they be participating in the side bet
11 market?

12 WITNESS KOHLHAGEN: I say yes. A well-run
13 organization, a bank, a securities firm--and you can pursue
14 this this afternoon with Goldman Sachs--basically at least
15 used to look very, very carefully at their counterparty
16 risk.

17 All of the organizations that they had--you call
18 them side bets; I call them derivatives contracts--with,
19 they looked very carefully and they managed that
20 counterparty risk.

21 Now just a personal comment to Commissioner Born.
22 Back in the '90s when you were advocating greater regulation
23 of the derivatives market, and I was an executive in the
24 derivatives market, I completely disagreed with you. I
25 could not imagine the banks mismanaging this function. It

1 was not imaginable to me. And I said that in public
2 speeches, and I've said it since I retired in 2002 in public
3 speeches, and I was wrong.

4 CHAIRMAN ANGELIDES: So you are dependent on
5 their ability to manage--

6 WITNESS KOHLHAGEN: You're dependent--

7 CHAIRMAN ANGELIDES: --and to the extent that
8 we're backstopping, that is relevant to participation in the
9 side bet market?

10 WITNESS KOHLHAGEN: --as a Nation we are
11 dependent on private sector firms to manage themselves well.
12 And if they don't manage themselves well, they go out of
13 business--

14 CHAIRMAN ANGELIDES: Or--or--

15 WITNESS KOHLHAGEN: --or if they're too big to
16 fail, then we have a problem.

17 CHAIRMAN ANGELIDES: And I want to just pick up,
18 because I think at the end of the line of questions you
19 added, "don't forget too big to fail," and I didn't want
20 that lost in the side bet discussion about what's proper,
21 what's not, what's perhaps contributory to the crisis and
22 what wasn't.

23 WITNESS KOHLHAGEN: As long as there are firms
24 and trading exchanges in the future that are too big to
25 fail, the Taxpayer is going to be on the hook for them.

1 CHAIRMAN ANGELIDES: Mr. Hennessey, why don't you
2 go ahead and take a couple of minutes of time, which will
3 come off our ledger, and then we're going to actually--I
4 made a mistake. We're not going to Senator Graham, we're
5 going to go to Mr. Wallison, who was the other member of the
6 Working Group.

7 COMMISSIONER HENNESSEY: Just to follow up on
8 this. If I mismanage my hardware store and it goes
9 bankrupt, that's not a concern of policymakers. And I
10 think, again the concern of policymakers with a large
11 financial institution mismanaging their risk is, if that
12 large financial institution is too big to fail.

13 And so I think it keeps coming back to
14 policymakers' need, or perceived need for a bailout that
15 then injects the policymakers into overseeing whether or not
16 they were making stupid decisions with their risk
17 management.

18 VICE CHAIRMAN THOMAS: But what I don't
19 understand is, if in fact they were in that position and you
20 have that large a responsibility, as a government you should
21 be on top of it looking at it carefully, making sure that
22 the management was appropriate because the downside bet is
23 too great a risk.

24 COMMISSIONER HENNESSEY: Right. If you run a
25 commercial bank, you're not allowed to bet your depositors'

1 money on the world cup.

2 WITNESS KOHLHAGEN: If I could just add--

3 COMMISSIONER HENNESSEY: Like if the supervisors
4 step in and say there are certain things you are not allowed
5 to do.

6 WITNESS KOHLHAGEN: To Mr. Kyle's point--

7 COMMISSIONER HENNESSEY: That's because there's a
8 public guarantee.

9 VICE CHAIRMAN THOMAS: Well especially with the
10 referees at the World Cup.

11 (Laughter.)

12 WITNESS KOHLHAGEN: To Mr. Kyle's point, if the
13 U.S. Government allows private-sector firms to make the
14 money when they win and bails them out when they lose, the
15 American people are going to pay a high price for that
16 system.

17 VICE CHAIRMAN THOMAS: And all of them want to be
18 in the same business.

19 CHAIRMAN ANGELIDES: All right. This is a very
20 good discussion. Mr. Wallison, you're up.

21 COMMISSIONER WALLISON: Thank you very much,
22 Mr. Chairman.

23 As I say in every one of these meetings, we are
24 in the business of trying to find out what caused the
25 financial crisis. So a lot of this stuff, talking about

1 various ways that a particular institution like AIG may have
2 missed the boat and made mistakes is not exactly the issue.

3 What we have to find out really is, systemically
4 what was it about credit default swaps that caused problems
5 here. And I don't think I've heard a lot.

6 If we talk about AIG just for a moment, AIG
7 obviously made some bad bets. But on the other hand, so did
8 many of the other institutions who were before us on exactly
9 the same ground. And that is, Citibank kept a lot of super
10 senior securities thinking that they were completely safe.

11 Now of course they lost. AIG lost for making the
12 bet on the other side--that is, they protected these super
13 senior securities. And the puzzling thing to me is that now
14 we denounce AIG for making a mistake that was exactly the
15 same as Citibank's. And so what we have to find out is
16 whether there's really any difference between making bad
17 loans and being involved in the CDS world.

18 I would like to start with you, Mr. Masters, and
19 see if we can bring some clarity here. If there had been no
20 subprime mortgages, would there have been a financial
21 crisis?

22 WITNESS MASTERS: I don't know. I think that's
23 the honest answer. I think that the subprime crisis was a
24 different crisis than the derivatives crisis that I
25 addressed.

1 COMMISSIONER WALLISON: Are you saying that even
2 if all the mortgages were 20 percent down payment and made
3 to people who could afford them, they were prime mortgages,
4 the mere fact that credit default swaps existed as a way of
5 people taking on exposure, or eliminating exposure, would
6 have caused the financial crisis?

7 WITNESS MASTERS: The answer is, I think that the
8 derivatives market was a necessary precondition to
9 furthering a subprime credit crisis, if you will.

10 So I think without some crisis involved--

11 COMMISSIONER WALLISON: I think I can follow your
12 thought, and you're saying that there must be some
13 underlying problem for the CDS to have transmitted the risks
14 or the losses? Is that what you're saying?

15 WITNESS MASTERS: Yes. I think that there had to
16 be some other--

17 COMMISSIONER WALLISON: Okay. Now you said that
18 the credit default swap market ground to a halt. I think
19 there was some question about that by some of my colleagues,
20 but I actually have some numbers here from Market Serve,
21 which now publishes these numbers, and I want to read you
22 the numbers for the credit default swap market from June of
23 2008 until December of 2008, so that it covers the period
24 where Lehman failed and we believe the financial crisis
25 began, and I think this was the period you were referring

1 to.

2 In June--I'll leave out anything other than just
3 the dimensions--251,000. In July, 284,000. In August,
4 188,000. In September, the month that we had the failure of
5 Lehman, 315,000. October, 379,000. November, 305,000.
6 December, 255,000.

7 So that doesn't sound to me--

8 VICE CHAIRMAN THOMAS: And that's the year 2008?

9 COMMISSIONER WALLISON: Sure. Yes. All of this
10 was 2008. That doesn't sound to me as though a market has
11 ground to a halt. It sounds to me as though it's continuing
12 to function.

13 Now how do you explain that?

14 WITNESS MASTERS: Well I would say what I was
15 really referring to in my testimony was the period from
16 Lehman's failure to AIG's bailout, which was only a couple
17 of days. And there were trades that happened. But to be
18 more clear--

19 COMMISSIONER WALLISON: Okay--

20 WITNESS MASTERS: --there was a fear that
21 everything would have stopped. And there were actions taken
22 that wouldn't have been taken otherwise to unwind swaps from
23 institutions--

24 COMMISSIONER WALLISON: So we're talking--I might
25 just interrupt because my time is limited--so we're talking

1 about a two-day period when it ground to a halt. And it was
2 the two-day period that caused the systemic crisis? Is that
3 what you're saying?

4 WITNESS MASTERS: Well it could have been much
5 longer than two days had AIG collapsed. It could have gone
6 on to this day. I mean, it's a situation that--

7 COMMISSIONER WALLISON: Well we actually don't
8 know that. What we do know is that Lehman collapsed.

9 WITNESS MASTERS: Right.

10 COMMISSIONER WALLISON: And what we wanted to
11 find out from that is what the interconnections that you
12 were talking about actually caused.

13 Can you identify any institution that was caused
14 to go into bankruptcy or otherwise to have a serious
15 financial problem because it was interconnected with Lehman,
16 other than through a loan but through a CDS? Do you have
17 the name of such an institution?

18 WITNESS MASTERS: Well I would say AIG had, had
19 significant counterparty risk with Lehman Brothers.

20 COMMISSIONER WALLISON: Actually, AIG's relation
21 with Lehman turned out to be, in the end, \$600 million.

22 WITNESS MASTERS: It depends on the round you're
23 using. It depends on how you classify exposures.

24 COMMISSIONER WALLISON: Okay, but AIG was not
25 seriously connected with Lehman.

1 WITNESS MASTERS: But AIG was connected with
2 other folks, and if anybody had exposures on AIG with Lehman
3 Brothers, suddenly--for instance, let's just say that you've
4 made a bet with AIG, and you've got Lehman as your
5 counterparty, and suddenly--or you made a bet on an AIG
6 issue, on a credit instrument, and you've got Lehman as the
7 counterparty--suddenly now you don't have that hedge anymore
8 that you thought you had.

9 COMMISSIONER WALLISON: Right. But on the other
10 hand, you know what a reference entity is of course. We
11 haven't used the term "reference entity." But any of these
12 bets are on a reference entity of some kind. That is,
13 that's the party that has to default in order for anyone to
14 be paid. Right?

15 So if the reference doesn't fail, the fact that
16 AIG couldn't pay off, or the fact that Lehman couldn't pay
17 off, isn't relevant, is it?

18 WITNESS MASTERS: I think that the issue, I mean
19 you're sort of dancing around the issue. Had AIG failed,
20 the discussion is different. So you're saying,
21 hypothetically what would happen, and whatnot.

22 COMMISSIONER WALLISON: Excuse me, but someone
23 else is talking hypothetically. You're suggesting that if
24 AIG had failed that there would have been some kind of
25 serious crisis. That's hypothetical, because we don't know.

1 WITNESS MASTERS: Well I think the Treasury
2 Secretary felt like that at the time.

3 COMMISSIONER WALLISON: Right, the Treasury
4 Secretary and others did. That is not evidence of anything
5 except the fear that the Treasury Secretary felt at the
6 time, or the Chairman of the Federal Reserve.

7 WITNESS MASTERS: Well it was a heck of a price
8 to pay for the American public to spend the billions of
9 dollars to bail out AIG, then.

10 COMMISSIONER WALLISON: Right. I agree, the--

11 WITNESS MASTERS: If what you're asserting is
12 correct.

13 COMMISSIONER WALLISON: --the Taxpayers should be
14 complaining about what the Treasury Secretary did, and the
15 Chairman of the Federal Reserve, but let me go back to your
16 point.

17 That is, that there was some loss as a result of
18 the failure of Lehman Brothers. And I want you to identify
19 what that loss was.

20 WITNESS MASTERS: Hedge funds around the world--
21 and I've talked to them about this view--suddenly didn't
22 know if their counterparty was good, if they were going to
23 get paid.

24 COMMISSIONER WALLISON: Right.

25 WITNESS MASTERS: And that forced them to unwind

1 exposures in many other instruments, to force a rapid de-
2 leveraging, which caused a--certainly affected markets and
3 prices around the world, which wouldn't have happened
4 otherwise had Lehman not failed.

5 COMMISSIONER WALLISON: And who did they unwind
6 these transactions with?

7 WITNESS MASTERS: They unwound them with many
8 different brokers as they could.

9 COMMISSIONER WALLISON: Those are dealers,
10 wouldn't you say?

11 WITNESS MASTERS: Right. Swaps dealers.

12 COMMISSIONER WALLISON: These are swaps dealers.
13 And who are they?

14 WITNESS MASTERS: There are 20 different ones.

15 COMMISSIONER WALLISON: There are 26 or so, and
16 probably many more, but the major ones are about 26. These
17 were all the institutions that were thought to be in danger,
18 right?

19 I mean, if you wanted to go in and buy or sell a
20 swap, you had to deal with one of these institutions that you
21 told us a little while ago were in trouble, and people
22 didn't know whether they were safe or sound. Isn't that what
23 you said?

24 WITNESS MASTERS: What I said was, that you had a
25 situation where dealers, well counterparties were fearful.

1 COMMISSIONER WALLISON: Yes.

2 WITNESS MASTERS: And the fear of other dealers
3 going out of business--

4 COMMISSIONER WALLISON: Right

5 WITNESS MASTERS: Even though they didn't
6 actually go out of business--

7 COMMISSIONER WALLISON: Right.

8 WITNESS MASTERS: --and we don't know what would
9 have happened, as I said, hypothetically. All right, let's
10 just say we don't know what happened. There was a palpable
11 fear that customers needed to unwind their bets with these
12 various dealers, which they did.

13 That wasn't driven by a fundamental belief in the
14 bet they were making. It was driven by a fear of
15 counterparties eventually failing--

16 COMMISSIONER WALLISON: Okay--

17 WITNESS MASTERS: --and that's what I was really
18 trying to say.

19 COMMISSIONER WALLISON: --but they did deal with
20 the very people who you were suggesting were in some kind of
21 trouble, right? I mean, you said people didn't know, and
22 yet when they went to--when they had to unwind their
23 transactions, their swaps, they had to deal with the people
24 who were actually the ones who you said were now in
25 questionable financial condition.

1 WITNESS MASTERS: Well I mean it's, it's sort of
2 like, you know, you've got one going down, and you believe
3 that others are going down. And in the interim, which is a
4 short period of time, before AIG was saved, there are still
5 people still standing. But that being said, your actions
6 have changed as a counterparty because now you're unwinding
7 bets that you wanted to have on, that you had on as a hedge
8 and you thought were a part of your fiduciary
9 responsibility. Now as a fiduciary you have to make the
10 decision to unwind bets that had nothing to do with the bet
11 you wanted to have on.

12 COMMISSIONER WALLISON: Let me read you something
13 from Fitch Ratings, published in early 2009, about 2008.
14 And it says, among other things: The CDS market has
15 generally remained open throughout the crisis, particularly
16 for indices and single-name CDS contracts, and this has
17 enabled market participants to hedge or take on credit
18 exposures.

19 This is in direct contrast to the near complete
20 drying up of liquidity in the CDO market. So in fact what
21 happened, isn't this true, that although run by the large
22 banks throughout the World, not just U.S. banks but many all
23 over the World, the CDS market continued to function
24 perfectly well through this period?

25 I read you the numbers of transactions, and they

1 remained just about the same, within the same general range,
2 between June and December of 2008. So there wasn't any
3 collapse of that market, as you suggested, was there?
4 People were trying to unwind. And what you were saying is
5 that for the two-day period between the time that Lehman
6 failed and the time that AIG was rescued, for whatever
7 reason it was rescued, there was some panic in the market?
8 Is that what you're saying?

9 WITNESS MASTERS: I'm saying that there was panic
10 in the market, and it caused institutional investors and
11 other fiduciaries to do things that they would not have done
12 otherwise because they were fearful of credit issues with
13 regard to Lehman, AIG, and other swap counterparties.

14 COMMISSIONER WALLISON: Was there a domino effect
15 after Lehman, as you suggested?

16 WITNESS MASTERS: There would have been had we
17 not rescued AIG. There was a domino effect in the sense of
18 it changed people's investment strategies to have to account
19 for worrying about one's credit counterparties, when maybe
20 one hadn't worried about that in the past.

21 COMMISSIONER WALLISON: Let me understand what
22 AIG's rescue did. Did that mean that--do you think it meant
23 that every other institution after AIG would be rescued?

24 WITNESS MASTERS: I think that the belief of the
25 market was that, once AIG was rescued that that was it; that

1 others would be rescued after that.

2 COMMISSIONER WALLISON: And were others rescued
3 after that?

4 WITNESS MASTERS: It didn't seem like others
5 needed to be.

6 COMMISSIONER WALLISON: Needed to be rescued,
7 right. Okay, so what I'd just like to establish with you is
8 the question of whether Lehman's failure resulted in any
9 substantial loss to anyone else.

10 Do we have any data on that?

11 WITNESS MASTERS: We have the hundreds of
12 billions of dollars that the Taxpayers spent. I mean, I
13 would say that's quite a significant amount of data, in
14 terms of the amount of dollars that they had to put up, when
15 Lehman went down to bail out AIG. And the reason that--and
16 as you will recall there was some question on whether or not
17 AIG should have been bailed out by the Treasury. But the
18 reason it ultimately--I believe they did it, was because of
19 the interconnectedness of AIG and the derivatives contracts
20 they had on with other folks.

21 And so the Taxpayer ended up with that direct
22 loss.

23 COMMISSIONER WALLISON: Lehman was also
24 interconnected, was it not?

25 WITNESS MASTERS: They were. And I think that

1 started the change in behavior, if you will, from one to the
2 other.

3 COMMISSIONER WALLISON: I think I've run out of
4 time.

5 VICE CHAIRMAN THOMAS: Mr. Chairman, yield the
6 Commissioner an addition two minutes.

7 COMMISSIONER WALLISON: I could use more than
8 that, but I'll take two.

9 VICE CHAIRMAN THOMAS: Yield the gentleman an
10 additional four minutes?

11 COMMISSIONER WALLISON: All right, we'll
12 negotiate about that later, but that's fine. Thank you.

13 VICE CHAIRMAN THOMAS: Yield the gentleman an
14 additional five minutes?

15 (Laughter.)

16 CHAIRMAN ANGELIDES: Are you playing the AIG to
17 his Goldman?

18 VICE CHAIRMAN THOMAS: No--

19 (Laughter.)

20 VICE CHAIRMAN THOMAS: --I'm trying to satisfy
21 him. Five minutes? Is that okay?

22 COMMISSIONER WALLISON: Yes, that's fine. Thank
23 you very much.

24 So we're talking about what happened after
25 Lehman. And you referred to it as a "domino effect." That

1 others were going to fail after Lehman. But actually,
2 Lehman was cleaned up, was it not, within five weeks with an
3 exchange of funds among the various counterparties? Unless
4 you can identify anyone other than AIG, I don't know that
5 we're talking about any large effect of Lehman's failure.

6 I don't see the interconnections yet. And could
7 you make that clear?

8 WITNESS MASTERS: You know, with AIG I mean it's
9 sort of like saying, you know, other than the bullet, Mrs.
10 Lincoln, how was your night at the theater? I mean, it is
11 the issue.

12 COMMISSIONER WALLISON: Well there are outliers,
13 of course, and AIG was an outlier. All of the references we
14 hear today from this panel, and also from your panel, is
15 about AIG. But what we ought to really be thinking about is
16 whether there were other institutions.

17 AIG was actually a tremendous outlier because AIG
18 took only one side of these transactions. So to establish
19 policy on the basis of the failure by one kind of
20 institution, one institution, which made a large, a huge
21 mistake, would be a mistake, I think. We ought to be
22 considering how others in this market behaved. But, please.

23 WITNESS MASTERS: Well I mean, again, there was
24 significant fear from a wide diversity of market
25 participants that the credit component of their counterparty

1 swap agreement they would have a problem because of what had
2 happened with Lehman. And especially they were worried
3 what happened with other firms. So it was the fear of
4 something happening that really seized up the market and
5 made people change their behavior.

6 Had AIG gone down, then in my view it is very
7 likely that we would have lost Goldman Sachs, we would have
8 lost Morgan Stanley, and we would have probably lost other
9 institutions as well.

10 COMMISSIONER WALLISON: Yes, Mr. Kyle?

11 WITNESS KYLE: Yes. So keep in mind that after
12 Lehman failed we had the Reserve Fund, the money market
13 fund, which suffered big losses because it held Lehman
14 bonds. And when it broke the buck, it triggered a run on
15 the entire money market fund industry.

16 So I would say that is a spillover from the
17 failure of Lehman into the entire economy. And it resulted
18 in the government essentially insuring the money market
19 industry, bailing out the whole industry, and it resulted in
20 the Fed kind of bailing out the commercial paper--

21 COMMISSIONER WALLISON: Well if we're going to
22 talk about all those things, you can understand why the
23 Reserve Fund kept those bad securities, and that is because
24 Bear Stearns was bailed out. And they figured that everyone
25 was going to be bailed out after Bear Stearns, so they were

1 not going to have to suffer losses on those securities they
2 were holding.

3 So it is not--we can't look at these things in
4 isolation, which is the problem that we are all suffering
5 here, is that we are looking at these instances in isolation
6 as though they are not related.

7 The Reserve Fund lost money because it had
8 assumed that its bad investments were going to be taken care
9 of by the bailing out of Lehman the way Bear Stearns was
10 bailed out. So once we bailed out Bear Stearns, we were in
11 a different world. And that is one of the issues I think we
12 have to understand.

13 WITNESS KYLE: I agree with that.

14 WITNESS GREENBERGER: Commissioner Wallison, may
15 I comment on your--

16 COMMISSIONER WALLISON: Sure.

17 WITNESS GREENBERGER: First of all, in terms of
18 your numbers, please look at the number of the overall value
19 of credit default swaps. The swaps dealers after Lehman
20 were running around--that's why I used the figure \$35
21 trillion to \$65 trillion--the swaps dealers were running
22 around, and you can look at DTCC statistics, Bank of
23 International Settlement Statistics, the overall notional
24 value dropped from \$65 trillion to \$35 trillion.

25 Now can I tell you that for a fact? No. Because

1 it's a--if I could finish--

2 COMMISSIONER WALLISON: One of the reasons--one
3 of the reasons--excuse me, but these numbers are not worth
4 discussing right now because there was compression taking
5 place right around this time.

6 WITNESS GREENBERGER: That's my exact point.

7 COMMISSIONER WALLISON: Okay. So what is the
8 point that you were trying to tell me about?

9 WITNESS GREENBERGER: That Mr. Masters was right,
10 this market was freezing up. It dropped by half.

11 COMMISSIONER WALLISON: No, I was talking about
12 the number of transactions.

13 WITNESS GREENBERGER: Yes, and I'm talking about
14 the total value. You can have--I can buy a thousand peanuts
15 for \$1. That doesn't tell me the value of whether this
16 market is going down.

17 COMMISSIONER WALLISON: Commissioner Hennessey
18 made the valid point. And that was, if he and Commissioner
19 Holtz-Eakin had bet, or had speculated between the two of
20 them, that would have doubled the total amount of credit
21 default swap notional amounts in the market.

22 WITNESS GREENBERGER: And it went down by half.

23 COMMISSIONER WALLISON: That is not a significant
24 number. The significant number is the number of
25 transactions.

1 CHAIRMAN ANGELIDES: Time. Thank you. Thank
2 you, very much. I just knew this could go on for quite some
3 time. Thank you very much.

4 Now, Senator Graham.

5 COMMISSIONER GRAHAM: Thank you--

6 CHAIRMAN ANGELIDES: Microphone, Senator.

7 COMMISSIONER GRAHAM: This has been a very
8 instructive panel. I wanted to clear up one thing.

9 A few moments ago Mr. Greenberger had stated I
10 think that the ripple effect of AIG was contained because
11 the Taxpayers stepped up to those other affected parties and
12 essentially made them at least partially whole so they could
13 manage the consequences of AIG.

14 Then you were asked if you, Mr. Kohlhagen, if you
15 agreed or disagreed, and you said you disagreed with Mr.
16 Greenberger's analysis. What do you think would have
17 happened if the Taxpayers had not stepped in to assist those
18 institutions that were affected by AIG?

19 WITNESS KOHLHAGEN: If that was Mr. Greenberger's
20 position, I agree with it. I either misunderstood--one of
21 us misunderstood Mr. Greenberger's position in the question.

22 COMMISSIONER GRAHAM: Did I correctly state your
23 position?

24 WITNESS GREENBERGER: Yes.

25 COMMISSIONER GRAHAM: And you agree with that?

1 WITNESS KOHLHAGEN: I personally believe had the
2 government not stepped in to save AIGFP, we would have had a
3 total disaster on our hands; yes.

4 COMMISSIONER GRAHAM: I am interested in this
5 thing which has been defined as either "side bets," "naked
6 credit default swaps," "synthetic CDOs," et cetera. What
7 are the social values? What are the values to the American
8 economy of these, what I call peripheral derivatives? That
9 is, the ones that are a long way away from the farmer
10 selling his field of corn?

11 WITNESS GREENBERGER: It has the same value to
12 the economy that Las Vegas and Atlantic City provide.

13 COMMISSIONER GRAHAM: Well then maybe--I'm not
14 going to ask you to speculate on the social value of New
15 Jersey or Nevada in terms of their contributions, but is
16 that to say that you don't think they have a social value?

17 WITNESS GREENBERGER: It's not only that they
18 don't have a social value. I know there's this idea that it
19 sends signals to the market, and I will deal with that in a
20 question. But, no, I don't think they have social value.

21 If people had not been able to bet--leave aside
22 insuring your risk--nothing would have happened.

23 Now Mr. Kohlhagen or Mr. Kyle said, oh, this
24 sends signals to the market. People now knew that these
25 things were dangerous. Well, there were real credit default

1 swaps that sent signals to the market. And you know Warren
2 Buffett once said: The social value of the real credit
3 default swaps is insurance on the bond.

4 Warren Buffett once said, if you feel you need
5 insurance on a bond, don't buy the bond. We went through--
6 the naked credit default swaps were developed in the 1990s.
7 We went through the founding of this Republic to the
8 beginning of the 1990s without credit default swaps or naked
9 credit default swaps. Senator Graham, you were in public
10 office probably a lot during that period. I'm sure there
11 wasn't one Florida citizen who came to you and said: Where
12 the heck are all those credit default swaps I need?

13 They are now arguably insurance, but if it is
14 insurance, Senator Graham, it should be treated like
15 insurance. You should have all the protections that
16 insurance policies provide.

17 On the naked, it's the mere taking of a bet. And
18 if Mr. Dinallo is right that 3 to 4 times the bets were made
19 as the real risk, the American Taxpayer was the lender of
20 last resort to a casino, worse than a casino because Las
21 Vegas would have made sure the casino had capital. Here
22 there was no capital backing the bets.

23 COMMISSIONER GRAHAM: Does anyone want to defend
24 the synthetic CDOs, et cetera, in terms of their social
25 value? Yes, Mr. Kohlhagen?

1 WITNESS KOHLHAGEN: I now do officially disagree
2 with Mr. Greenberger.

3 (Laughter.)

4 WITNESS KOHLHAGEN: And he misquoted me. I never
5 said anything about a signal to the markets.

6 The derivatives--by the way, the Republic lasted
7 without the Internet for that same period of time, and I
8 don't think we're arguing whether or not it provides any
9 value.

10 WITNESS GREENBERGER: The Taxpayer didn't have to
11 bail out the Internet.

12 WITNESS KOHLHAGEN: Not yet. Every--

13 COMMISSIONER GRAHAM: Wait. Could you just state
14 what do you think is the social value that warrants these
15 transactions being treated as securities, as opposed to I
16 think what Mr. Greenberger would recommend, that they be
17 treated like craps, or the roulette wheel in Las Vegas?

18 WITNESS KOHLHAGEN: I interpreted your question
19 more broadly to mean all derivatives. Are you only--

20 COMMISSIONER GRAHAM: No, I'm speaking of the
21 synthetic CDOs. What I call the "peripheral derivatives."

22 WITNESS KOHLHAGEN: If somebody has an exposure
23 to General Motors, or has an exposure to IBM, or has an
24 exposure to a supplier, has an exposure to assets, it
25 provides a method for them to hedge those risks. And that

1 is an extraordinarily valuable economic and financial
2 service.

3 COMMISSIONER GRAHAM: Can't they do that by
4 buying instruments that actually are on the actual
5 indicators of ownership of General Motors, as opposed to
6 buying a synthetic?

7 WITNESS KOHLHAGEN: Not as efficiently, and not
8 as quickly and easily. By the way, Warren Buffett--I'm a
9 big fan of Warren Buffet, as we all are--he has sold
10 billions and billions of equity derivatives. Just for the
11 record.

12 WITNESS GREENBERGER: He also sold Inray
13 Insurance because he couldn't figure out what the
14 derivatives meant, which is why he said they were weapons of
15 mass destruction.

16 COMMISSIONER GRAHAM: Mr. Kyle, did you have a
17 social value for--

18 VICE CHAIRMAN THOMAS: Would the gentleman yield
19 for just a moment? It is going to get very difficult to
20 carry out a continued discussion if you guys decide to take
21 over the time and talk to each other, versus allowing us to
22 play our role and acknowledge folks. Okay?

23 COMMISSIONER GRAHAM: Mr. Kyle?

24 WITNESS KYLE: Yes. I think naked CDS bets do
25 play a valuable role. And the valuable role they play is to

1 provide signals to people who would buy bonds, or who would
2 sell protection, that they may be paying too much.

3 I heard several of the other people here say that
4 if we had had CDS trading on organized exchanges and the
5 market had been generating price signals, then AIG's senior
6 management would have seen what AIG's Financial Products
7 Group was doing, because the price signals they would have
8 gotten from the organized exchanges would have indicated
9 that there was some danger here, and maybe these assets were
10 very risky.

11 And I agree with what the other people said. But
12 the mechanism by which the senior management at AIG would
13 have learned that would have been people going in and taking
14 short positions on the products that AIG was betting the
15 other direction on. And those short positions would have
16 depressed the price of those products and made people think,
17 well, maybe they're not AAA. Maybe they're not safe. A lot
18 of people out there think they're going to default. A lot
19 of people out there are willing to bet that they're going to
20 default, including Mr. Paulson.

21 So this notion that moving trading to central
22 exchanges, and having transparent prices sends valuable
23 signals to the market to protect relatively unsophisticated
24 investors relies upon the ability of speculators to take
25 short position, and in particular people like Mr. Paulson to

1 take naked positions in the CDS market.

2 COMMISSIONER GRAHAM: Mr. Masters, do you think--

3

4 CHAIRMAN ANGELIDES: Senator Graham, would you
5 like a couple of extra minutes?

6 COMMISSIONER GRAHAM: Yes, please.

7 CHAIRMAN ANGELIDES: Okay. And then meanwhile,
8 press, I am going to ask you in the back--Press! Cameras!
9 Sir! Folks, I am going to ask you to kind of just wait.
10 You will have your opportunity to take photos of other
11 witnesses. So I don't want to distract this important
12 proceeding, if you would please refrain right now. Thank
13 you.

14 COMMISSIONER GRAHAM: Mr. Masters, what do you
15 think about the question of is there social utility in these
16 peripheral derivatives such as synthetic CDOs?

17 WITNESS MASTERS: I think it depends on what the
18 derivatives are. With regard to synthetic CDOs, I don't
19 personally see a lot of use for them. Just in terms of an
20 overall, it sort of begs the question. I mean, you know,
21 there's--not all financial innovation, which a synthetic CDO
22 is a form of financial innovation, is good. And I've talked
23 about this in past testimonies.

24 But, you know, Ford had the Edsel, and in this
25 case I think that synthetic CDOs really with regard to the

1 ultimate destruction, that they were part and parcel of with
2 regard to our economic system, in hindsight they certainly
3 don't seem to have a lot of benefit.

4 COMMISSIONER GRAHAM: I'm going to ask a
5 question, and I would like a one word 'yes' or 'no' answer
6 from each member of the panel.

7 We were told that in the year 2000 as part of the
8 Commodities Reform Act there was a prohibition on placing
9 these types of instruments through a gaming commission, such
10 as the Nevada Gaming Commission. It's my understanding from
11 a recent conversation that actually the current law in
12 Nevada would authorize these type of items to be a subject
13 of gaming, but for the federal prohibition.

14 Should the federal prohibition on placing these
15 matters on a regulated gaming system be repealed?

16 WITNESS GREENBERGER: Yes.

17 WITNESS KOHLHAGEN: I'm sorry, they should not be
18 allowed to be on those exchanges.

19 WITNESS KYLE: I think that derivatives should be
20 traded, CDS should be traded on organized derivatives
21 exchanges, and trading them in Las Vegas for entertainment
22 value is somewhat unnecessary.

23 COMMISSIONER GRAHAM: Mr. Masters?

24 WITNESS MASTERS: I'm just going to respond
25 directly to the question: Yes.

1 COMMISSIONER GRAHAM: Thank you, Mr. Chairman.

2 CHAIRMAN ANGELIDES: Thank you, Senator Graham.
3 Mr. Holtz-Eakin--oh, I'm sorry, I always try to alternate.
4 While we're a bipartisan Commission, I try to alternate
5 folks. So I will make sure Mr. Holtz-Eakin goes last next
6 time.

7 COMMISSIONER HOLTZ-EAKIN: Thank you,
8 Mr. Chairman. It's my first positive contribution to this
9 economy in years.

10 Thank you, gentlemen. This has been a very
11 useful discussion. I think we have all benefitted greatly
12 from it. At this point I don't think there are some
13 enormous issues left to resolve, so let me just go back and
14 pick up a couple of things.

15 First, Professor Kyle, it was striking to me that
16 in your opening remarks you immediately went to the notion
17 of shifting risk, and in particular shifting risk to
18 Taxpayers.

19 In light of the discussion since, can you just be
20 real clear about how you view the time line of that? Do you
21 believe that there was an expectation of shifting losses to
22 taxpayers before Bear Stearns? Before Lehman? I mean--or
23 was this a pre--this is a big issue for this Commission,
24 sort of the notion of too-big-to-fail, expectations, moral
25 hazard. So would you walk through that carefully for me?

1 WITNESS KYLE: I think there was. And here is
2 one of the reasons I think so.

3 Go inside Bear Stearns. They are taking bets
4 basically that housing prices are going to keep going up
5 because they have loaded up on mortgage securities. In some
6 sense they've got a lot of exposure to the credit risk on
7 mortgages.

8 So how carefully do you think they modeled the
9 credit risk associated with their exposure to mortgage-
10 backed securities? Keeping in mind that if the housing
11 market melted down, Bear Stearns did know full well that it
12 would be out of business.

13 And the answer to that question is that when they
14 applied to be a CSE firm, regulated by the SEC, they had
15 these scenarios that were essentially melt-down in the Alt A
16 market, or subprime market, and a melt-down in the prime
17 market, but they didn't have these scenarios implemented as
18 part of their risk management. In other words, they looked
19 at the bad events that they were insuring against and simply
20 ignored them.

21 I think if they were not risk-shifting, they
22 would have engaged in a very careful analysis of what those
23 risks were, even if it's just a one percent, or one-tenth of
24 a percent probability, and done a really good job of
25 evaluating the credit risks on the bets that they were

1 taking.

2 But the fact that they kind of didn't do it and
3 didn't do it in front of the open eyes of the SEC suggests
4 to me that what was going on was risk-shifting.

5 COMMISSIONER HOLTZ-EAKIN: And just to be real
6 clear. There is one view that says that systematically
7 markets failed to price risk effectively during this period,
8 both internal markets, risk-management systems inside firms,
9 formal markets. That's different than assessing those risks
10 and expecting the government to step in and absorb the
11 losses.

12 You believe it is the latter and not the former?

13 WITNESS KYLE: I believe that they expected the
14 government to step in and absorb the risks in the event that
15 they failed, but the evidence for that is not that they went
16 out and said we might fail, because they're not going to do
17 that. The evidence for that is that internally they didn't
18 carry on the rigorous intellectual debate about what's going
19 to happen if these bad events occur because internally they
20 effectively realized that it didn't matter what happened
21 when those bad events occurred; it's not their money they're
22 playing with, it's Taxpayer money that's at stake there.

23 COMMISSIONER HOLTZ-EAKIN: Thank you.

24 Mr. Masters, you made the point that CDS in
25 particular created systemic risk, and when you described

1 that what I heard you say was that it produced in the moment
2 of panic a desire to unwind positions, particularly those of
3 the counterparties.

4 Is there anything special about CDS versus the
5 repo market, corporate lending, asset-backed commercial
6 paper, and other places where we saw a financial market
7 interconnectedness, versus the CDS. Is there anything
8 special in that regard?

9 WITNESS MASTERS: And just to be clear, I think I
10 was talking about unregulated derivatives en mass, not just
11 CDS. I mean, CDS is a form of derivative, but I was talking
12 about overall derivatives.

13 COMMISSIONER HOLTZ-EAKIN: But the language you
14 used was not about contractual relations that produced an
15 interconnectedness. It was about the fact that financial
16 markets are interlinked and you can always have
17 externalities from fire sales. Is there anything special in
18 these unregulated derivatives in that regard?

19 WITNESS MASTERS: Well I think in the case of
20 unregulated derivatives, the problem was that without a
21 central clearing regime there was an unknown element that
22 was difficult to price. And that was what one was trying to
23 price was the positions that another firm, that happened to
24 be your counterparty, had on with other counterparties. And
25 whether or not those counterparties would pay off with other

1 counterparties.

2 And so it was a question of if this counterparty
3 doesn't pay off that counterparty, then maybe my
4 counterparty may not pay off with me. And so this unknown,
5 this fear of are counterparties good or not, which suddenly
6 appeared, in my view really after Lehman Brothers, was, you
7 know, part and parcel for the change in behavior from
8 institutional investors and counterparties subsequently to
9 Lehman.

10 COMMISSIONER HOLTZ-EAKIN: And how was that
11 different from just fear of the credit quality of your
12 counterparties during fire sale of assets in general?

13 WITNESS MASTERS: I think it's different because
14 if you have a specific--you know, let's say you're worried
15 about MBS and you have a credit counterparty, and you're
16 worried about their position. Then you could theoretically
17 go out and buy CDS with someone else on that counterparty
18 and say, okay, even if they go down and I don't get paid off
19 my bets from them, I've got CDS on with someone else and
20 they'll take care of that because I'm making the bet that I
21 get paid if they go down. And so I've hedged myself.

22 But in the sense of if everyone suddenly could go
23 down because we're all interconnected and you lose someone
24 that has enough concentration and enough diversity in terms
25 of interconnectedness between various firms, then suddenly

1 the CDS that I bought on that firm that I was worried about,
2 it may not be good and I lose my hedge. And that's what
3 sort of creates the fear.

4 COMMISSIONER HOLTZ-EAKIN: Okay. Let me try to
5 clean up one more thing with Mr. Greenberger.

6 I wrote this down as you said it. You said if
7 there was no naked CDS, then nothing would have happened.
8 So can you clarify what you mean by that?

9 WITNESS GREENBERGER: Well I would like to
10 clarify it. What I mean is this: The naked CDS made every
11 default three or four times as serious as it was. That is
12 to say, naked CDS is essentially somebody was betting, made
13 the perfectly rational bet by the way, that people who
14 didn't have good credit wouldn't pay their mortgages.

15 So people wanted to--they didn't want to be
16 exposed to the mortgage, because that's a risk. They didn't
17 want to get involved in the market. All they wanted to do
18 was play the very best kind of Fantasy Baseball.

19 After all, in Fantasy Baseball you have to take
20 your turn to pick your player. Mr. Paulson didn't take
21 turns. He picked the very poorest players and bet they
22 wouldn't make the Major Leagues. And so when those things
23 fail, when those underlying mortgages don't get paid, Mr.
24 Paulson makes his \$1 billion. He never invested it in the
25 market at all. He's just at a casino, like betting on the

1 Yankees beating the Red Sox.

2 VICE CHAIRMAN THOMAS: Mr. Chairman, yield the
3 gentleman an additional two minutes.

4 COMMISSIONER HOLTZ-EAKIN: Two minutes. Mr.
5 Hennessey and I engaged in a naked CDS of exactly this kind of type,
6 and what is the downside risk to the economy for us having
7 done that?

8 WITNESS GREENBERGER: It depends what you're
9 betting on. If you were betting on people would--

10 COMMISSIONER HOLTZ-EAKIN: I'm betting on Peter's
11 mortgage.

12 WITNESS GREENBERGER: Well that's a risky bet--
13 only kidding, Commissioner Wallison. I mean, look, it's
14 hard to say if you and Mr. Hennessey--what we have here is a
15 six hundred--well, for credit default swaps a minimum \$35
16 trillion market. A lot of that was devoted--

17 COMMISSIONER HOLTZ-EAKIN: And again we've
18 established that those numbers have no particular meaning.

19 WITNESS GREENBERGER: But, look, the fear of
20 those numbers. We went to War in Iraq--

21 COMMISSIONER HOLTZ-EAKIN: Fear--

22 WITNESS GREENBERGER: Yeah, we went to War in
23 Iraq because we feared weapons of mass destruction. There
24 were no weapons of mass destruction. You cannot say the War
25 in Iraq has nothing to do with weapons of mass destruction.

1 COMMISSIONER HOLTZ-EAKIN: This is a Commission
2 about the financial crisis, not the War in Iraq, sir.

3 WITNESS GREENBERGER: And what I'm telling you
4 is, if you don't believe in figures--and I think there's a
5 basis for your skepticism, because it's a private,
6 bilateral, opaque market, people were afraid that this
7 market was so huge--we know from the Paulson bet that a
8 billion dollars was bet on people not paying their
9 mortgages.

10 That means when those mortgages weren't paid, not
11 only did the lenders, or the MBS, or the CDO have a
12 commitment to make, but ACA Royal Bank of Scotland had a
13 commitment to make. So the British, for example, gave \$16
14 billion to the Royal Bank of Scotland so it could pay Mr.
15 Paulson. That had real impact on the economy. It is filling
16 the hole of three times the number of bets as mortgages that
17 I believe caused this to be a systemic crisis.

18 COMMISSIONER HOLTZ-EAKIN: There are centuries of
19 episodes of fear in financial markets that have nothing to
20 do with naked credit default swaps, and fear in highly
21 levered institutions of the financial type will always have
22 some downsides. So I think we need to distinguish between
23 fear and this particular contractual arrangement.

24 And the point I was trying to get some clarity
25 about is, in what circumstances these contractual

1 arrangements actually generated the downside. It seemed to
2 me that an earlier discussion focused on concentrations in
3 large institutions that are or are perceived to be too big
4 to fail, inadequacy of capital behind them in those
5 institutions, not in the contracts themselves.

6 WITNESS GREENBERGER: Absolutely. It's the
7 inadequate--

8 COMMISSIONER HOLTZ-EAKIN: Mr. Chairman, 36
9 seconds?

10 VICE CHAIRMAN THOMAS: Do you want anyone else to
11 respond?

12 CHAIRMAN ANGELIDES: Why don't you just add two
13 minutes, Mr. Vice Chairman.

14 VICE CHAIRMAN THOMAS: Unless you want to
15 continue the dialogue, it's your time to control as you
16 wish.

17 COMMISSIONER HOLTZ-EAKIN: I would like you to
18 finish briefly, and then we'll hear from Mr. Kohlhagen.

19 WITNESS GREENBERGER: Absolutely it is the
20 inadequacy of the capital that caused the problem here.

21 COMMISSIONER HOLTZ-EAKIN: Not the contracts?

22 WITNESS GREENBERGER: Not the contract. If the
23 contract had been capitalized--

24 COMMISSIONER HOLTZ-EAKIN: If I could hear from
25 Mr. Kohlhagen on my time.

1 WITNESS GREENBERGER: --the Taxpayer wouldn't of
2 had to bail these people out.

3 WITNESS KOHLHAGEN: Just quickly, on your
4 question for Mr. Masters of how it was different from normal
5 counterparty measure, I absolutely disagree with Mr.
6 Masters. It's exactly the same as the daily counterparty
7 risk management.

8 COMMISSIONER HOLTZ-EAKIN: I yield back.

9 VICE CHAIRMAN THOMAS: Mr. Chairman, he yields
10 back.

11 CHAIRMAN ANGELIDES: All right, thank you very
12 much. Mr. Georgiou, my fellow Greek-American Democrat who
13 feels he is being discriminated against.

14 COMMISSIONER GEORGIOU: Yes, thank you very much,
15 Mr. Chairman.

16 I think fear is not necessarily a bad thing. I
17 guess to follow on Commissioner Hennessey's point, as a
18 former math major whose high school math skills qualified me
19 for an academic scholarship that enabled me to afford to go
20 to college, not only do I not think math is evil, I am one
21 of the few people in 2010 who actually loves math.

22 And I guess my feeling about it is that
23 derivatives--what we're talking about here, and in
24 particular the credit default swaps, the synthetic CDOs, and
25 a variety of other instruments, are simply another

1 manifestation of the current structural problem in the
2 financial services industry that has resulted in the
3 victimization of the real economy and caused such enormous
4 consequences, and devastating consequences, to the Taxpayers
5 and so forth.

6 The problem is not mathematical models, per se,
7 or the creation of financial instruments per se. The
8 problem is that the economists building the models, and the
9 kids pricing these instruments, to use Mr. Kohlhagen's term,
10 bear no consequences for their failure.

11 Their actions are completely divorced from their
12 responsibilities and consequences. These enormous fees were
13 earned by the creation of all these instruments by all of
14 these players at every stage of the process, and none of
15 them bore consequence for their failure.

16 Now why was that? There was no capital in the
17 game. Fees were earned. Revenues were booked by the
18 entities that created them, and metrics were reached in
19 terms of bonuses and so forth on the basis of these
20 revenues--without consequence to the ultimate failure of the
21 instruments, and the consequences that occurred to the
22 investors who bought them.

23 So the problem it seems to me is the connection
24 of some degree of responsibility. And I have been harping
25 on this, hearing after hearing of having more skin in the

1 game, of being required to eat your own cooking. These
2 kids, the reason why they created all of this stuff was
3 because they made money at it at the end of the day, and
4 they never lost any money regardless of what happened.

5 You know, one of the examples I guess I would
6 point out to you is there is a chart here that is going to
7 come into the record here. We are going to mark it chart
8 number two. It is the multiplication that occurs just in
9 Goldman Sach's synthetic CDOs.

10 You know, synthetic CDOs, first of all you take
11 the mortgage-backed securities and you slice and dice them
12 up, and then you take the BBB tranches, which are the
13 lowest rated tranches above equity. Then you take those,
14 and you slice them up into CDOs. Then you create synthetic
15 CDOs. And in this chart you can see that there were 3,408
16 synthetic and partially synthetic CDOs created by Goldman.
17 And the underlying asset-backed securities were replicated
18 2,537 times--one deal replication; 610 times the same
19 security was used in 2 deals; 170 times in 3 deals; and so
20 forth. In one instance the same underlying mortgage was in 9
21 different deals.

22 Now why would you create all those deals unless
23 you could make money from creating them and not have any
24 consequences to their losses?

25 So I guess I would like to ask each of you

1 whether, you know, whether you believe that the lack of
2 capitalization in particular--I know some of you have said
3 it already--and the lack of consequences; we've discovered
4 that there were never any clawbacks of any bonuses earned by
5 anybody as a result of the failure of these instruments, and
6 having the government bail out the institution rather than
7 people bear the bankruptcy consequences of normal capitalism
8 contributed to the crisis?

9 Mr. Kohlhagen?

10 WITNESS KOHLHAGEN: I was hoping I could go
11 fourth. I think it is an enabler. I think that basically--
12 let me put it in sort of a praying mantis kind of analogy.

13 I think what happened is, as I stated in my
14 testimony, the cause of all of this was the U.S. Government
15 trying to bring housing, in a commendable way, to the next
16 group of American citizens, and noncitizens, for that
17 matter.

18 But in order for it to happen, in order for it to
19 happen in a way that it did, the private sector had to
20 enable it. It wasn't just government guarantees and
21 government subsidies. It had to be enabled somehow.

22 So ultimately it came to Wall Street. And Wall
23 Street ultimately said, in the early part of the last
24 decade, wait a minute. What you want us to do is to find a
25 way for the market to lend money to people who shouldn't be

1 borrowing money?

2 And the government in effect said, yes, that's
3 what we want you to do. And Wall Street said, okay, watch
4 this.

5 COMMISSIONER GEORGIOU: Right. Wait, okay, I--

6 WITNESS KOHLHAGEN: So basically--

7 COMMISSIONER GEORGIOU: I could dispute your
8 characterization whether the government encouraged it, or
9 whether the necessity of government encouragement--whether
10 there was any such necessity, whether the market just did it
11 on its own because, after all, at the end of the day, you
12 know, the financial services industry is there to make a
13 profit. There's nothing necessarily wrong with that.

14 The problem it seems to me is divorcing the
15 ultimate consequences and shifting to the Taxpayers and
16 others the burdens of the losses.

17 WITNESS KOHLHAGEN: Left out of all of this, and
18 I think it's implicit in what you're saying, is that what
19 got divorced was the lenders being able to lend money but
20 not take the risk, to find a way to pass the risk on to
21 others who didn't want--

22 COMMISSIONER GEORGIOU: Lenders, securitizers,
23 credit rating agencies, auditors, I mean the list goes on
24 and on of people who were enriched, who received revenues
25 from creating the system.

1 WITNESS KOHLHAGEN: Originally you can go back to
2 the 1970s, the operating model was firms lent money to
3 corporations and people. And they took the risk. So they
4 had skin in the game.

5 COMMISSIONER GEORGIU: Right.

6 WITNESS KOHLHAGEN: What happened, what changed
7 from the '70s to the early part of the last decade was they
8 found a way to have no skin in the game.

9 COMMISSIONER GEORGIU: Right. And so--and to
10 me, it seems to me that is an overriding theme that we've
11 seen in our securitization analysis, and the credit rating
12 analysis, the housing mortgage--you know, the mortgage
13 finance area, in all these elements.

14 Now I guess, Professor Kyle, you wanted to
15 respond? It looked to me like you had a thought.

16 WITNESS KYLE: Well I don't like the idea of
17 Taxpayer money being used to subsidize the losses of other
18 people's bad decisions. But in addition to looking at
19 executive compensation and the salary structure of firms on
20 Wall Street, you have to look at who was really bailed out.
21 And for the most part it was the debt-holders that were
22 bailed out.

23 So I think what we need is a mechanism to have
24 some discipline imposed on investors in debt securities, and
25 in particular debt securities issued by leveraged financial

1 institutions like banks. And one such possibility would be
2 contingent capital, or a quick resolution mechanism which we
3 might be getting that would essentially convert these debt
4 securities into equity when the underlying institutions get
5 into trouble and therefore force the underlying
6 institution's security owners to pay for the bad decisions
7 of the firms that they invest in.

8 CHAIRMAN ANGELIDES: Three more minutes for Mr.
9 Georgiou?

10 COMMISSIONER GEORGIOU: If I could. Thank you
11 very much, Mr. Chairman.

12 I want to go back to the discussion that occurred
13 here between Commissioner Wallison and Mr. Masters about
14 what would of happened if one of these firms failed.

15 We know that Bear was saved through a shotgun
16 merger, and Lehman was not. But Merrill was. And one of
17 our previous witnesses, Mr. Buffett, seemed to suggest that
18 that was key that Merrill was saved, as well as AIG, because
19 there were so many--the enormity of their counterparty
20 exposure dwarfed a number of the other entities, and so that
21 was required.

22 Do you have a view, Mr. Masters, of what would
23 have occurred had they not--had AIG and Merrill not been
24 effectively saved?

25 WITNESS MASTERS: Yes. I mean I was thinking

1 about the term "saved" in a different manner. In other
2 words, I think it was more of sort of a behind-the-scenes
3 shotgun marriage.

4 COMMISSIONER GEORGIU: Well, but it was a
5 guarantee. There was huge Taxpayer involvement in the Bear
6 marriage and in the Merrill Lynch marriage, in that a number
7 of those risky securities that were on the books of those
8 entities were guaranteed by the Fed as part of the
9 transaction. Otherwise, the purchasers wouldn't have gone
10 through them.

11 WITNESS MASTERS: Yes, I think it speaks to the
12 scope of the problem. I think that regulators felt like
13 they had to pull out all the stops, if you will, to sort of
14 save the system at that point in time.

15 COMMISSIONER GEORGIU: And I guess, you know, my
16 fellow Commissioner Wallison, I take it, would assume that
17 had we not saved Bear it would have triggered more
18 responsibility in the system. But I guess one might argue
19 that at that point it was too late for everybody to unwind
20 their positions in a relatively short period of time because
21 they had amassed these enormous positions, uncanceled and
22 unhedged. I mean that seems to me to be my fear.

23 WITNESS MASTERS: I think that's absolutely
24 right.

25 COMMISSIONER GEORGIU: Professor Grasp--

1 WITNESS GREENBERGER: Greenberger.

2 COMMISSIONER GEORGIU: Greenberger, I'm sorry.

3 WITNESS GREENBERGER: I just wanted to say that
4 you asked the question: Is capitalization a problem here?
5 It was a very big problem. The American Taxpayer ended up
6 capitalizing this.

7 I thought it was interesting, your point that one
8 tranche in a CDO was used nine times in synthetic CDOs.
9 That means every time a default occurred in the real CDO,
10 there was nine times the betting on that.

11 COMMISSIONER GEORGIU: Right.

12 WITNESS GREENBERGER: That's my point. The
13 betting aggravated the problem.

14 COMMISSIONER GEORGIU: Well, and--

15 WITNESS GREENBERGER: And the final point I would
16 make is, you, as I think the entire American public wants to
17 know where is the accountability here? And I sympathize
18 with you on that. Madison said: If men were angels, we
19 wouldn't need government. We can't keep saying, oh, there
20 should have been more risk management. There should have
21 been more this. That's what regulation in this context,
22 market regulation, is about.

23 In the securities market you can't do these
24 things. It's not a matter of risk management. The SEC
25 governs the market. In the regulated futures market, the

1 CFTC governs the market. In 2000, a decision was made that
2 there would be no clearing and no exchange trading--

3 COMMISSIONER GEORGIU: Right. Understood. But--
4 -

5 CHAIRMAN ANGELIDES: Byron, we are over time and
6 we are running behind, so I am going to--we need to wrap up
7 right now, except two final minutes to Ms. Born as one of
8 the Working Group members, and then the Vice Chair has a
9 question, and then we will adjourn for lunch.

10 COMMISSIONER BORN: Thank you. I just wanted to
11 follow up a little bit also on Commissioner Wallison's
12 discussions with Mr. Masters.

13 First, just confirm, Mr. Masters, that when you
14 are talking about the interconnectivity through the market,
15 through over-the-counter derivatives that leads to potential
16 systemic risk, you are talking about all over-the-counter
17 derivatives, not just credit default swaps? Is that
18 correct?

19 WITNESS MASTERS: That's right.

20 COMMISSIONER BORN: And in your discussion you
21 were discussing Lehman Brothers failure, a freeze-up for a
22 couple of days in the over-the-counter derivatives market,
23 and the rescue of AIG with a government commitment of \$180
24 billion of rescue money. And also it has been pointed out
25 that one big money market fund went down, and so the

1 government had to step in to insure money market accounts.

2 But also, didn't the government immediately at
3 this time seek \$700 billion in TARP funds? Didn't it open
4 the Discount Window to the investment banks who were the big
5 over-the-counter derivatives dealers? Didn't our largest
6 over-the-counter derivatives dealers, Merrill Lynch, Morgan
7 Stanley, JPMorgan, Bank of America, Citigroup, Goldman
8 Sachs, all get tens or hundreds of billions of dollars of
9 direct and indirect support from the government in order to
10 contain the contagion that would have occurred?

11 CHAIRMAN ANGELIDES: And by the way, I'm going to
12 ask you to go ahead and answer. The time is up, but why
13 don't you go ahead and give the answer.

14 WITNESS MASTERS: I think all those were
15 obviously part and parcel of the bailout. And, you know,
16 one final point I would say, just in terms of transactions
17 in derivatives, even though you could have had more
18 transactions between the period of Lehman and AIG, at that
19 moment in time, the reality is because of the shrinkage of
20 notional we know that those were all closing transactions.
21 So it was people getting out that did add consequences on
22 other folks. So I just wanted to make that final point.

23 COMMISSIONER BORN: Thank you.

24 CHAIRMAN ANGELIDES: All right. Vice Chairman
25 Thomas.

1 VICE CHAIRMAN THOMAS: Thank you. I am trying to
2 structure a take-away. You've been an excellent panel, and
3 I want to see if I can say that after I go through this
4 routine as well.

5 I want to try to run down a list of--we're here
6 to try to find the causes of the financial crisis. So I am
7 going to run down a list of items that I heard discussed
8 here, or that we have talked about. And then what I would
9 like to do is to turn to each of you and, if there is
10 something I did not mention that you would, give me like the
11 top three, or the top five from your position.

12 One, I want to see the degree of diversity or
13 commonality in terms of what you would choose.

14 We talked about U.S. Government support of the
15 housing market. The lack of proper regulation of the
16 financial markets. International capital flows we've been
17 concerned about. Also, the Federal Reserve interest rate
18 policy, the loose credit standards. Firm level risk
19 management failures. Lack of transparency about who was
20 exposed to the mortgage market. System-wide leverage.
21 Dependence on short-term funding. Financial market
22 interconnections. The too-big-to-fail argument. Rating
23 agencies, and all that entails. Corporate compensation
24 models in terms of their inducement of certain behaviors.
25 What happened where the rubber meets the road in terms of

1 opportunities on creating these mortgages by real estate and
2 other folk, leading to a degree of fraud.

3 Let's start from the left and go to the right.
4 Three to five, and kind of rank them, if you would, if it's
5 possible.

6 CHAIRMAN ANGELIDES: And go fast.

7 WITNESS GREENBERGER: My view is, if the over-
8 the-counter derivative market had required capital and had
9 been transparent, the rest of the list would have been
10 irrelevant.

11 WITNESS KOHLHAGEN: Number one, the U.S.
12 Government policy to expand the homeowner market. That's
13 the cause, to my mind. The enablers, the major enablers
14 were the Fed's monetary policy, federal regulation
15 liberalization, forbearance, and the absolute
16 irresponsibility of the rating agencies.

17 WITNESS KYLE: I think risk shifting is number
18 one. Irrational exuberance is number two. And government
19 mandates for home ownership probably number three, but
20 derivatives, OTC derivatives pretty far down the list.

21 WITNESS MASTERS: I would say that over-the-
22 counter derivatives had a very significant and key role in
23 transferring credit crisis into a broad scope financial
24 crisis.

25 VICE CHAIRMAN THOMAS: So you have a mono-cause?

1 WITNESS MASTERS: A what?

2 VICE CHAIRMAN THOMAS: You have a single cause?

3 That was the cause of the financial crisis?

4 WITNESS MASTERS: Right. Well, a dispersant.

5 VICE CHAIRMAN THOMAS: Okay. Thank you.

6 CHAIRMAN ANGELIDES: All right, gentlemen. Thank

7 you very much for your time and your testimony. We

8 appreciate it very much.

9 We are now going to take a break and recommence

10 at 12:25 in this room.

11 (Whereupon, at 12:02 p.m., the meeting was

12 recessed, to reconvene at 12:31 p.m., this same day.)

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1 AFTERNOON SESSION

2 (12:31 p.m.)

3 CHAIRMAN ANGELIDES: The meeting of the Financial
4 Crisis Inquiry Commission will come back to order. We will
5 now start our second session of the day on AIG and
6 Derivatives.

7 I want to welcome our witnesses. We will begin
8 by doing what we customarily do, which is we will ask all
9 three of you gentlemen to please stand and be sworn.

10 Please raise your right hand. Do you solemnly
11 swear or affirm under penalty of perjury that the testimony
12 you are about to provide the Commission will be the truth,
13 the whole truth, and nothing but the truth, to the best of
14 your knowledge?

15 MR. SULLIVAN: I do.

16 MR. LEWIS: I do.

17 MR. CASSANO: I do.

18 (Witnesses sworn.)

19 CHAIRMAN ANGELIDES: Thank you very much.

20 Gentlemen, we thank you for submitting your
21 written testimony which the Commissioners have had a chance
22 to review. We would like to begin today's session by asking
23 that each of you provide an oral statement of no more than
24 five minutes.

25 There is a device at the table which will signal

1 yellow when there's one minute to go, and red when your time
2 is up. And so we would ask you to adhere to that five
3 minutes, and that will allow us then significant time to ask
4 you questions on the matters before this panel.

5 So with no further ado, I am going to go--I think
6 this time, I always vary the order--I am going to start with
7 you, Mr. Sullivan, then go to Mr. Lewis, and then Mr.
8 Cassano. We will go in that order. So if you would begin
9 your statement, that would be terrific.

10 WITNESS SULLIVAN: Thank you, sir. Good
11 afternoon.

12 Chairman Angelides, Vice Chairman Thomas, and
13 Members of the Commission:

14 My name is Martin Sullivan. I was President and
15 Chief Executive Officer of AIG from March of 2005 through
16 June of 2008. My career at AIG spanned almost four decades.

17 I started work at age 17 in the accounts
18 department of AIU London Ltd., which was the UK-based non-
19 life subsidiary of AIG. Thereafter I took on increasing
20 responsibility for the property underwriting side of the
21 business.

22 In 1996 I moved to New York, and I have lived
23 there ever since. I became Chief Operating Officer and later
24 President of AIU. In 2002, I became Co-Chief Operating
25 Officer of AIG.

1 As Co-CLO, my primary oversight responsibilities
2 continued to be in the non-life area of AIG's insurance
3 business. In March 2005, I was asked by the Board to become
4 President and Chief Executive Officer of AIG. At the time I
5 assumed this position, the company was in crisis. AIG's
6 outside auditors had informed the Board that they could not
7 rely on prime management certification.

8 We thus had to advise all interested parties that
9 we would be delaying the filing of the 2004 10K. We then
10 undertook an internal review of AIG's books and records.
11 This review spanned AIG's major business units globally and
12 involved more than 30 multi-discipline teams reviewing the
13 company's global operations.

14 I was meeting regularly with our key state and
15 federal regulators, and working with senior management to
16 strengthen and enhance AIG's overall financial reporting and
17 internal control environment.

18 AIG was segmented into four lines of business:
19 life, non-life, financial services, and investments. AIG's
20 Financial Services subsidiaries engaged in diversified
21 financial products and services, including aircraft and
22 equipment leasing, consumer finance and insurance premium
23 financing, and capital market transactions.

24 AIGFP, within the capital markets area, conducted
25 interest rate, currency, equity, commodity, energy, and

1 credit transactions. During most of my tenure, Mr. Cassano
2 was CEO of AIGFP. He reported to the head of Financial
3 Services, Mr. Dooley. Mr. Dooley in turn reported to me.

4 You have also asked me to address risk management
5 practices at AIG. The four components of Enterprise Risk
6 Management were credit, market, operational, and later
7 liquidity. The senior managers who headed each of these
8 units reported to the Chief Risk Officer, Mr. Lewis, who
9 reported to the CFO until early 2008, and then to me.

10 Mr. Lewis provided regular reports to both the
11 finance committee and the audit committee. Many of the
12 business units also had their own risk control units. Thus
13 risk was managed both at the parent and line-of-business
14 level.

15 The risk controls in place at AIG were designed
16 to ensure that all information was shared across business
17 lines, and that senior risk managers approved all strategic
18 decisions. But each business unit then made decisions based
19 on its overall strategy, and in light of all relevant
20 business factors. And because of the events that occurred
21 in March of 2005, risk management was a priority for the
22 Board and for me.

23 Finally, you have asked me to discuss the events
24 of 2007 and 2008. We devoted significant time and effort to
25 analyzing and disclosing in detail the company's potential

1 exposure across the board in all of its businesses to the
2 deteriorating U.S. residential housing market.

3 AIG repeatedly revised and corrected estimates as
4 it developed better information. In February of 2008, AIG
5 was advised by its independent auditors that they believed a
6 material weakness existed in its internal controls over
7 financial reporting and oversight relating to the fair value
8 valuation, sometimes referred to as the mark-to-market
9 valuation of AIGFP's super senior credit default swap
10 portfolio.

11 Shortly thereafter, AIG issued a Form 8K
12 describing this issue and revising its valuation of the
13 portfolio. After issuing its Form 8K, AIG also undertook an
14 assessment of its valuation controls and procedures, and
15 instituted managerial changes within AIGFP.

16 Throughout my tenure as CEO, my goal was to
17 communicate as openly and directly as possible within the
18 organization with investors and with regulators. I
19 appreciate this opportunity to share my views, and I look
20 forward to your questions.

21 Thank you very much, indeed.

22 CHAIRMAN ANGELIDES: Thank you, Mr. Sullivan.
23 Mr. Lewis?

24 WITNESS LEWIS: Chairman Angelides, Vice Chairman
25 Thomas, and Members of the Commission:

1 I am pleased to help in any way I can in the
2 Commission's efforts to learn about AIG and the complex
3 derivative financial instruments that I understand to be the
4 subject of today's hearing.

5 I am the Chief Risk Officer of AIG. I joined AIG
6 in 1993 as the company's Chief Credit Officer, and in 2004
7 was appointed the company's first Chief Risk Officer by
8 then-CEO M.R. Greenberg.

9 As Chief Risk Officer, I established and
10 continued to be responsible for the AIG corporate-level risk
11 management function known as Enterprise Risk Management, or
12 ERM.

13 As an insurance company, AIG is in the business
14 of taking on risk. AIG's basic approach is that
15 responsibility and accountability for the risks assumed by
16 the various AIG business units actually reside within the
17 business units themselves.

18 My role as Chief Risk Officer, supported by
19 Enterprise Risk Management is to assist the businesses in
20 identifying, evaluating, and managing aspects of their
21 risks.

22 I understand that the focus of today's hearing is
23 on complex financial derivatives, and in particular on the
24 credit default swaps sold by AIG's Financial Products
25 Division known as FP. So let me then get right to that

1 subject.

2 An important aspect of the management of the risk
3 from FP's sale of credit default swaps involved the CDO
4 structure of the assets underlying the swaps themselves.

5 Basically, as I believe the Commission now very
6 much understands, a CDO consists of a tower of loans with
7 the uppermost level known as the super senior level having
8 the first right to the entire tower's cash flow in the event
9 of defaults and consequent losses above an agreed-upon
10 level.

11 FP's approach to the management of its risk was
12 to structure the credit default swaps so that they would
13 only be triggered if the underlying losses were severe
14 enough to rise to the highest levels in the tower, a risk
15 that FP determined to be exceedingly unlikely even under
16 severe economic scenarios.

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

25 This statistical analysis demonstrated to a 99.85

1 percent confidence level that the upper level portion of a
2 CDO tower insured by an FP credit default swap would not
3 suffer credit losses.

4 FP sold its first default swap in 1998, and for
5 years things worked as FP's models had predicted. However,
6 in the latter part of 2005 ERM at the corporate level began
7 to get concerned based on increasingly aggressive bank
8 lending practices, and a housing market that was unduly
9 heating up.

10 In early 2006, my chief credit officer discussed
11 these concerns with FP's CEO in London who responded that
12 FP's own risk analysis was identifying the same concerns,
13 and that he had decided it was time to shut down.

14 At that point, commitments were already in place
15 so it was not realistic to terminate the business
16 instantaneously. However, with one exception FP decided to
17 end its business of new credit default swap sales involving
18 subprime exposure.

19 As to those swaps already on the books, the
20 judgment was that they would continue to perform
21 satisfactorily given the safety of the tower structure, and
22 the fact that those swaps covered earlier mortgages provided
23 at a time of more conservative lending practices.

24 As it turned out, we were wrong about how bad
25 things could get. What ended up happening was so extreme

1 that it was beyond anything we had planned for. The CDO
2 tower structure, nonetheless, did provide significant
3 protection to AIG because those investors at the top of the
4 tower were legally protected by their superior rights to the
5 tower's cash flow.

6 But the market's apparent anticipation of further
7 cash flow declines, combined with an extraordinary erosion
8 in market liquidity generally, resulted in a collapse of
9 fair values, thereby triggering collateral calls.

10 AIG's liquidity was thus depleted, not
11 withstanding that credit losses to AIG were not actually
12 occurring and, given more time, the values would have been
13 expected to come back.

14 As the credit crisis reached its peak, AIG's
15 ability to maintain its liquidity declined precipitously as
16 credit markets froze, other liquidity issues developed, and
17 FP could not make good on all collateral call demands.

18 It was at that point that the Federal Government
19 stepped in with Taxpayer assistance.

20 I would be pleased to answer any questions.

21 CHAIRMAN ANGELIDES: Mr. Cassano.

22 WITNESS CASSANO: Chairman Angelides, Vice
23 Chairman Thomas, Commissioners:

24 My name is Joseph Cassano. I worked at the
25 Financial Products Division of AIG for over two decades, and

1 was the head of the group since January of 2002.

2 I was proud of FP's employees and remain proud of
3 them today. If, as a result of this process, you are
4 critical of our work, please direct that criticism at me,
5 not them.

6 Thank you for having me. I fully appreciate the
7 importance of your mission generally, and the importance of
8 the events surrounding the AIG bailout specifically.

9 I want to thank your staff especially for their
10 professional approach and many courtesies during my
11 cooperation with the Commission. I know you have read my
12 written submission. I will not repeat it here.

13 Although my perspective diverges in important
14 ways from the popular wisdom, I am very willing to answer
15 all your questions about our portfolio of credit swaps; our
16 risk assessment and monitoring of that portfolio; our
17 decision to exit the subprime business in early 2006--well
18 ahead of many others in the market; our continuing
19 surveillance of that portfolio; the fundamental analysis and
20 contractual rights that formed the basis of our response to
21 collateral calls during my tenure; the analytic method we
22 used to value the portfolio for accounting losses; and
23 issues surrounding our compensation structure generally, my
24 compensation in particular, and the circumstances leading to
25 my retirement. And of course any other questions the

1 Commissioners may have.

2 Chairman Angelides, you said that this
3 Commission's work would be tethered to the hard facts. I am
4 grateful for that. I intend to give you my best
5 recollection and candid perspectives. I look forward to
6 your questions.

7 CHAIRMAN ANGELIDES: Thank you very much. We
8 will begin the questioning now. I will begin the
9 questioning, and then we will go to Vice Chairman Thomas,
10 and then to the Members of the Commission who led this
11 portion of our inquiry.

12 I want to start with some questions first of all
13 on the management of derivatives by the organization. So
14 this is really about both the derivatives business as well
15 as risk management in the company. And I obviously want to
16 start with the perspective that things did not go well.

17 Earlier today one of our witnesses indicated that
18 his view--which I think is shared by many--is that the story
19 of AIG's management was one of irresponsibility only matched
20 by a lack of accountability. So I want to talk a little bit
21 about the risk management measures and how you viewed this
22 marketplace.

23 Mr. Sullivan and Mr. Cassano, on December 5th of
24 2007 there was an investor conference. And at that time,
25 Mr. Sullivan, you said that the risks that AIG took in the

1 housing sector was, quote, "risk supported by sound analysis
2 and a risk management structure that allows AIG to put our
3 capital to work in an efficient manner."

4 And you went on to say that AIG, quote, "had a
5 centralized risk management function that oversees the
6 market, credit, and operational management of each of our
7 businesses as well as the parent company."

8 During that same investor call, Mr. Cassano, you
9 said that AIGFP performed, quote/unquote, "thorough due
10 diligence on each CDS trade" and it was, quote, "a very
11 selective process" with, quote, "rigorous modeling
12 assumptions."

13 I want to ask you a number of questions about
14 risk management. In that regard, I want to enter into the
15 record a number of documents. It is a document called "Risk
16 Management." There are a number of documents which we've
17 received and reviewed both from AIG and from Price
18 Waterhouse Coopers.

19 So the first is that in 2005 the amount of
20 derivatives that you've written triples from about \$17
21 billion to \$54 billion during that year.

22 Mr. Sullivan, you told our staff that you did not
23 know in 2005 that the decision had been made, and that in
24 fact you had tripled your exposure to credit derivative
25 swaps for asset-backed securities. Tell me why you were out

1 of that loop.

2 WITNESS SULLIVAN: Thank you, sir. As I
3 mentioned earlier in my opening remarks, obviously during
4 2005 I was focused on resolving the issues that were facing
5 the corporation at that time, and I won't repeat those for
6 the record.

7 My first knowledge of the CDS, super senior CDS
8 portfolio was sometime during 2007.

9 CHAIRMAN ANGELIDES: So you had a book of \$78
10 billion of exposure by 2007 and you didn't become aware of
11 it until then?

12 WITNESS SULLIVAN: What I was receiving was
13 regular reports from not only Mr. Cassano on his business,
14 but also from Mr. Lewis and Mr. McGinn on AIGFP's business
15 in its totality, including the credit default swap
16 portfolio. But to the best of my knowledge, I never
17 recognized that portfolio, and there were no issues raised
18 in the correspondence that would have given me cause for
19 concern.

20 CHAIRMAN ANGELIDES: Okay, Mr. Cassano, in the
21 management reports sent up to the parent company, would the
22 information have been there that in fact the exposure had
23 gone from \$17 billion in 2005 at the beginning of the year
24 all the way up to \$78 billion in 2007? That would have been
25 in the management reports floating up, correct?

1 directly, we never diluted our underwriting standards at any
2 point in time. We had rigorous standards, standards set by
3 the AIG Credit Risk Management, that we then employed in
4 underwriting these transactions.

5 It's important to recognize I think that we did
6 take the difficult decision to exit the business in 2005.
7 But the other thing that I think substantiates our
8 underwriting criteria in these transactions is that many of
9 these multi-sector CDOs that we did now reside in Maiden
10 Lane III, which is the special-purpose vehicle that the
11 government set up after the bailout of AIG.

12 And to date that vehicle is performing. I think,
13 you know, I'm sure the Commission knows the statistics. The
14 Federal Government lent that vehicle \$24 billion. To date
15 that vehicle has repaid \$8 billion through the performance
16 of these transactions. And as far as I can see from where I
17 sit, when I look at the portfolio residing in Maiden Lane
18 III, I don't think any of the transactions have pierced the
19 attachment levels that we had set in our underwriting
20 standards.

21 CHAIRMAN ANGELIDES: But my understanding, Mr.
22 Cassano, on that point that, while the real economic losses
23 today may be relatively small, that the projections for the
24 economic losses may be upwards of 25 percent, perhaps up to
25 50 percent on those portfolio. Do you think that's just not

1 accurate?

2 WITNESS CASSANO: What I look to is the
3 performance, and to see if anything has been pierced. Now
4 we've gone through obviously one of the worst financial
5 crises since, you know, in anybody's lifetime. And as we
6 move through this and we come through the financial crisis,
7 the only thing I can do is look at the existing portfolio
8 and say that it is performing through this crisis, and it is
9 meeting the standards that we set.

10 And I think our reviews were rigorous. I think
11 the portfolios are withstanding the test of time in
12 extremely difficult circumstances.

13 CHAIRMAN ANGELIDES: All right, let me move on
14 because it really does bring me to the next issue, which is
15 that here is something that I want to particularly query Mr.
16 Sullivan about, and that's the following:

17 The contracts that were written with
18 counterparties like Goldman provided for collateral calls if
19 there were declines in market value, mark-to-market. Now I
20 will stipulate at the beginning that of course Mr. Cassano
21 was aware of this, Mr. Forster was aware of this, Mr. Frost
22 was aware of this, Mr. Sun at AIG Financial Products were
23 aware of it. My understanding is there would be collateral
24 calls on AIG if there were economic losses, real losses, on
25 the loan; if there were downgrades to AIG; and thirdly, if

1 there were declines in market value of these securities,
2 which in fact did happen.

3 And I am going to talk to you a little more at
4 length about how this happened, particularly with respect to
5 Goldman Sachs, in a few minutes. But, Mr. Sullivan, I just
6 have to ask you, because here is a major commitment by your
7 company--and I'm going to ask you, too, Mr. Lewis--in which
8 you're backing ultimately \$78 billion of protection. And
9 what was imparted to us in our interviews is that you said
10 to the best of your knowledge you were not aware of these
11 mark-to-market terms in these contracts until the summer of
12 2007, which makes sense since you weren't aware of the
13 contracts apparently until 2007.

14 Your CFO said that he wasn't aware that the
15 contracts required posting of collateral if the fair value
16 declined. He first became aware in the third quarter of
17 '07.

18 Mr. Lewis, you are the Chief Risk Officer and you
19 told our staff that you didn't know about this until Goldman
20 made its first margin call on July 27th, '07. And when
21 asked if the provisions caused consternation within the
22 company, in our interview you say, quote, "I would say
23 that's an understatement."

24 The Financial Services Division CFO, Mr. Habayeb,
25 will be here tomorrow and he said he didn't know. AIG Chief

1 Credit Officer Kevin McGinn said he didn't know. How could
2 it come to be, Mr. Sullivan and Mr. Lewis, that you have \$78
3 billion of contract and you do not know that the contracts
4 have a provision in them where you're going to have to post
5 billions of dollars if market values decline, which in fact
6 happened? How does that happen?

7 And I might add--and I don't want to be--you
8 know, particularly in the context of compensation, \$100
9 million plus awarded to you as CEO, how does that happen?

10 I mean, how would you now characterize that?

11 WITNESS SULLIVAN: Thank you, sir. I mean, the
12 only way I can respond is by giving you the facts. The fact
13 is that I only became aware of the CDS portfolio during
14 2007, although I was receiving reports that did not indicate
15 that there were any issues pertaining to that portfolio and
16 recognizing that no new business had been written since the
17 end of 2005.

18 CHAIRMAN ANGELIDES: Well actually that's not
19 true. I mean, the book was \$54 billion at the end of 2005.
20 It did climb to \$78 billion. There were deals in the
21 pipeline, and there were--we have a log. There were deals
22 made. Now apparently a decision was made to do it, but a
23 full wind-down did not happen immediately. You added
24 another \$24 billion of exposure, unhedged.

25 WITNESS SULLIVAN: Well my understanding was that

1 obviously there was a meeting of the minds, as both my
2 colleagues have articulated, between ERM and AIGFP to cease
3 writing that business, or writing new business at the end of
4 2005.

5 As I said, the first time I became aware of the
6 portfolio and collateral calls, to the best of my
7 recollection, sir, is--

8 CHAIRMAN ANGELIDES: 2007.

9 WITNESS SULLIVAN: --2007.

10 CHAIRMAN ANGELIDES: That's stunning.

11 Mr. Lewis, you are the Chief Risk Officer.

12 Anything you want to add to this?

13 WITNESS LEWIS: I would state that the risk
14 issues that were the focus of the attention at AIG were
15 around the actual credit risks and the underlying
16 portfolios. And the rigorous work that we did, together
17 with FP was to determine what the likelihood was of
18 suffering credit losses through defaults and losses in the
19 underlying mortgages.

20 The liquidity aspects were something that we,
21 quite frankly, just didn't focus on to the extent that we
22 now know we should have. These instruments, up until the
23 time of the crisis, had traded in very narrow bands, highly
24 liquid, AAA securities, until the crisis occurred when they
25 traded off quickly. And then there was no market.

1 CHAIRMAN ANGELIDES: But were you aware that
2 there was a liquidity provision? You weren't, were you?

3 WITNESS LEWIS: No, I was not, until the day I
4 testified.

5 CHAIRMAN ANGELIDES: All right, let me now ask
6 one more question, and then I want to turn to Mr. Cassano
7 and ask a little bit about how this market worked, this
8 over-the-counter market worked, and I'm going to really talk
9 about the relationship with Goldman. But I want to ask one
10 more question of the two of you, which is:

11 So the decision is made ostensibly to stop
12 writing protection on subprime-backed CDOs, even though the
13 exposure continues to climb. But meanwhile, another
14 division of your company, AIG Investments, which invests on
15 behalf of the insurance subsidiaries, is upping its bet very
16 substantially. Decisions are made to change the policy for
17 investment.

18 At the very time that one unit is saying let's
19 pull back, AIG Investments starts to load in and invested a
20 substantial amount of money, about \$49.5 billion, or 65
21 percent of your \$75 billion security lending portfolio in
22 securities backed by subprime mortgages. That's by the end
23 of 2007.

24 In the end of the day, you didn't hedge your
25 credit default swap portfolio. You dramatically increased

1 your securities lending portfolio. And in the end of the
2 day you lose about \$40 billion on these credit default
3 swaps. You lose about \$55 billion on your securities
4 lending portfolio.

5 Again, how does this happen? How do you begin to
6 up your exposure in one part of the company--I think Price
7 Waterhouse Cooper said that this was a conclusion that this
8 was a risk management failure, but you told our staff that
9 you didn't think it was.

10 So you're recognizing a risk in one place, but
11 you're substantially upping your bets in another. How does
12 that happen? The two of you?

13 WITNESS LEWIS: The, the circumstances at the
14 time were discussed. The concerns that we had about the
15 overheating of the market and the relaxation of lending
16 standards was discussed throughout the corporation with both
17 Financial Products and the Investment Department.

18 The Investment Department was--is also
19 responsible, obviously, for investing the cash of the
20 corporation to receive and to earn a profit. So there's a
21 tradeoff between risk and return which our investment
22 professionals are responsible for.

23 We in Risk are only obviously concerned about the
24 downside. So what occurred--and I think you referred to
25 investment guidelines that established an overall limit, not

1 a directive or an--

2 CHAIRMAN ANGELIDES: You lifted the limit, yes.

3 WITNESS LEWIS: The limit was determined, and it
4 was a quid pro quo, if you will. We agreed to up the limit.
5 The compromise that we reached was that they would--their
6 investments would only be in the highest grade of the
7 securities, triple B, RMBS. There were no CDOs in that
8 structure.

9 CHAIRMAN ANGELIDES: All right. But at the end
10 of the day, you did decline the exposure supposedly in one
11 area, but you upped it in the other, and apparently--I just
12 want to make the point--do you still disagree with Price
13 Waterhouse Coopers that this was a failure in risk
14 management?

15 WITNESS SULLIVAN: I think, with respect, sir,
16 that Mr. Lewis has articulated what occurred, there was a
17 dialogue between the credit offices and the ERM staff, and
18 that the decision was made to make those investments in high
19 grade securities.

20 CHAIRMAN ANGELIDES: All right. I guess the
21 answer is, you still don't believe it was a failure. All
22 right, let me move on.

23 Mr. Cassano, in the time I have right now before
24 we can circle back, I want to probe an issue. I have been
25 fascinated by how this over-the-counter derivatives market

1 worked as between parties, particularly the fact that it
2 wasn't traded on exchanges, and clearly I want to get a bead
3 on precipitating factors in the crisis.

4 And at kind of the heart of the questions I am
5 going to ask is: Was it really the diminishing quality of
6 the subprime lending? Which you dispute. Was it a rapid
7 decline in market values? Or were there dominos pushed here
8 along the way?

9 Now it's no secret that Goldman Sachs was a very
10 significant counterparty of yours. I believe they had
11 about, of the \$78 billion of exposure, they had about \$21
12 billion of that exposure.

13 I am going to enter an item into the record,
14 which is a chronology of all the capital calls that Goldman
15 Sachs made, the amount of collateral you posted, the amount
16 of credit protection that Goldman Sachs went and bought on
17 your company as well as a lot of the correspondence back and
18 forth.

19 But when you look at that record, some things are
20 clear. Goldman Sachs was first in the door demanding
21 collateral. They were the most aggressive in terms of the
22 timing and amount. For example, by the end of the year of
23 '07, of all the counterparties, while they were 27 percent
24 of your book, you had posted 89 percent of the posted
25 collateral was for them.

1 By June 30th, while they were 27 percent of the
2 overall book, 48 percent of the collateral calls being made
3 were by them. They were way ahead of everyone else in terms
4 of the amount they were asking for, when they were asking
5 for it, and they were much more aggressive in marking these
6 securities down.

7 And so, you know, when I look at this I'm trying
8 to figure out what happened. Are they just reflecting what
9 was happening in the market? Is it like one of those
10 Discovery Channel episodes where the cheetah is chasing down
11 the weak member of the herd? Is it the first domino that
12 begins pushing market values down?

13 Now, Mr. Cassano, in our staff's interview with
14 you, you said that you thought something was up with Goldman
15 because their first collateral call, which comes in July 27,
16 '07, they revised it quickly downward from \$1.8 billion to
17 \$1.2 billion, because they based it on bids, not the mid-
18 point between bid and ask. They settled, even though they
19 reserved the rights to dispute, for \$450 million.

20 You said that Mr. Sherwood had told you that
21 Goldman, quote, "didn't cover ourselves in glory during this
22 period." Later on you said that Mr. Sherwood said that the
23 market is starting to come our way, which you took from our
24 interview as an implicit admission that Goldman's initial
25 collateral calls were too low.

1 You noted that Mr. Blankfein had announced that
2 Goldman was short on the subprime market, and you wondered
3 whether Goldman was pushing or driving the market.

4 The records here--I want to ask you: How do you
5 perceive what happened here? And I'm trying to also get to
6 how the heck do you set market prices during this time
7 period when Goldman in its own disclosures as it begins to
8 continue to sell synthetic CDOs, they sold \$63 billion worth
9 of these from I think '04 all the way through April of 2007,
10 I want you to give me your perception of what was happening
11 here.

12 WITNESS CASSANO: I will.

13 CHAIRMAN ANGELIDES: Is that a lot?

14 WITNESS CASSANO: Yes. And I will, as I go
15 through this, if I miss anything that you're still
16 interested in, just probe me again and we'll just keep going
17 through it until I cover it.

18 CHAIRMAN ANGELIDES: And I may have to go to
19 other members because of my time.

20 WITNESS CASSANO: Yes, sir.

21 If we take the period of July--the initial
22 collateral calls that came to us, if we put ourselves back
23 into that period, it was a period where it was one of the
24 first periods of increased market disruption due to what was
25 to become the financial crisis of '08.

1 Goldman Sachs made the call on us of
2 \$1.8 billion. They then--we were surprised at the magnitude
3 of the call, surprised at the lack of incrementality to the
4 call, right? It went from nothing to \$1.8 billion.

5 Obviously my job is not to trust Goldman Sachs
6 numbers but to verify. We received their numbers. We went
7 out and asked other major participants in the market for
8 pricing on the same instruments, or similar instruments, and
9 we received wide variances from the Goldman numbers.

10 And Goldman's numbers were always lower than the
11 others.

12 CHAIRMAN ANGELIDES: And I should remark in this
13 chronology they're lower all the way through.

14 WITNESS CASSANO: Yes, sir. And so my team, I
15 instruct my team to assert basically the contractual rights
16 that we had, which is to review the marks and the calls that
17 they're making, along with others. And, as you pointed out,
18 Chairman Angelides, the call rapidly declined, right? It
19 went, as you pointed out, \$1.8 billion at the end of July,
20 \$1.6 billion it became very rapidly. It then moved to \$1.2
21 billion within maybe another 10 days. But by the time, if
22 my dates are right, by the very early part of August, the
23 number was down to \$600 million. And this time in the
24 market not a lot is going on.

25 The market is beginning to seize up at this point

1 in time, so not a lot of changes. And my team was in a
2 regular dialogue with the folks at Goldman.

3 CHAIRMAN ANGELIDES: Go ahead.

4 WITNESS CASSANO: As we went through this
5 process, we did settle at the \$450 million mark. I
6 called my counterpart at Goldman, Mike Sherwood, and I
7 said, Look, Mike, I don't understand what happened over at
8 your shop where you come in at one point eight and end at
9 four fifty, but I did know that it was difficult to source
10 clear views of pricing in a market on transactions that
11 really don't trade actively even in the best of times.

12 And what Mike said in the call was, look, I don't
13 think we covered ourselves in glory in this whole process.
14 And the reason for me calling him was to say, look, we need
15 to meet again. You and I need to sit down and we need to
16 figure out an objective way of getting values here. And how
17 are we going to manage this going forward?

18 And we met to do that again, to sit down and iron
19 that out, in September, in the early part of September. So-
20 -but I think your question is: What's my perception of what
21 was going on?

22 I think my perception at the time, and still now,
23 is that we were working in an opaque market. Because of the
24 market disruptions, it was difficult to find price
25 discovery. I think even a firm as esteemed as Goldman Sachs

1 was having trouble getting price discovery.

2 And what made--convinced me that this was a
3 difficult process was the rapidity at which they lowered
4 their prices, or in which they raised their prices and
5 lowered the collateral call.

6 CHAIRMAN ANGELIDES: But then they kept at it.
7 They kept at it for a number of months. They kept coming.

8 WITNESS CASSANO: I'm sort of segmenting it into
9 these periods, right. And because what happens then in
10 September is we meet to try and figure out a way in which we
11 can use the contractual rights that we have in the contract.
12 Right?

13 If you have a strong disagreement in our
14 collateral calls and you don't agree with the counterpart,
15 the contractual rights that exist is for you to ask for a
16 dealer poll, all right? And say, look, I don't like this.
17 We're not agreeing. Let's go to the market. Let's get four
18 people to put prices on these things. Let's average those
19 out and we'll use those as the arbiter.

20 We went and discussed that in September. And
21 then the process went dormant for awhile. But also at the
22 same time that it went dormant, if you remember in late
23 September I think the Fed may have made one of the initial
24 rate cuts, which sort of added a relief rally to the market.
25 And so this issue went on a back burner.

1 It wasn't until I think the very end of October,
2 the beginning of November, when I received another call from
3 Mr. Sherwood. And he explained to me that they were looking
4 at their month-end numbers. He wanted to give me a heads-
5 up, and they were going to make another call, and
6 another significant amount, and this time their call was at
7 \$3 billion.

8 I said to Mike, look, we've got to look at these
9 numbers because of what happened the last time. And at that
10 point, that was when the response was: Well, you know, we
11 think the market is coming our way at this time.

12 CHAIRMAN ANGELIDES: All right. Well, I am going
13 to move on. We have entered into the record this full
14 chronology, which I believe is the first time it's been done
15 because it's a very interesting look at how this market
16 worked.

17 I do want to return to this issue. I know that
18 we have the Goldman folks later today. We have a full panel
19 tomorrow morning. If there is some time at the end I would
20 like to follow up with some additional questions on this
21 matter, but I do want to move to other members at this time.

22 With that, Mr. Vice Chairman?

23 VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman.
24 My understanding from staff is--and first of all I want to
25 thank you for coming. We have to be able to at least

1 understand the mindset and the activities at the time from
2 many different sources to understand the way you looked at
3 the world at that time.

4 And it is always easy in hindsight in anything to
5 talk about what would've, could've, should've, but our goal
6 in part is to try to understand where you were at the time
7 that it happened.

8 I know, Mr. Cassano, you are looking at where you
9 are today in terms of the value, and you make those
10 arguments. And I used to hear an old story which was
11 supposed to be funny, about a guy who pulls up to a gas
12 station in Vermont and asks directions of the old Yankee
13 there, and he finally said: Well, have you lived here all
14 your life?

15 And the old guy says: Not yet.

16 So are you able to project risk ahead? I assume
17 that would have been part of your fundamental business. And
18 the answer that I thought I heard from you to the Chairman's
19 question was that they haven't fallen apart yet.

20 Do you believe you're going to make money on
21 these? Is there going to be a loss eventually? Can you
22 project that out?

23 WITNESS CASSANO: Vice Chairman, nobody can see
24 into the future. What I was responding to the Chairman's
25 question was that we employed a very--one of the questions I

1 think is: Was it credit risk that destroyed, that caused
2 the problem in this portfolio?

3 I think the credit risk analysis that we did, and
4 the underwriting standards that we met, and the structural
5 supports that were built into the transaction are so far
6 standing the test of time.

7 VICE CHAIRMAN THOMAS: Yes, just like the fellow
8 who said "not yet." So, so far.

9 In terms of this assessment, in terms of risk,
10 you mentioned in your testimony something that others have
11 repeated. That is, that the underlying structure were,
12 after all, AAA. Did you ever look into, as part of your due
13 diligence in terms of risk, how the rating companies were
14 coming up with what were AAA ratings? And what was AAA a
15 few years ago was or was not the same standard? Or you
16 simply took the AAA label for what it was?

17 And I guess, Mr. Lewis, you're part of that
18 question as well.

19 WITNESS CASSANO: But you're asking me first,
20 right, Vice Chairman?

21 VICE CHAIRMAN THOMAS: Sure. Go ahead.

22 WITNESS CASSANO: We did a fundamental analysis
23 of the transactions. My team reviewed the underlying
24 portfolios and the underlying assets within the portfolios
25 directly.

1 So we were not reliant on the rating agencies to
2 tell us what was good or bad in these portfolios.

3 VICE CHAIRMAN THOMAS: So you were actually
4 observing the degradation of the types of collateral--in
5 fact, no collateral, no-doc loans--that was occurring in the
6 mortgage activities backing these?

7 WITNESS CASSANO: That is--the issue that you
8 identify about the underwriting standards slipping is
9 exactly what made us come to the conclusion that we needed
10 to exit the subprime underwriting within the multi-sector
11 CDO business as we saw the beginnings, or the potential for
12 those underwriting standards not hitting the targets that we
13 had set because of the issues that you just identified.

14 VICE CHAIRMAN THOMAS: And that was in '05?

15 WITNESS CASSANO: The analysis was done in the
16 last quarter of '05, and the decision was made in December
17 of '05, and then we ran through the portfolio.

18 VICE CHAIRMAN THOMAS: One other date check, Mr.
19 Sullivan. You indicated that you got the margin call, or at
20 least the initial communication, with Goldman in July of
21 '07?

22 WITNESS CASSANO: Yes, sir.

23 VICE CHAIRMAN THOMAS: And you were not
24 surprised, because you knew in the contracts that there was
25 a margin call. You were surprised at the size of the

1 margin?

2 WITNESS CASSANO: Yes.

3 VICE CHAIRMAN THOMAS: Was that when you found
4 out there were margin calls, Mr. Sullivan?

5 WITNESS SULLIVAN: Thank you, Vice Chairman. I
6 think to the best of my recollection it was some weeks or
7 months later.

8 VICE CHAIRMAN THOMAS: After he began the
9 negotiations in terms of whether or not those were
10 appropriate amounts for the margin call? You weren't aware
11 of that at the time that it occurred? You found out about
12 it months, weeks or months later?

13 WITNESS SULLIVAN: Certainly I think, certainly
14 nowhere around the July time. I think it was much later on
15 in the year.

16 VICE CHAIRMAN THOMAS: Okay. I'm just trying to
17 take this stuff in. I appreciate your cooperation, and I
18 will admit I have never been involved in an enormous multi-
19 national operation in which apparently there's not as much
20 communication about what I would consider a major problem in
21 a significant sector of the business.

22 So I want to ask some questions, Mr. Sullivan,
23 about how we got into this. If you weren't aware there were
24 margin calls--I guess I should address it to Mr. Cassano,
25 but anybody who could answer me--you were in this business

1 fairly fast and furious prior to your recognition that you
2 had dug a hole that you could not climb out of in essence,
3 so you stopped digging.

4 Was it motivation on the basis of a compensation
5 structure that you were doing all this in the volume that
6 you were doing it? Because it was a line of business that
7 was going to make a lot of money? Or that people who were
8 doing it were making a lot of money? And they're not always
9 the same thing.

10 WITNESS CASSANO: I think one way of looking at
11 this is to say that we, early on in 2005, we took the
12 decision to run down our portfolio--

13 VICE CHAIRMAN THOMAS: I'm more interested in
14 '02, '03, '04 when you were running it up. Taking one side
15 of the bet from almost all comers.

16 WITNESS CASSANO: I think what you need to look
17 at within these transactions is the underwriting standards
18 that we committed to to do these transactions.

19 I've heard this phrase that it's a one-sided bet,
20 but when you think about the protections that we built into
21 the contracts through the subordination levels, through the
22 structural supports that we built into the contracts, and
23 then through the very, very strict underwriting standards we
24 performed, this was extremely remote risk business.

25 And it's not the credit risk here that eventually

1 became the issue at hand. My point has been that the
2 underwriting standards, and the credit risk within these
3 transactions, have to date been supported and still perform.

4 VICE CHAIRMAN THOMAS: Then I guess I have to ask
5 you the question: How much money did you get from the
6 Federal Government?

7 WITNESS CASSANO: For the credit default
8 portfolio? The Federal Government paid \$40 billion. But
9 one of the things I wonder about when I look at that is I've
10 never understood why the \$40 billion was accelerated to the
11 counterparts.

12 Now I haven't been involved in that, and I'm only
13 looking at it from afar, but when I think about the
14 contractual defenses and the contractual rights we had in
15 the contracts, it has caused me to scratch my head and ask
16 why was it that \$40 billion was accelerated to the
17 counterparts.

18 VICE CHAIRMAN THOMAS: Okay, so you weren't in
19 the room when that kind of a decision was made.

20 Mr. Sullivan, were you in the room when that
21 decision was made?

22 WITNESS SULLIVAN: No, sir. I had left the
23 company some months earlier.

24 VICE CHAIRMAN THOMAS: Okay, it's always someone
25 else. So partly convenient leaving helps a lot in our not

1 fully understanding.

2 This is one of the problems that I have when I
3 try to explain what occurred, and so maybe I need a little
4 help. There are people out there who are no longer in their
5 homes through what they believe is really no fault of their
6 own, although we could nitpick in terms of why did they go
7 ahead and get money out of their homes in terms of
8 diminishing their equity and all of those other arguments.

9 But what I have a hard time doing is explaining
10 why some people in the business, that their Taxpayer dollars
11 kept in business, even receiving as much as a million
12 dollars a month when some of the folk who lost their homes
13 won't make that much in their lifetimes. And then they read
14 a newspaper story that their tax dollars going to AIG. What
15 does "A" stand for?

16 WITNESS LEWIS: "American."

17 VICE CHAIRMAN THOMAS: American. The Taxpayer
18 dollars going to AIG wind up in a bank in Great Britain, in
19 a bank in Germany, a couple of banks in Germany, banks in
20 France, banks in Scotland, in Maiden Lane III in banks in
21 Canada. How do I explain to them, based upon what happened
22 to them, that what occurred between you and the Federal
23 Government was something that should have been done, needed
24 to be done, and that in fact was the right thing to do in
25 terms of resolving this issue?

1 Is there anything you can give me that I can tell
2 them?

3 WITNESS LEWIS: Mr. Vice Chairman, what I would
4 say is that AIG was under tremendous liquidity pressure at
5 that point in time, and the Taxpayer came in through the
6 Federal Reserve Bank of New York and assisted AIG. And our
7 board made the determination to accept that assistance and
8 move on.

9 At that point in time, however, when the
10 government came in, the markets were still in decline, and
11 there were further liquidity needs being put upon AIG. At
12 that period of time, the Federal Reserve Bank took over
13 negotiations and determined--and went and had discussions
14 with the counterparts. We were not a party to that. And a
15 decision was made that the best way to arrest the further
16 requirements of liquidity on AIG would be to set up the ML
17 III structure. And through that structure, the credit
18 default swaps were extinguished and cancelled, and for that
19 the decision was made that the cash collateral that we had
20 posted, which the Federal Reserve had funded, would be part
21 of the consideration given to the counterparties, as well as
22 the sale of their CDOs to the ML III structure.

23 VICE CHAIRMAN THOMAS: And what probably begins
24 to concern me even more is that, even to date, witness--did
25 you see the article in this morning's New York Times?

1 WITNESS CASSANO: Yes, sir.

2 VICE CHAIRMAN THOMAS: Discussing the
3 possibility, when you decided, as you indicated, Mr. Lewis,
4 to accept and move on, that apparently, and my timing may
5 not be exactly right, the move on part was an agreement that
6 was reached with the Federal Government in terms of a
7 condition of aid that there would not be certain activities
8 pursued by AIG, either of a legal or other nature, toward
9 Goldman Sachs, I think the story said. Were any of you
10 aware of that prior to the story breaking this morning in
11 The New York Times?

12 WITNESS SULLIVAN: I was just going to answer, I
13 didn't read the article and unfortunately I had left the
14 company months earlier. So I can't respond to your
15 question.

16 VICE CHAIRMAN THOMAS: So you haven't read the
17 article?

18 WITNESS SULLIVAN: No, sir.

19 VICE CHAIRMAN THOMAS: That apparently there was
20 an arrangement in which they would not pursue legal--Mr.
21 Lewis, I guess you're the one left there. Everybody else is
22 going to talk about retirement if I ask.

23 WITNESS LEWIS: No, I was not aware of that. But
24 our Legal Department would have been responsible for those
25 negotiations. I was not a party to it.

1 VICE CHAIRMAN THOMAS: Well I guess then I would
2 just ask your opinion. Can you give me your opinion of--you
3 read the story?

4 WITNESS LEWIS: Yes.

5 VICE CHAIRMAN THOMAS: How is someone supposed to
6 take the information in the story about that kind of a deal
7 being arranged? How do you take it?

8 WITNESS LEWIS: Well I--as I say, I was not
9 involved. I'm not responsible for the legal negotiations of
10 AIG, and certainly not for the Federal Reserve Bank. At the
11 time--

12 VICE CHAIRMAN THOMAS: Are you shocked or
13 surprised that there would be a deal like that? Do you
14 think it was a fair thing? Would you have done it had you
15 been in their position? All I'm looking for is a personal
16 response.

17 WITNESS LEWIS: Without knowing the other
18 circumstances, I would be surprised, yes.

19 VICE CHAIRMAN THOMAS: You would be surprised
20 that they did agree to that? Or that maybe the situation
21 was so bad they would agree to anything, and that was what
22 they wound up agreeing to?

23 WITNESS LEWIS: Surprised, but I certainly can't
24 take into consideration other aspects that I am not aware
25 of.

1 portfolio as a whole, did you hedge any parts of that
2 portfolio?

3 WITNESS CASSANO: Yes.

4 COMMISSIONER BORN: Which parts?

5 WITNESS CASSANO: Much of--we just--we ran books,
6 derivatives portfolios in interest rates and currencies, in
7 equity derivatives, commodities, and in credit. And in all
8 of those portfolios, we operated with risk mitigants,
9 including the super senior credit derivative portfolio, as I
10 was talking about earlier, with the first loss pieces on the
11 underwriting we did.

12 But we ran--you know, nothing is a hundred
13 percent hedged, but the books were generally considered
14 fully hedged.

15 COMMISSIONER BORN: Well let's look at your
16 credit derivatives portfolio. I think there was something
17 like more than \$560 billion in notional amount of credit
18 derivatives in your portfolio in 2007. Were you actually
19 hedging in the conventional sense? Or were you relying on
20 tranching and the level at which you were insuring?

21 I want you to answer as to whether you were
22 hedging the way you were hedging your interest rates by
23 taking offsetting positions.

24 WITNESS CASSANO: Perhaps the best way to
25 delineate this is that the super senior credit derivative

1 book, which is the book you're--the super senior credit
2 derivative book globally, which is the book you're
3 referencing at \$560 billion, we were using basically an
4 actuarial basis in order to secure that business.

5 So it wasn't--it's not hedged in the conventional
6 sense that you're talking about buying and selling interest
7 rate risk.

8 COMMISSIONER BORN: You were just relying on the
9 structure of the instrument and what you were assessing as
10 the safety factor, the extremely low risk of default that
11 you were assessing for that instrument. You were not
12 otherwise hedging by going out and getting offsetting? You
13 weren't purchasing any credit default swaps to offset the
14 ones you were selling? Is that correct?

15 WITNESS CASSANO: Yes. But, you know, and I've
16 made this point before, but if you look at if there had been
17 any realized losses in these portfolios, and as I've said we
18 can see the Maiden Lane III portfolio, but we also can see
19 the other portfolios as they still exist in AIG, and as best
20 as I can tell there had been limited--and perhaps Mr. Lewis
21 knows this answer better than I do because I'm not inside
22 the company anymore--but there have been limited losses
23 associated with the piercing of the attachment point where
24 risk would come to AIG.

25 I think, from what I saw in the AIG reports,

1 there was a realization event when they unwound a portfolio
2 that they had.

3 COMMISSIONER BORN: But in your assessment of the
4 risk in the underlying of the super senior credit default
5 swaps that you had been issuing, you were only looking at
6 one kind of risk on those instruments, weren't you? The
7 default risk on the underlying?

8 WITNESS CASSANO: Yes.

9 COMMISSIONER BORN: You were not looking at the
10 risk that AIG would have to post collateral, for example?

11 WITNESS CASSANO: We managed the liquidity risk
12 during the process. We knew, as I think we need to--the
13 transactions that had the collateral calls associated with
14 them were the transactions in the United States. It's the
15 multi-sector book. We had those collateral calls'
16 provisions.

17 We knew we had the resources to manage those
18 collateral call provisions. Through my tenure with the
19 company, we adequately managed--

20 COMMISSIONER BORN: Were those from capital
21 reserves? Where were your liquidity provisions being held?

22 WITNESS CASSANO: Well it was liquidity that we
23 needed, right? You needed to be able to pledge collateral,
24 or to give people collateral at that time. We had an asset
25 and liability committee within our group, that Asset

1 Liability Committee, who did a continuous review of our
2 liquidity needs and our potential liquidity needs.

3 And if we needed to, we could liquidate an asset
4 that we had. We managed some approximately \$50 billion in
5 liquid securities. We could liquidate those securities and
6 then use those to pledge the collateral--pledge as
7 collateral.

8 As I understand it at least, and again, you know,
9 your knowledge is probably more perfect than mine, is that
10 there were no--there were strains, but there were not issues
11 meeting the collateral calls all the way up to the September
12 events when the capital markets had seized up completely.

13 But I think all through that period, the FP team
14 was able to adequately meet the collateral calls through the
15 liquidity provisions that we had.

16 COMMISSIONER BORN: Mr. Lewis, as the Chief Risk
17 Officer, were you aware of the collateral obligations of
18 AIGFP on these contracts?

19 WITNESS LEWIS: As I testified earlier, I only
20 became aware of the collateral call provisions in this book,
21 the book regarding residential mortgages, in the latter part
22 of '07.

23 COMMISSIONER BORN: And had you--therefore you
24 had not made any kind of liquidity provisions up until that
25 time for that obligation?

1 WITNESS LEWIS: The responsibility for liquidity
2 risk management did not--was not directly under my
3 jurisdiction. However, I was generally aware of the
4 liquidity risk management process that Financial Products
5 did undertake where they reviewed their contingent liquidity
6 requirements.

7 And the requirements presented by this book of
8 business did not rise to a level of concern until the market
9 really crashed in the '08 period of time.

10 COMMISSIONER BORN: So you think there were
11 adequate liquidity provisions even though AIG ended up
12 losing \$40 billion on that portfolio?

13 WITNESS LEWIS: Well clearly--

14 COMMISSIONER BORN: And needing a government bailout
15 and commitment of \$180 billion-plus?

16 WITNESS LEWIS: Clearly, clearly as it turned out
17 we did not have adequate liquidity management processes that
18 took into account such a severe stress to the market and the
19 requirement for liquidity under those stressful conditions.
20 And clearly we did not.

21 During that period of time, '07 into '08, I was
22 asked to take on responsibility together with our treasury
23 of addressing liquidity risk management processes and
24 framework in the corporation. Until that time, I was not
25 responsible for liquidity. But clearly, as it turns out, we

1 did not have adequate liquidity risk management. Otherwise,
2 we would have had sufficient liquidity to weather that
3 storm.

4 COMMISSIONER BORN: Let me ask Mr. Cassano
5 whether he was aware of the practices of other large over-
6 the-counter derivatives dealers with respect to their CDS
7 transactions. Was it unusual to hedge credit default swaps
8 as an over-the-counter derivatives dealer? Or were other
9 dealers actually hedging those risks?

10 WITNESS CASSANO: It's a broad category, CDS. If
11 we're talking about super senior CDS and looking at them on
12 an actuarial basis, I think--and the super senior, it's my
13 understanding that there were many dealers who--or many
14 participants in the market who had the same types of
15 positions that we did, where they were relying on the
16 underwriting standards of these trades.

17 COMMISSIONER BORN: Well for example--

18 WITNESS CASSANO: But, Commissioner, if I could
19 go back--

20 COMMISSIONER BORN: --Goldman Sachs in the
21 transactions that we've seen where you wrote credit default
22 swaps for Goldman Sachs, Goldman Sachs was apparently using
23 you to hedge its own commitments to other customers with
24 credit default swaps.

25 WITNESS CASSANO: In that instance, that's

1 possible. I don't know what Goldman was doing. I do know
2 that there were others who were treating the business the
3 same way we did.

4 COMMISSIONER BORN: Do you know which
5 institutions were doing that?

6 WITNESS CASSANO: The monoline insurance
7 companies were looking at it the same way. There
8 were--those are the ones who come to mind right now.

9 COMMISSIONER BORN: Did you ever consider putting
10 up side-capital reserves the way, for example, a monoline
11 insurance company would be required to do in order to back
12 up your obligations on these contracts?

13 WITNESS CASSANO: We had reserves in AIGFP
14 against our entire book. There was a program that we needed
15 to--that we had developed between us and the credit risk
16 management and market risk management functions in which we
17 set aside reserves for the risk that this business took.

18 So we had a pool of reserves that was available.
19 I think, you know, one of the--when I look at this business
20 and I try and segment what happened and what went--what
21 caused the bailout, it doesn't appear to me to have been a
22 credit risk issue. I think it was a liquidity issue.

23 And it was a liquidity issue that was brought
24 about by the seizing up of the capital markets, but also
25 added to that issue was that there was a market disruption

1 event going on in terms of trying to find the fair value for
2 these contracts. Because these aren't tradable
3 instruments. These aren't the kinds of things that even, as
4 I've said before, even in the best of times would trade
5 freely.

6 And so, putting on--trying to come up with a fair
7 value estimate for these contracts in a market disrupted
8 period is difficult. And what should have happened, in my
9 estimation, as the crisis moved on was--and it's the thing I
10 raised earlier where I said I don't understand why the funds
11 were accelerated to the counterparties the way they are--we
12 should have gone to the dealer poll.

13 The reason we should have gone to the dealer poll
14 at some point in time--and, you know, either sometime in the
15 summer or in the early autumn--was I believe the dealer poll
16 would have failed, because of the market disruption that was
17 going on.

18 COMMISSIONER BORN: Well, let's--

19 WITNESS CASSANO: Can I--

20 COMMISSIONER BORN: Before we get into, you know,
21 whether the markets were accurate, or how we--I would rather
22 ask you--

23 WITNESS CASSANO: --if the dealer poll failed--

24 COMMISSIONER BORN: I would rather ask you about
25 something else, if you please.

1 WITNESS CASSANO: Sorry, Commissioner.

2 COMMISSIONER BORN: Aren't these exactly the
3 kinds of concerns, drying up of liquidity, need to post
4 collateral, downgrading of the company, downgrading of the
5 underlying reference collateral, loss of price--loss of
6 value in the underlying reference collateral, that you
7 should have been thinking about in hedging or keeping
8 capital reserves?

9 WITNESS CASSANO: So, Commissioner--

10 CHAIRMAN ANGELIDES: I yield five minutes.

11 COMMISSIONER BORN: Thank you.

12 WITNESS CASSANO: Commissioner, as I said, with
13 the contractual supports that we had, and the contractual
14 rights that we had in the contracts, in a severe event that
15 would have caused prices to go as low as they were, as they
16 did, we should--and you assert those contractual rights,
17 what you then do if this dealer poll fails, which it would
18 have because nothing was trading, right. In these
19 distressed periods, money market instruments aren't trading.

20 Liquidity is at a super premium. It's difficult
21 to find anything other than a Treasury that might trade.
22 The dealer poll would have failed. You would have been back
23 to a negotiated situation. And where you would have been is
24 where the company was during the period that I was in the
25 company. You would be negotiating deep discounts on these

1 collateral calls.

2 So from my point of view, a failsafe mechanism
3 built into this process that said that we did have adequate
4 liquidity reserves, because we were able to meet the
5 collateral calls, that in the severe scenario that you're
6 outlining, the contracts allowed you to assert rights that
7 would then compel the counterparty to come back to the
8 table--

9 COMMISSIONER BORN: But you never asserted those
10 rights.

11 WITNESS CASSANO: Commissioner, this is--

12 COMMISSIONER BORN: And you never got to that
13 point. That's pretty hypothetical.

14 WITNESS CASSANO: But, Commissioner--

15 COMMISSIONER BORN: Did you ever try to hedge
16 these, your exposure on this? Did you ever go into the
17 market and try to get offsetting contracts?

18 WITNESS CASSANO: As I've said before, we were
19 relying on our underwriting standards.

20 COMMISSIONER BORN: So you're saying, 'no'?

21 WITNESS CASSANO: Yes, ma'am.

22 COMMISSIONER BORN: I know that you say that you
23 reduced--you made a decision no longer to write CDS on super
24 senior CDOs in early 2006. I don't quite see that in the
25 numbers.

1 At the end of 2005 you had \$54 billion in that
2 portfolio. Two years later, in 2007, you had \$80 billion.
3 That's a 50 percent increase almost. How was it that you
4 stopped writing and yet you almost doubled--you increased by
5 50 percent your portfolio after you supposedly stopped
6 writing these?

7 WITNESS CASSANO: The answer to this is in the
8 details. Because what we announced was that we were
9 stopping our underwriting of subprime securities in 2005.

10 We still underwrote multi-sector CDOs that had
11 prime or had CMBS in them. And I think we've been fairly
12 clear on this--

13 COMMISSIONER BORN: And that's what's in that \$80
14 billion?

15 WITNESS CASSANO: And that's the--there are two
16 things that are in that number, just to be clear, right? We
17 took the decision at the end of '05. We had commitments in
18 a pipeline. We ran those commitments through until just
19 about the end of May. I think there was one special
20 exemption at the end of May that we did in coordination with
21 an agreement with ERM.

22 And by I believe it's June of '07, we were no
23 longer underwriting any subprime collateral on our multi-
24 sector CDO book. And that is why we have such limited
25 exposure in our book, or had such limited exposure in our

1 book to the problematic vintages of '06 and '07. Because,
2 you know, you need--

3 COMMISSIONER BORN: Well you still lost \$40
4 billion.

5 If you had been being treated as a regulated
6 insurance company, you would have had to keep adequate
7 reserves. If you had been trading on a regulated futures
8 exchange, there would have been no question about price
9 discovery because there would have been trading that would
10 have a transparent and available price. There would have
11 been no question about AIG building up a big exposure
12 because your contracts would have been mark-to-market twice
13 a day, and you would have had to pay margin at the end of
14 the day, if the value of your contracts eroded.

15 Were you exploiting a regulatory gap by avoiding
16 insurance regulation with these credit default swaps which
17 acted virtually like insurance? Were you avoiding futures'
18 regulation in instruments that were virtually like futures
19 in order to be able to build up this enormous exposure and
20 make profits on an almost infinite leverage?

21 CHAIRMAN ANGELIDES: And, by the way, time. And
22 then we will circle back. Go ahead. I want you to answer
23 the question.

24 WITNESS CASSANO: Commissioner, I would have been
25 happy to do this business in a regulated insurance company.

1 And I think in some of the public statements I've made in
2 the past, I have advocated that these transactions are
3 almost similar to, or in many ways are--

4 COMMISSIONER BORN: Identical.

5 WITNESS CASSANO: --insurance contracts. And,
6 that I would have thought that was a good thing. Because
7 what it would have done, since insurance contracts are not
8 mark-to-market, it would have saved us the issue of having
9 to come find a fair value for these contracts when no market
10 existed, and discovery of prices and creating a fair value
11 was near-impossible.

12 So when you ask me if I was avoiding: No. I
13 would have encouraged that kind of regulation, and I would
14 like to have had this business done in an insurance company.

15 COMMISSIONER BORN: Why didn't you just become an
16 insurance company? You were a subsidiary of one.

17 WITNESS CASSANO: We were a dealer in
18 derivatives, and this business in itself trades in the
19 derivatives markets. And, you know, that's the business we
20 were doing.

21 COMMISSIONER BORN: Because that was a
22 nonregulated market.

23 CHAIRMAN ANGELIDES: All right. Thank you very
24 much.

25 Mr. Hennessey?

1 COMMISSIONER HENNESSEY: Thank you, Mr. Chairman.

2 I want to see if I can do this in reverse
3 chronological order. I want to start with that third week
4 in September. And I guess, Mr. Lewis, you were the only one
5 of the three who was still there.

6 So, September 17th, 18th, 19th of 2008 is when
7 the Federal Reserve Bank of New York provides \$85 billion of
8 revolving credit to AIG, to the parent company, right, not
9 to AIGFP?

10 WITNESS LEWIS: To the parent company, yes.

11 COMMISSIONER HENNESSEY: Okay. And that was
12 because AIG was facing a liquidity crisis. You needed cash
13 to pay somebody. What was the proximate need? Who needed
14 the money at that point in time? And I've heard a couple of
15 you talking about adverse market conditions. Was it because
16 there was a sudden increase in the demand for cash from AIG,
17 for instance from counterparties? Or I've heard talk of the
18 risk of a ratings downgrade. Or was it that you couldn't
19 raise the cash that you needed in overnight markets?

20 What was the reason for the significant change in
21 a need for liquidity?

22 WITNESS LEWIS: In that period of time, the
23 liquidity was completely dried up in the markets. And there
24 was little access to AIG's usual sources of liquidity to
25 issue commercial paper, issue debt, et cetera. It was a

1 general freeze of liquidity in the markets.

2 The demand for liquidity at the AIG level at that
3 point in time was in order to continue to meet the margin
4 call requirements at FP, as I recall. And also in our
5 securities lending business we were trying to increase
6 liquidity because the customers that we dealt with in the
7 securities lending business, who were themselves financial
8 institutions, were themselves trying to husband liquidity at
9 the time.

10 So the Federal Reserve came in with a revolving
11 credit of \$85 billion. I don't recall the specific number
12 that was borrowed under that facility at the first day, but
13 I--

14 COMMISSIONER HENNESSEY: I'm not interested in
15 that. I'm trying to rebuild the chain of events by working
16 backward.

17 So the Fed provided the \$85 billion of cash. AIG
18 needed the cash both because there was a supply--there was a
19 decline in the supply of available cash, and there was an
20 increase in the demand for cash from their counterparties on
21 both the collateral calls on AIGFP and also on the
22 securities lending? I've got it right so far?

23 WITNESS LEWIS: Yes.

24 COMMISSIONER HENNESSEY: Okay. Now those
25 collateral calls had been going on for some time, right? I

1 mean, they didn't just start in September. And what I think
2 has been happening is week bumping up against Mr. Cassano
3 saying, look, I was right in how I estimated the value of
4 these CDOs and CDS, and by the way the process by which that
5 dispute was resolved was nontraditional.

6 But I guess what I'm trying to get at was: Whose
7 job was it to anticipate the possibility and manage the risk
8 of an increase in collateral calls?

9 WITNESS LEWIS: At the AIG, Inc., level,
10 ultimately the responsibility for ensuring sufficient
11 liquidity of the corporation rested with the CFO and the
12 treasurer of the corporation.

13 COMMISSIONER HENNESSEY: Okay, and to whom do
14 they look to manage the risk that our counterparties might
15 show up and demand more money, and we might argue with them
16 but we might lose that, whether we're right or wrong? Is
17 that the treasurer and the CFO? Are those individual
18 business units within AIG?

19 WITNESS LEWIS: Yes. The respective chief
20 financial officers and treasurers in the business unit
21 subsidiaries would be responsible for the liquidity
22 management in those businesses.

23 COMMISSIONER HENNESSEY: Okay. Because I'm going
24 to, Mr. Cassano, your point about this being a liquidity
25 issue because, whoever was right in evaluation of these

1 underlying securities, someone got it wrong in terms of
2 their estimation that they would win or lose that dispute,
3 or that the process would not work out their way.

4 Was that you who mis-estimated the risk that you
5 might have to put up more cash to your counterparties?

6 WITNESS CASSANO: Commissioner Hennessey, I don't
7 think I mis-estimated the risk. I think if you look at my
8 time with the company, which I was always able to negotiate
9 extremely steep discounts with all the large requests for
10 collateral.

11 So when someone would come and ask for
12 collateral, doing fundamental analysis of the collateral
13 call, and combined with asserting the contractual rights
14 within the contracts, we were able to substantially discount
15 the collateral calls that were being made, and continue to
16 adequately manage them.

17 COMMISSIONER HENNESSEY: Right. And you were
18 able to work that out, say, for instance with Goldman every
19 single time, and then something changed. What changed, and
20 when?

21 WITNESS CASSANO: I left the company in March,
22 right? I was asked to retire in March, at the end of March.
23 I wish I was able to have stayed on and helped through this
24 process, because I don't know the answer to this.

25 This is--of the things that I look at as

1 surprising to me is, even in the period in September, I
2 don't understand why people didn't look at the contracts and
3 assert the rights under the contracts to preserve the
4 liquidity. And I think if they did that, the Taxpayer would
5 not have to have accelerated the \$40 billion that it did.

6 COMMISSIONER HENNESSEY: Okay, after you left did
7 the payouts then of those collateral calls change
8 qualitatively from when you had been doing it? You had been
9 able to negotiate deep discounts. Then you leave. Then
10 things change and AIG is paying out more cash to Goldman and
11 other counterparties? Is that how it works?

12 WITNESS CASSANO: What I'm thinking about is the
13 September number. I mean, I can see what happened in
14 September and I can see that the counterparties were paid
15 off at 100 cents on the dollar. I'm not sure. I wasn't
16 involved in the collateral call process from the time, from
17 March 30th. So all I can see is what the events were on the
18 big dates of the bailout right now.

19 But I don't know how the negotiations went during
20 the interim period.

21 COMMISSIONER HENNESSEY: Anything you can add,
22 Mr. Lewis?

23 WITNESS LEWIS: I was not directly involved in
24 the negotiations with the counterparts regarding the
25 collateral call postings. My only involvement was I

1 attended a couple of meetings, two meetings specifically,
2 with Goldman Sachs where we were trying to understand their
3 marks, their prices, and to what extent they were really
4 real prices in the marketplace.

5 And so I did attend two meetings there where they
6 discussed their prices.

7 COMMISSIONER HENNESSEY: Okay, and I'm not
8 interested in the particulars of specific transactions. I'm
9 trying to get a sense of the general gestalt here. Because
10 what we have is a disagreement over how much these
11 securities are worth. Right? You think they're worth a
12 certain amount because you've got certain assumptions about
13 the housing market. Your counterparties have a different
14 thought.

15 Your auditor comes in and says: We think you're
16 over-valuating--you're over-valuing those securities. All
17 right. You then leave. And then presumably, I assume
18 induced in part by the signal from your accounting firm,
19 that then tips AIG's behavior. That it's not just that Mr.
20 Cassano leaves, but that the firm starts making more
21 payouts, more cash is going out the door, and you're running
22 down your liquidity more. Is that--and I don't need
23 specifics, but presumably something changed after he left.

24 WITNESS LEWIS: I am not aware--I am not aware of
25 our external auditors' view that we were overstating the

1 value of the derivatives that we filed in our financial
2 statements.

3 We worked very closely with our external auditors
4 to determine what we ultimately filed as our best estimate
5 of the fair value of those securities.

6 COMMISSIONER HENNESSEY: Mr. Chairman, did you
7 have something?

8 CHAIRMAN ANGELIDES: Yes. I had two comments. I
9 was getting clarification on the second. But, Mr.
10 Hennessey, I did want to point out, in the chronology which
11 the staff has prepared, I think you've alighted on a very at
12 least important issue here of at least pre-Mr. Cassano's
13 departure there seems to be a pretty fulsome record here of
14 disputing, challenging collateral calls.

15 Whether it's that the paper trail becomes thinner
16 after that date or not, after that time period you see a
17 dramatic acceleration in the calls and the payments by AIG.
18 And I think you've lighted on something from a risk
19 management standpoint that was very interesting.

20 COMMISSIONER HENNESSEY: Right. Thank you.
21 Because as I'm looking at this, I'm seeing, you know, March
22 3rd, Goldman increases their margin call from \$2.5 to \$4.2.
23 Two weeks later they increase their margin call from \$4.2 to
24 \$4.8 billion. And I understand that different people can
25 come up with different values and can have different views

1 as to how much collateral is necessary, but given that that
2 dispute is now highly visible, and I presume that all the
3 way up to you that you're aware that there are disputes with
4 Goldman in the hundreds of millions if not billions of
5 dollars as to how much collateral should be posted, did
6 anyone at that point in time--I guess I'll ask you, Mr.
7 Sullivan, did anyone at that point in time say what happens
8 if these disputes keep going? What happens if they ratchet
9 up? Do we have enough cash on hand?

10 Because it wasn't until nine months later that,
11 you know, that you had to knock on the door and get money
12 from the New York Fed.

13 CHAIRMAN ANGELIDES: And one more point,
14 Mr. Hennessey. I got clarification on this second point,
15 because you asked two very good questions. And secondly,
16 just for clarification, yes, Price Waterhouse Coopers did I
17 believe in the preparation of the 8K, which was filed in
18 February of 2008, indicated that they should have been
19 taking into account the marks and the market in valuing
20 their portfolio.

21 COMMISSIONER HENNESSEY: Mr. Sullivan?

22 WITNESS SULLIVAN: Commissioner, what I can tell
23 you is that I was aware of two collateral calls, by name,
24 Goldman Sachs and Calyon. What the company had decided to
25 do early on in 2008, given the illiquidity in the

1 marketplace, and bearing in mind we could have had a
2 hurricane, we could have had an earthquake, or whatever, we
3 made the decision to build up our cash reserves.

4 AIG had significant cash flow, and we made the
5 determination to build up our cash. In the event that any
6 event occurred that required AIG to pay out cash, we didn't
7 have to sell into what was becoming a fairly illiquid
8 market, and became a very illiquid market. And we actually
9 announced--we advised the market of that because, obviously,
10 if you're harboring cash, you're not generating any
11 investment income of any consequence.

12 Up until the time I left in the middle of June of
13 2008, whatever collateral call that emerged, we were able to
14 handle those, and there was certainly no need, or no
15 indication whatsoever when I left that in three months time,
16 or four months time the company was going to need government
17 intervention.

18 What occurred during the period around the dates
19 you articulated in September, unfortunately the only person
20 on this panel that was there was Mr. Lewis, and I think he's
21 articulated very well what occurred.

22 COMMISSIONER HENNESSEY: Okay, because here's
23 what I'm finding difficult. In March we know that there are
24 disputes between AIG and Goldman in the hundreds of millions
25 of dollars--or, sorry, billions of dollars of margin calls

1 based on a difference of opinion about the values of certain
2 securities.

3 You're there up until June. You know that there
4 is a risk from this because--and we know this because you
5 tell us that you are building up cash reserves--but then
6 things change so dramatically. Somebody seriously under-
7 estimated the liquidity risk, and I'm trying to understand.
8 Because separating out the question of how much were these
9 securities worth, somebody didn't figure out how much cash
10 you might need if these margin calls got out of hand.

11 Is that a fair characterization?

12 WITNESS SULLIVAN: All I can say in response,
13 sir, is we were building up cash, given the significant cash
14 flow of the organization, in order to respond to any set of
15 circumstances, whether it was a collateral call, a
16 hurricane, an earthquake, whatever. And as I said, up until
17 the time I left there was, to the best of my knowledge, we
18 were able to respond to whatever collateral calls were
19 required.

20 And up until that time, we were still building up
21 cash. What happened after I left, sir, I would like to be
22 able to help you but I simply can't.

23 COMMISSIONER HENNESSEY: I understand. Okay.
24 I'm running out of time. I want to come now to--

25 VICE CHAIRMAN THOMAS: Yield to the gentleman.

1 COMMISSIONER HENNESSEY: Okay. It sounds like
2 you had two disputes with Goldman. One was over the value
3 of the securities, and one was over the process by which
4 differences of opinion would be resolved. Is that fair?

5 WITNESS CASSANO: I don't--I think of it as all
6 just one negotiation that we're having with them in the
7 process.

8 COMMISSIONER HENNESSEY: Okay. Because where I'm
9 coming to is I was frustrated by the back and forth with you
10 and the Vice Chairman in the "not yet," which is you made
11 certain assumptions about what would happen to housing
12 prices. And what you said is that so far the attachment
13 point hasn't been punctured? I think I've got the language
14 right here.

15 WITNESS CASSANO: Pierced.

16 COMMISSIONER HENNESSEY: Pierced. Which sounds
17 to me like you're saying the cash flows on these things that
18 were rated AAA are still flowing?

19 WITNESS CASSANO: Yes.

20 VICE CHAIRMAN THOMAS: Mr. Chairman, yield the
21 gentleman five minutes.

22 COMMISSIONER HENNESSEY: Thank you. And what I
23 think I heard the Vice Chairman saying is, well just because
24 the cash flows have flowed so far, that doesn't mean that
25 they're going to continue to flow.

1 And so what I'm trying to get at is, now, later,
2 now that we know more about the housing market, does your
3 estimate of the value of those, has it changed? Has it
4 declined in time?

5 WITNESS CASSANO: When I was answering the Vice
6 Chairman's question it was a question about the fundamental
7 analysis, and whether or not there had been or would be
8 enough defaults to pierce the attachment level at which we
9 had structured these deals.

10 COMMISSIONER HENNESSEY: And now we're in a
11 different environment. Now we all have more information
12 about what's actually happened in the housing market.

13 WITNESS CASSANO: Right.

14 COMMISSIONER HENNESSEY: Given that new
15 information about the housing market, what do you think
16 about the value of those securities?

17 WITNESS CASSANO: I still think that the
18 underwriting standards that we had set will support those
19 transactions--

20 COMMISSIONER HENNESSEY: My question is not about
21 the underwriting standards. My question is: If you think
22 of yourself in a profit-making environment back in time, if
23 you could scribble a note and send yourself a message back
24 in time and say here's what's going to happen to housing
25 prices, would that information have changed your valuation

1 then? Were you overly optimistic in what would happen to
2 housing prices?

3 WITNESS CASSANO: I think what we--I'm sorry, I'm
4 struggling with the confluence of the underwriting standards
5 and the performance of default in the mortgage market, and
6 then the question of value that you're ascribing to the
7 portfolios. Because it's clear that these things don't
8 trade anymore.

9 It's clear that the market is not trading, unless
10 it's a government-guaranteed mortgage product. And so the
11 market itself is ascribing--you know, it's in a disrupted
12 state, and it still is.

13 So putting a value on these is a difficult
14 proposition without the market--without market
15 participation.

16 COMMISSIONER HENNESSEY: Right. And I'm not
17 asking what you think the market would--how the market would
18 value these. What I'm asking is, you were making
19 assumptions at that point in time about the cash flows that
20 would occur.

21 Have your estimates, now that you have more
22 information about those cash flows, changed? Those future
23 cash flows?

24 WITNESS CASSANO: I still think the cash flows
25 from the underlying portfolios will meet the commitments,

1 and these will--we will not pierce the attachment levels.

2 COMMISSIONER HENNESSEY: Okay. And in that
3 judgment does PWC in effect have a different judgment about
4 that?

5 WITNESS CASSANO: I don't have any contact with
6 PWC.

7 COMMISSIONER HENNESSEY: But is that what they
8 were saying in their statement?

9 WITNESS CASSANO: Commissioner Hennessey, I think
10 we're conflating two issues.

11 COMMISSIONER HENNESSEY: Help me separate them
12 because I'm struggling.

13 WITNESS CASSANO: And the issue that developed
14 with PWC is we were creating a valuation model that we
15 initially started to create in order to have a way of
16 fundamentally reviewing collateral calls that came in.

17 It was then determined that that model that we
18 were working on should be used for the accounting, or fair
19 value of this overall portfolio. And that determination was
20 made by the CFO of Financial Services.

21 We then, working with that model, kept trying to
22 improve it and modify it as we moved along. So we had
23 iterations. And I think we can say we had two main
24 iterations of that model.

25 We had a basis that we used at the--

1 COMMISSIONER HENNESSEY: I'm sorry, I'm running
2 out of time and I've got to interrupt. I get the point,
3 which is they were criticizing your model rather than the
4 results that are coming from the model, I believe.

5 WITNESS CASSANO: Right. The main criticism that
6 PWC had was to an adjustment that was needed to be made to
7 the model that I, sitting here today, still believe that
8 model, that adjustment needs to be made. And because of the
9 decision that PWC made, and because they were our auditors
10 we had to abide by that decision, I believe that the
11 portfolio has been understated on the books of the company,
12 and severely understated on the books of the company,
13 because the adjustment that they rejected was an adjustment
14 between what a cash instrument would trade at and what a
15 credit derivative would trade at, which has no cash
16 involved. And there's a basis in those two.

17 COMMISSIONER HENNESSEY: So what I think I'm
18 picking up from you is that you believe today that the
19 original valuation of these securities was in fact and is
20 still valid. And, that both what Goldman has said and the
21 collateral calls that they have made are in some way, shape,
22 or form just wrong?

23 WITNESS CASSANO: Yes. I believe that the
24 models--other people's prices have overstated the losses
25 associated with these portfolios.

1 COMMISSIONER HENNESSEY: Okay. Thank you.

2 CHAIRMAN ANGELIDES: Very good line of
3 questioning. Mr. Wallison?

4 COMMISSIONER WALLISON: Thank you, Mr. Chairman.

5 One of the really interesting things about this
6 whole area is how very few people seemed to see the risks of
7 losses before they occurred. And I guess I would like to
8 ask you to start--and this is addressed to you, Mr. Cassano.

9 What did you think, what do you think now was
10 your major error here? Or, do you think, based on your line
11 of responses to my colleague, did you make an error?

12 WITNESS CASSANO: If I was to think about--when I
13 think about this, and I think about the single error that
14 may have been made by me, I reflect on when I retired that I
15 didn't volunteer--and volunteer more forcefully--to give up
16 my position as the president of the company, but to become
17 the chief clerk and negotiator for the collateral calls.

18 Because I believe that you need to have--these
19 are negotiations among market participants, and you need to
20 use, in periods of severe market disruption, you need to use
21 all available rights that are there and allowed by you. And
22 I believe I would have, as I did previously while I was the
23 head of the division, negotiated for substantial discounts
24 on the collateral calls. Therefore allowing the company to
25 preserve that segment of cash. And then, even when the

1 calamitous events of the capital markets seizing up in
2 September, the three issues that faced AIG--the FP
3 collateral calls, the securities lending portfolio, combined
4 with the diminution in value of the insurance company's
5 mortgage portfolios, that I would have gone to the
6 counterparts and I think even then I would have been able to
7 negotiate substantial discounts by using the rights
8 available to us such that the Taxpayer would not have had to
9 accelerate the \$40 billion to the counterparts.

10 So--and I see that as the linchpin in the issues
11 that we're talking about.

12 COMMISSIONER WALLISON: If I understand you
13 correctly, you're saying that if you had been allowed to
14 stay and work on this problem, the Taxpayers would not have
15 been required to put up any money, at least for the question
16 of the credit default swaps that you all had purchased? Is
17 that correct?

18 WITNESS CASSANO: I--I don't want to say "any
19 money," but I think I would have negotiated a much better
20 deal for the Taxpayers than what the Taxpayers got. And I
21 think I would have negotiated an appreciably better deal.

22 COMMISSIONER WALLISON: When did you decide to
23 enter this market? And what analysis did you receive in
24 order to do this?

25 WITNESS CASSANO: In the--I believe we entered

1 into the market in the beginning of--in 2003. Like most
2 things in the business, it was sort of an incremental
3 strategy. You know, the whole capital markets' business is
4 built on incrementalism and picking up on the last things
5 that were done.

6 What my team did at the time was a thorough
7 review of the structures of the multi-sector CDO market, the
8 CDO market, and then the underlying collateral. And that
9 was the review that was done.

10 And then from there, the business began to grow
11 through 2003. I think it grew appreciably in 2004. We've
12 talked about the growth in 2005, although that growth, as a
13 rate of growth in the portfolio, was lower than the previous
14 years. And we've spoken about exiting of the business at
15 the beginning of '05 and running down the portfolio in '06.

16 COMMISSIONER WALLISON: We know that you were
17 dealing with Goldman Sachs. Can you give us a percentage of
18 your total portfolio that Goldman Sachs was consuming? And
19 were they your initial customers? Or were they--did they
20 come along later?

21 WITNESS CASSANO: I--well, as the Chairman stated
22 in his remarks, I think Goldman was approximately \$20
23 billion of our portfolio. And this specific portfolio was -
24 -

25 COMMISSIONER WALLISON: That would be about a

1 quarter?

2 WITNESS CASSANO: Right.

3 COMMISSIONER WALLISON: But were they at the
4 beginning, or did they come along afterwards?

5 WITNESS CASSANO: I actually think the--to the
6 best of my recollection on this point, I think there were
7 other banks that were initial participants.

8 COMMISSIONER WALLISON: You were protecting
9 Goldman. Did you wonder why Goldman needed this protection
10 if you were under the impression that this was almost a
11 risk-free investment on your part?

12 WITNESS CASSANO: My understanding of what
13 Goldman was doing was that they were continuing to warehouse
14 and replicate the risk. And, while they had a pipeline to
15 deals themselves, that they were laying off the risk with
16 others as they kept accumulating new deals into their shop.

17 COMMISSIONER WALLISON: And they kept coming back
18 to you. Was your pricing particularly good, do you think?

19 WITNESS CASSANO: I think our pricing was
20 competitive with the market. I don't think that was...

21 COMMISSIONER WALLISON: What alerted you to the
22 danger of these transactions in 2005? What kind of analysis
23 did you do at that time which suggested to you and your
24 staff that things were much different than they had been
25 when you entered in 2003? It's only a two-year period.

1 What happened?

2 WITNESS CASSANO: Yes, sir. I think in the--just
3 before, if you don't mind, just a little bit of context, is
4 that there is a rapid growth curve in the CDO market and in
5 the subprime market from 2003, 2004, 2005, 2006, and even
6 '07, and this market is moving up very quickly, growing
7 exponentially.

8 My head trader came to me in 2005--this is Andrew
9 Forster, and he said to me that he was beginning to become
10 concerned that there was a potential that underwriting
11 standards would begin to slip; that we would not be able to
12 meet our underwriting standards in this project.

13 We discussed it. Obviously I asked Andy if there
14 was anything we needed to do at this moment, and he said
15 that what he really would like to do is go and do more
16 research on this issue.

17 And we talked about who would be the right people
18 to do this. We chose Al Frost, who is one of the marketers
19 of this business in North American, Professor Gorton, who
20 worked with us intimately on this product type, and Andrew
21 went--Andrew was based in London, went to the States, and
22 they met with a variety of people in the market.

23 They met with loan originators, portfolio
24 managers, investment banks, and banks, discussing the
25 subprime market and this potential for increasing--

1 decreasing standards and underwriting issues.

2 When Andrew returned is when he gave me his
3 analysis of the market. And that's what led to our December
4 decision. I think the groups were pretty split along the
5 way in any of these kinds of things. There were those who
6 still thought that the business was good to do. There were
7 those who thought, gee, the business is good to do, but I
8 sort of understand some of the arguments. To Andrew,
9 who--Andrew Forster who said, look, I think we need to get
10 out.

11 And I sided with Andrew on this, and that was
12 when we took the decision to exit the business.

13 COMMISSIONER WALLISON: But you didn't actually
14 get out. You continued to enter these contracts.

15 WITNESS CASSANO: Right.

16 COMMISSIONER WALLISON: Was that because you were
17 obligated in some way to do it?

18 WITNESS CASSANO: We had a commitment of a
19 pipeline of these transactions that we had been working on.
20 They have a fairly long gestation period. We were working
21 through that pipeline.

22 When we took the decision to exit the business,
23 we discussed the pipeline and discussed whether or not we
24 needed to adjust standards. What do we need to do?

25 The team believed that they were ahead of the

1 curve in sort of identifying, and I think they were probably
2 ahead of most in identifying this potential for underwriting
3 standards slipping.

4 And then we also took a review of the portfolio
5 that we had. Because obviously the question is: Well, if
6 you see this are you sure you don't have any issues in what
7 you own now? And we did that review.

8 And we were comfortable with the underwriting
9 standards that we had committed to. And those portfolios,
10 as they are now in Maiden Lane, would see us through the
11 test of time.

12 I think I want to make one thing clear, if I can.
13 During this process in the review, and even in the period
14 where we were beginning to ramp down the pipeline, we never
15 let our underwriting standards slip. We also maintained the
16 rigorous underwriting standards in which we made sure, not
17 only the FP teams review and analysis of these transactions,
18 the ongoing review of the book of business that we had, but
19 also we always made sure that we had the approval on all of
20 these transactions from a second set of eyes and a second
21 credit team at the AIG parent.

22 COMMISSIONER WALLISON: The puzzling thing about
23 this is that you didn't say just now that you are obligated
24 to continue to buy--to take on this risk. Did you feel you
25 were contractually obligated to take on the risk?

1 You decided--let me repeat what I thought I heard
2 you say. You said in 2005 you decided, after some debate,
3 that you would terminate going into this market any further
4 probably because you thought underwriting standards were
5 beginning to decline in the market and you didn't want to
6 take any further risk.

7 But were you contractually obligated to add what
8 I think is something like \$30 billion more in risk during
9 the next couple of years?

10 WITNESS CASSANO: Remember, Mr. Commissioner, the
11 decision that we took was the decision to exit the--

12 COMMISSIONER WALLISON: Go ahead.

13 WITNESS CASSANO: Everybody okay?

14 COMMISSIONER WALLISON: Yes.

15 WITNESS CASSANO: The decision that we took was
16 the decision to exit the subprime underwriting market. We
17 have--we did continue to underwrite prime mortgages, and we
18 made sure that those mortgages--you know, that the
19 underwriting standards for that business continued.

20 So the \$30 billion number that you're referencing
21 I think is a combination of two different products. I think
22 it includes some products that had subprime in them, and
23 that was the portfolio that we ran down. But it also
24 includes transactions that had prime securities, and it
25 included transactions that had commercial real estate in

1 them also, I believe.

2 So coming back to the decision that we made, and
3 whether or not we were contractually obligated, no, we were
4 not contractually obligated. This was a business decision
5 that we made in 2005 because we thought we could still run
6 through a pipeline of deals that we were building up, and we
7 would be able to still maintain our credit standards. And I
8 believe we never let our credit standards slip on this
9 issue.

10 Because what we say was the potential for
11 leakage, or slippage in these contracts; not that the
12 underwriting standards had slipped. Remember, this is 2005,
13 and I believe as we move forward in the more problematic
14 vintages of '06 and '07 is where most of the problems in the
15 housing market took place.

16 COMMISSIONER WALLISON: Yes, but that's when you
17 were buying 50 percent more than you had taken before.
18 Wasn't that true? In 2006 and 2007?

19 WITNESS CASSANO: Again we should look at the
20 portfolio. One of the issues is to look at the underlying
21 portfolios. Look at each portfolio individually. And look
22 at the asset classes that are composed of these portfolios.
23 And then we can see how we maintained our underwriting
24 standards through this process.

25 And I think the point I'm making is, 2006 and

1 subprime, when running through the pipeline to 2006 it was
2 accessing mostly 2005 vintage mortgages at that time. And
3 those mortgages still had reasonable house price
4 appreciation, good covenants in them, and where the
5 underwriting standards had not yet deteriorated.

6 COMMISSIONER WALLISON: I think one of the things
7 that sets AIG apart from others is that you took only one
8 side of a very substantial book. Are you aware of others,
9 other than the monolines, that did something like this? And
10 did you, if you were not aware of it, or if you were aware
11 of it would you tell us about others who might have been
12 doing this in the market?

13 WITNESS CASSANO: Nobody comes to mind right now.

14 COMMISSIONER WALLISON: And if not, then were
15 you--why did you suppose that you had done a better analysis
16 of this than, say, Goldman Sachs which was relying on you to
17 provide it with some protection?

18 WITNESS CASSANO: What we relied upon was the
19 underwriting standards that we had. I think we had a
20 rigorous set of standards. As I've said before, the
21 standards were set by the people at AIG. I think my team
22 did a very good job on our fundamental analysis. And I
23 believe these portfolios are standing the test of time today
24 when it comes to credit risk analysis, as they are paying
25 back the Taxpayer in Maiden Lane III.

1 And these portfolios have survived, and are
2 paying, and are performing in one of the most difficult
3 times in the capital markets in most of our lifetimes.

4 COMMISSIONER WALLISON: So would you--I'm
5 wondering whether what you are saying is that if you had
6 been allowed to remain in charge of these portfolios, and if
7 they hadn't in fact--if they were not going to depreciate
8 very substantially as you think, as you're saying now they
9 would not have, and have not, do you think that AIG could
10 have survived without any support from the government?

11 WITNESS CASSANO: It's a big question, because
12 there were other issues besides this portfolio that--

13 COMMISSIONER WALLISON: But let's leave the other
14 part alone and just talk about the question of credit
15 default swaps.

16 WITNESS CASSANO: Okay. So--

17 COMMISSIONER WALLISON: Just one minute?

18 VICE CHAIRMAN THOMAS: Yield the gentleman an
19 additional two minutes?

20 COMMISSIONER WALLISON: Two minutes.

21 VICE CHAIRMAN THOMAS: Okay.

22 WITNESS CASSANO: I think your question is, if I
23 remained in the company?

24 COMMISSIONER WALLISON: Yes, of course.

25 WITNESS CASSANO: Right, would I have been--

1 COMMISSIONER WALLISON: If you had continued to
2 be in charge of this subject.

3 WITNESS CASSANO: If the company had left me--I
4 believe, or one of the things I question, is if I was able
5 to stay in the company as the chief negotiator of the
6 collateral calls in these transactions, I think I would have
7 used all the rights and remedies that were available to us
8 in the negotiations. And in that process, I think we would
9 have not had to forward, or accelerate the \$40 billion that
10 the government did at the time, and I think I would have
11 been able to negotiate substantial discounts from the
12 collateral calls that had been made to date.

13 And I reflect on that only because I was able to
14 do it in the six months from July to March of '08 that this
15 business was being--when we were negotiating the collateral
16 calls while I was there.

17 COMMISSIONER WALLISON: I'm trying to--this is a
18 totally hypothetical question, and so I want you to leave
19 out the other decisions that were made by others about the
20 purchase of other assets that turned out to be rather poor.
21 I'm trying to focus in on the credit default swaps and your
22 views of what would have happened if that was the only bad
23 investment that AIG had made, can you say that there is a
24 chance--if you put a percentage on it, you're a business
25 person, you can probably put percentages on it--can you say

1 that the credit default swap portfolio that AIG had
2 purchased under your administration would have caused the
3 company to suffer losses or not? What kind of percentage
4 would you put on that?

5 WITNESS CASSANO: I think our portfolio would
6 have set--would--I think if we're working on a hypothetical--
7 -

8 COMMISSIONER WALLISON: Yes.

9 WITNESS CASSANO: --we have to remove the fair
10 value concept and we just look at the performance of the
11 portfolios themselves, if we're looking at the portfolios
12 performances of themselves, I believe these portfolios will
13 perform over the test of time. And I believe that no losses
14 will be incurred at the attachment point that we underwrote.

15 COMMISSIONER WALLISON: Thank you.

16 CHAIRMAN ANGELIDES: Good. I was going to defer
17 to the very end, but since this issue has been raised by Mr.
18 Hennessey and Mr. Wallison, I am just going to pursue it
19 just for a minute or two more and try to go very quickly
20 here in respect to my other members. But this goes--you
21 essentially make the point, a couple of points here, which
22 is that obviously the crisis, with respect to AIG, was
23 driven by these mark-to-market values. And secondly, by the
24 failure of AIG to negotiate reasonable settlements of those.

25 And I will say that the chronology that I entered

1 into the record--and this is in the way of absolution--
2 appears to indicate that there's some pretty hard fighting
3 with Goldman Sachs in particular through March of 2008, and
4 then after.

5 I used the analogy when I started here: Was
6 there a cheetah hunting down the weak member of the herd?
7 It appears somewhere in March of 2008 the Cheetah may have
8 caught the member of the herd.

9 I am trying to get to this very issue of was a
10 first domino pushed over? Or did someone light a fuse here?
11 And I just want to call out a couple of things.

12 I mean, Goldman appears to have been--and this
13 is, as you said, they were hard negotiators, but they were
14 below everyone else's marks. They were much more
15 aggressive. Other entities didn't make calls that were
16 similar. The price scene, as you look at the chronology,
17 was much higher. And in fact at one point SocGen makes I
18 think a call because it appears that Goldman's given them
19 their marks. They bring them to you. You dispute them.
20 They go back away.

21 Right after that first collateral call on July
22 30th, Mr. Forster, who will be with us tomorrow, tells
23 another member of AIG Financial Products that the Goldman
24 margin call, quote, "hit out of the blue, and a f[ing]
25 number that's well bigger than we ever planned for."

1 Goldman's prices were, quote/unquote, "ridiculous."

2 On August 1st, Mr. Athan writes to Mr. Forster
3 that Goldman was, quote, "not budging or acting irrational."
4 On August 2nd, this is when you get Goldman to back down.
5 Quote--this is an e-mail from Mr. Forster to I think you,
6 "They" Goldman, "realized they needed to use bids not bids"
7 meaning they needed to use the mid-point not just the bid
8 price.

9 Mr. Forster on August 16th, 2007, says: I've
10 heard several rumors now that GS--"GS" meaning Goldman--is
11 aggressively marking down asset types that they don't own so
12 as to cause maximum pain to their competitors. It may be
13 rozbush, but it's the sort of thing GS would do.

14 You said I think on September 11th there's
15 another communication between Mr. Athan and Mr. Forster
16 saying that SocGen NY said they, quote, "received marks from
17 GS on positions that would result in big collateral calls
18 but SG disputed them with GS."

19 But what I get in a flavor here--and there's
20 another e-mail from you saying that SocGen was, quote,
21 "spurred by GS calling them." So in this opaque market
22 where there's no open trading, is it possible that the mere
23 act of driving down prices drives down prices?

24 WITNESS CASSANO: Yes.

25 CHAIRMAN ANGELIDES: Okay. And your contention

1 is that, had you not had this driving down of mark-to-market
2 prices for which there was no real market, you might not
3 have faced the liquidity challenge at the end, if in fact
4 AIG had continued to contest those using all their remedies?

5 WITNESS CASSANO: Can I say, basically, yes.

6 CHAIRMAN ANGELIDES: Okay. Okay, thank you very
7 much, members, for allowing me to do that. I just wanted to
8 get some clarification on that matter.

9 VICE CHAIRMAN THOMAS: Mr. Chairman?

10 CHAIRMAN ANGELIDES: Yes--

11 VICE CHAIRMAN THOMAS: Just to--

12 CHAIRMAN ANGELIDES: --and thank you, Mr. Vice
13 Chair, for your courtesies today, too.

14 VICE CHAIRMAN THOMAS: --and wants to understand
15 what's going on, the way I would describe it to someone
16 else, or the way I would ask the question is: Do you think
17 Goldman was out to get you?

18 WITNESS CASSANO: No.

19 VICE CHAIRMAN THOMAS: No?

20 WITNESS CASSANO: I don't know what was--

21 VICE CHAIRMAN THOMAS: Were they out to get AIG?

22 WITNESS CASSANO: I don't know what was going on
23 in Goldman's side, and what they were--

24 VICE CHAIRMAN THOMAS: Had they done some of the
25 same things, and they needed money, and they were going to

1 get it out of you?

2 WITNESS CASSANO: Vice Chairman Thomas, I don't
3 know what was on the other side of the Goldman trades. I do
4 know that Goldman kept coming to the table with us, and I do
5 know that as they came to the table--and this happened over
6 a long period of time--

7 VICE CHAIRMAN THOMAS: Right.

8 WITNESS CASSANO: --they kept reducing their
9 collateral calls.

10 VICE CHAIRMAN THOMAS: I understand that. And
11 then you left AIG, I guess asking why you left, or why they
12 wouldn't keep someone who was fairly aggressive in their
13 corner--and clearly the negotiation structure changed after
14 you left--is a question I will ponder.

15 WITNESS CASSANO: Are you asking me why I left?

16 VICE CHAIRMAN THOMAS: I don't think I'm supposed
17 to, but I'm pondering it.

18 WITNESS CASSANO: Okay. Sorry, sir.

19 (Laughter.)

20 VICE CHAIRMAN THOMAS: So what would you ponder?

21 (Laughter.)

22 WITNESS CASSANO: Well if we can ponder this
23 together--

24 (Laughter.)

25 VICE CHAIRMAN THOMAS: Just you and me--

1 WITNESS CASSANO: And a couple of cameras.

2 VICE CHAIRMAN THOMAS: Well--

3 WITNESS CASSANO: I was at the--after the
4 Material Weakness finding, and the disallowance of the
5 Negative Basis Adjustment in our modeling effort, at the end
6 of that week Mr. Sullivan asked me to come and see him. And
7 as I think he said in his testimony, he told me that changes
8 needed to be made. He didn't think I would be happy with
9 the changes that needed to be made. And he suggested that I
10 retire. And I did.

11 VICE CHAIRMAN THOMAS: Okay. Maybe you should
12 have been at a higher level. I'm through.

13 CHAIRMAN ANGELIDES: We will now go to the next--
14 I will say one thing. One thing we will want to follow up
15 on you, because members have asked, is this issue of you
16 continuing to write CDS. We won't take time now, but just
17 be on notice that we will--the staff has indicated that CDS
18 continued to be written on what was called "prime RMBS," and
19 at least in our review it looked like that included Alt A,
20 interest-only, no-doc, low-doc. So I think we're going to
21 want to visit that issue to get clarity. Pay option ARMs,
22 and Home Equity Loans that included subprime. So we want to
23 get clarity about whether there really was a stop.

24 All right. Senator Graham?

25 COMMISSIONER GRAHAM: Thank you, Mr. Chairman.

1 I want to use my time to talk about risk
2 management in four buckets. One is what I would call
3 "situational awareness." Another is "history." Another is
4 "personnel." And then "organizational structure."

5 On the situational awareness, it would seem to
6 me, and I will state as a lay person in this area, that
7 there were certain advantages to doing business with AIG in
8 this area that weren't available from other competitors in
9 the marketplace.

10 One was that you had in your contracts this
11 provision that required you to put up collateral if there
12 was a reduction in the market value of the underlying
13 assets.

14 And, two, the fact that you could put up
15 collateral. I understand that some of your competitors,
16 particularly the monolines, were not allowed to put up
17 collateral until there was a default.

18 In light of that, it would seem to me that you
19 would be in a very competitive position in terms of the
20 premiums to coverage that you would offer, since you had
21 contractual benefits from the side of your purchasers that
22 others did not have. Is that a correct hypothesis?

23 WITNESS CASSANO: I know that we were able to
24 pledge collateral. I'm not sure what others could do.

25 COMMISSIONER GRAHAM: Apparently, I've been told,

1 because of certain conditions from the rating agencies the
2 monolines were not allowed to post collateral until after
3 default.

4 WITNESS CASSANO: Okay. I'll accept that, yes.

5 COMMISSIONER GRAHAM: Well if that's the case,
6 then what I don't understand is, it seems as if you were
7 actually significantly underpriced, according to this chart
8 that we have about one particular security, which was the
9 Abacus--

10 VICE CHAIRMAN THOMAS: Senator, just one moment
11 while we get this chart--

12 COMMISSIONER GRAHAM: It's number four.

13 VICE CHAIRMAN THOMAS: --so that others can see.

14 COMMISSIONER GRAHAM: Yes, okay. This is the
15 Goldman Sachs Synthetic CDO Abacus 2004-1. According to
16 this chart, AIG would sell you \$1.76 billion of coverage for
17 an annual premium of \$2.1 million. Is that correct?

18 WITNESS CASSANO: I'm going to accept your
19 premise here. I just haven't--I don't know these numbers.

20 COMMISSIONER GRAHAM: Well, then you'll just see
21 the others selling the same product, that TCW, you could buy
22 \$22.5 million for \$384,000; and with GSC you could buy \$7.5
23 million for \$510,000. I mean, these are dramatically
24 different ratios of premium cost to amount of coverage.

25 You indicated that you thought that your premium

1 charges were competitive with the marketplace, selling what
2 looks like to be a superior instrument for the reasons that
3 I cited earlier, yet you're getting dramatically less per-
4 dollar of coverage than others.

5 Is this an accurate reflection of what the
6 marketplace was? And if so, it does not appear as if you
7 were competitive with the market.

8 WITNESS CASSANO: I would need to spend some time
9 and understand what this chart is exactly.

10 COMMISSIONER GRAHAM: Then, unless Mr. Lewis or
11 Mr. Sullivan wishes to comment, I will defer and if you
12 could give us a written response to--

13 WITNESS CASSANO: I'm more than happy to work
14 with your staff on this, yes.

15 COMMISSIONER GRAHAM: All right. The second
16 thing is history. In February of '08, Price Waterhouse
17 Coopers made a number of recommendations to the AIG Board
18 Chairman Robert Willumstad. One of those was what I would
19 call "history."

20 They said that a factor in the current situation
21 regarding the super senior credit default swaps was a lack
22 of leadership, unwillingness to make difficult decisions
23 regarding FP in the past, and inexperience in dealing with
24 these complex matters.

25 Mr. Sullivan I assume as the CEO. Mr. Robert

1 Willumstad communicated PWC's concerns to you?

2 WITNESS SULLIVAN: Sitting here today, sir, I
3 don't recall Mr. Willumstad discussing that with me. But as
4 Mr. Cassano articulated earlier, shortly after the filing of
5 that 8K we recognized that changes needed to be made within
6 AIGFP. And during a very short meeting between Mr. Cassano
7 and I, we concluded that Mr. Cassano would retire.

8 COMMISSIONER GRAHAM: According to this, in terms
9 of history, it said there had been an unwillingness to make
10 difficult decisions regarding FP in the past. Do you--had
11 this--were there issues that had been surfaced previously
12 that had not been dealt with?

13 WITNESS SULLIVAN: As I said, sir, sitting here
14 today I can't recall Mr. Willumstad discussing that with me.

15 COMMISSIONER GRAHAM: Were you aware,
16 independently of what Price Waterhouse told the Chairman of
17 the Board about these problems at FP in the past?

18 WITNESS SULLIVAN: Without knowing the specifics
19 of what motivated their comments, sir, I can't.

20 COMMISSIONER GRAHAM: Okay, number three is the
21 area of personnel, where the PWC comments said: Ensuring
22 that people have the skills, including leadership,
23 execution, and change management skills and ability to hold
24 people accountable, and experience in dealing with large-
25 scale improvement and change efforts.

1 You've informed us about the decisions relative
2 to Mr. Cassano. Were there any other personnel changes that
3 you made between February of '08 and September of '08?

4 WITNESS SULLIVAN: Just for the record, sir, I
5 left in June, so I won't respond to that period in time.
6 Following Mr. Cassano's agreement to retire, Mr. Dooley, who
7 was the head of the Financial Services Sector, and Mr.
8 Cassano reported directly to him, took over as interim CEO
9 during that period of time as we went out to look for a new
10 head of AIGFP.

11 Sitting here today, I can't recall any other
12 changes during that period of time. But there may have been
13 others who came or left, but I simply can't recall.

14 COMMISSIONER GRAHAM: But from February to June
15 of '08, in light of this comment about your personnel, you
16 made one change? Is that right?

17 WITNESS SULLIVAN: As far as AIGFP is concerned,
18 that's--

19 COMMISSIONER GRAHAM: I mean what about the rest?
20 I don't think these comments were particularly intended to
21 be limited to FP. Were there any major changes made
22 elsewhere in the company?

23 WITNESS SULLIVAN: Sitting here today, one that I
24 recall is we changed the reporting line of Mr. Lewis from
25 the CFO to myself.

1 CHAIRMAN ANGELIDES: Would you like a couple of
2 extra minutes, Senator?

3 COMMISSIONER GRAHAM: Yes.

4 CHAIRMAN ANGELIDES: Two minutes to the Senator.

5 COMMISSIONER GRAHAM: Okay, that gets to the
6 fourth issue, which is the organizational structure. PWC
7 said there was a need to address the reporting lines for
8 ERM, the lack of access that ERM had into units like AIG
9 Investments and others, and that Lewis had not aggressively
10 addressed these issues in the past.

11 One of the matters that came up earlier was the
12 fact that, while one unit of the company had adopted at
13 least a stated policy that they were no longer going to be
14 purchasing these types of securities, that another unit, AIG
15 Investment, increased its holdings by some \$50 billion.

16 Was the fact that there was no access by the ERM
17 to the AIG Investment Unit a factor in the failure to
18 communicate what one unit of the company had decided was an
19 excessively risky investment to another side of AIG?

20 WITNESS SULLIVAN: I can't answer the question as
21 to why they decided to continue investing there, but I do
22 believe to the best of my knowledge that the information
23 flow between ERM and AIG Investments was there.

24 I think the Credit Risk Committee had oversight,
25 and I think the data flow and Mr. Lewis would be much more

1 able to respond there, was there.

2 COMMISSIONER GRAHAM: In light of--

3 WITNESS SULLIVAN: But following this period of
4 time, sir, it's also probably that I put Mr. Lewis on the
5 Executive Committee of the company, and also I've, just
6 sitting here, recalled that I did ask the CFO to take over
7 senior management responsibility for the Financial Services
8 Division at the time, shortly before I left.

9 COMMISSIONER GRAHAM: In December of 2007 at the
10 Investors Conference Day, you made a statement which
11 included this quotation, AIG took in the U.S. residential
12 housing sector was, quote, "risk supported by sound analysis
13 and a risk management structure that allows AIG to put our
14 capital at work in an efficient manner."

15 Two months later, on February 6th of '08, this
16 report by PWC was given to your Chairman of the Board with
17 multiple critical comments about your risk management. Did
18 that cause the company to reassess whether it had in fact a
19 risk management structure that allowed it to put its capital
20 to work in an efficient manner?

21 CHAIRMAN ANGELIDES: Right. And then can we
22 answer the question and move on? Answer the question,
23 please.

24 WITNESS SULLIVAN: No, sir. I truly believe
25 everything I said at the December Investor Call, based on

1 all the information I was receiving.

2 COMMISSIONER GRAHAM: And that report by Price
3 Waterhouse 60 days later didn't cause you to reassess that?

4 WITNESS SULLIVAN: With the utmost respect, sir,
5 I'm not sure what report because I don't think I ever saw
6 that report. I don't think it was addressed to me, was it,
7 sir?

8 COMMISSIONER GRAHAM: No, it was addressed to the
9 Chairman of the Board.

10 WITNESS SULLIVAN: Thank you. So I'm not sure I
11 ever saw that report.

12 COMMISSIONER GRAHAM: Thank you.

13 CHAIRMAN ANGELIDES: Mr. Georgiou--and actually,
14 I think on this very point, perhaps.

15 COMMISSIONER GEORGIOU: Yes. Thank you,
16 Mr. Chairman. I actually want to make one point, and I'll
17 come right back to it, if I can.

18 Mr. Sullivan, you were paid \$107 million from
19 2003 to 2008, including \$47 million during 2008? Is that
20 correct, roughly?

21 WITNESS SULLIVAN: I have no knowledge or
22 recollection of those numbers whatsoever, sir.

23 COMMISSIONER GEORGIOU: You don't remember how
24 much you made?

25 WITNESS SULLIVAN: I certainly don't recall

1 earning that amount of money, sir.

2 COMMISSIONER GEORGIOU: That's what our staff
3 established.

4 CHAIRMAN ANGELIDES: These are from public
5 filings.

6 COMMISSIONER GEORGIOU: These are from public
7 filings of the company.

8 And, Mr. Cassano, you were paid \$280 million from
9 2000 to 2007, correct?

10 WITNESS CASSANO: I don't know the periods, but I
11 made over \$300 million during my career at AIG.

12 COMMISSIONER GEORGIOU: Okay, including a million
13 dollars a month during the six months after you retired as a
14 consultant?

15 WITNESS CASSANO: Yes.

16 COMMISSIONER GEORGIOU: Mr. Lewis, you're still
17 the Chief Risk Officer, correct?

18 WITNESS LEWIS: Yes.

19 COMMISSIONER GEORGIOU: And you received about
20 \$15 million in total compensation from 2004 to 2008? That's
21 what our records reflect.

22 WITNESS LEWIS: I believe the compensation I
23 received--I don't know the total of that number, but it
24 would have included cash and stock compensation valued at
25 the time.

1 COMMISSIONER GEORGIU: Right. And Mr. McGinn, I
2 take it, is still the Chief Risk Officer, is he?

3 WITNESS LEWIS: Yes, he is.

4 COMMISSIONER GEORGIU: And he was during this
5 period?

6 WITNESS LEWIS: Yes. Mr. McGinn was appointed
7 Chief Credit Officer in the summer of 2004 when I was
8 appointed to the Chief Risk Officer position.

9 COMMISSIONER GEORGIU: And he's the one, is he
10 not, who suggested that the period of time--that the
11 increase, the 50 percent increase, in exposure to these
12 derivatives after the time that you decided--the exposure
13 that was created by AIG Investments after the time that
14 AIGFP decided to stop funding them, was akin to Nero playing
15 the fiddle while Rome burned. That was his comment, was it
16 not? Do you recall that?

17 WITNESS LEWIS: I have seen an e-mail from Mr.
18 McGinn where that statement was made. I recall that it did
19 not refer to FP, but to other parts of AIG.

20 COMMISSIONER GEORGIU: To the AIG Investments,
21 which was continuing to expose the company to these types of
22 risks after the decision was made by FP no longer to go
23 forward in that regard.

24 Now I guess my question is really to
25 Mr. Sullivan. You were there until June of '08. Did you

1 ever consider replacing the Chief Risk Officer, Mr. Lewis,
2 or the Chief Credit Officer, Mr. McGinn, in light of what
3 occurred? Which included, of course, \$130 billion of
4 government assistance to AIG, a commitment of up to \$52
5 billion more, and the loss by shareholders of \$147 billion
6 of market capitalization, which is what AIG was worth at the
7 end of '07, and it's worth nothing now, effectively.

8 Now did you ever think that maybe the Chief
9 Credit Officers or the Chief Risk Officers ought to be
10 replaced?

11 WITNESS SULLIVAN: Not up until the time I left
12 the organization, to the best of my knowledge, sir.

13 COMMISSIONER GEORGIU: Okay. And did anybody
14 try to claw back any of this compensation from any of these
15 people, in light of the failures that occurred? To the best
16 of your knowledge, did any executive ever give back any of
17 the money that they made on the basis of the products that
18 were created that caused the company ultimately to fail?

19 WITNESS SULLIVAN: To the best of my knowledge,
20 no, sir.

21 COMMISSIONER GEORGIU: Okay. And did the Board
22 of Directors ask you, as CEO, to give back any of your
23 compensation in light of your leadership of the company
24 during this period?

25 WITNESS SULLIVAN: To the best of my knowledge,

1 no, sir.

2 COMMISSIONER GEORGIU: Okay. All right, I'd
3 like to turn, if I could, then to a discussion of the
4 December 5th of '07 representation that there was a \$1.5
5 billion estimated unrealized valuation loss on the super
6 senior credit default swap portfolio.

7 I would like to introduce into the record, if I
8 could, there's a three-page document, which I've written all
9 over but I'm sure we'll introduce into the record a clean
10 copy, which is our staff analysis and summary of this
11 particular report to the public.

12 CHAIRMAN ANGELIDES: With attachments?

13 COMMISSIONER GEORGIU: With attachments, please.

14 CHAIRMAN ANGELIDES: So be it, entered into the
15 record, or whatever they say here in Congress.

16 COMMISSIONER GEORGIU: Yes.

17 Now during this December 5th of '07 investor day
18 conference, Mr. Cassano reported that there was an estimated
19 \$1.5 billion unrealized valuation loss on the super senior
20 credit default swap portfolio, and didn't disclose at that
21 time, and nobody disclosed from the company to the investing
22 public, that that included two accounting adjustments, one
23 of which was something called a negative basis adjustment of
24 \$3.6 billion, and something else called a "structural
25 mitigant adjustment" of \$732 million.

1 Do you recall that discussion, Mr. Sullivan?

2 WITNESS SULLIVAN: Sitting here today I recall
3 Mr. Cassano during that presentation giving an update of the
4 unrealized loss valuation number following the third quarter
5 number we'd issued some weeks earlier.

6 COMMISSIONER GEORGIU: Right. Which was \$1.5
7 billion, which was disclosed to the public and the investing
8 public, at that time.

9 WITNESS SULLIVAN: If that was the cumulative
10 number.

11 COMMISSIONER GEORGIU: And the fact that there
12 were adjustments associated with that was not disclosed.
13 And at that time, had those adjustments not been made the
14 unrealized loss would have been \$5.9 billion as of December
15 of '07, if you would add those numbers back in.

16 Now it turns out that two months later, on
17 February 11th of '08, AIG issues a new Form 8K in which it
18 reports the adjustments that were not disclosed on 12/5/07,
19 and that it expected to include the structural mitigant in
20 the unrealized valuation loss but not the other matter, that
21 negative basis adjustment, which is another accounting
22 adjustment, because it could not reliably quantify the
23 judgment.

24 Now at that time, the unrealized loss was
25 estimated to be, if I'm correct here, \$11.9 billion--\$11.1

1 billion. So it jumped up, between December 5th, between
2 your estimate of it at December 5th of '07 from, at one
3 point, \$5 billion to \$11.1 billion, which you reported in
4 February that you had actually had an unrealized loss in
5 December of \$11.1 billion.

6 In response to that, of course, the market for
7 the stock cratered. It dropped \$6 a share, from \$50 to \$44,
8 an 11.7 percent decline. And this representation to the
9 public was a subject of the Securities and Exchange
10 Commission and Department of Justice investigations, and in
11 the course of which it appears that Mr. Cassano--that, Mr.
12 Sullivan, you testified to our staff during our
13 investigation that you never learned of the adjustment until
14 February of '08.

15 Mr. Habayeb said he learned of the adjustment in
16 late January of '08. Mr. Bensinger said that he learned of
17 the adjustment in late '08, and he learned it from Mr.
18 Habayeb.

19 Mr. Cassano, however, said that the negative
20 basis adjustment was disclosed to all of these executives
21 and to Price Waterhouse Coopers before the December 5th,
22 '07, Investor Day Conference, and several documents
23 corroborate that contention.

24 CHAIRMAN ANGELIDES: Two minutes.

25 COMMISSIONER GEORGIU: Okay. Thank you.

1 Now we're clear that these negative basis
2 adjustments wasn't disclosed on 12/5, and that the increase
3 of your estimate as of 12/5 changed between 12/5 to February
4 8th from \$1.5 billion to \$11.1 billion in loss.

5 And I just want to ask you, Mr. Sullivan, about
6 some documents. Because there's a document that's attached
7 to this summary which are typed notes prepared by Price
8 Waterhouse Cooper of a November 29th, '07, meeting, which is
9 a week before you told the public that this number was \$1.5
10 billion, which says that: Cassano said that the valuation
11 of the credit default swap book included a potential need to
12 quantify the CDS spread. I won't get into all the
13 technicals, but the typed notes also reveal that if AIG used
14 Goldman's values there could be an impact of \$5 billion for
15 the quarter.

16 And you're quoted as saying, Mr. Sullivan, that
17 this would, quote, "eliminate the quarter's profits
18 entirely."

19 Mr. Forster, who was at this meeting, told the
20 FCIC staff that CEO Sullivan responded to the \$5 billion
21 comment by saying he was going to have, quote, "a heart
22 attack." But Mr. Sullivan told FCIC staff that he does not
23 remember this part of the meeting, and he told FCIC staff
24 that he does remember a later part of the meeting that does
25 not include AIGFP executives.

1 Can you tell us what you remember about the
2 "heart attack" comment, and why it is that the public was
3 told that this loss was \$1.5 billion when really it was
4 closer to \$5.9 billion in December?

5 WITNESS SULLIVAN: Well thank you, Commissioner.
6 First of all, I can't help you with the "heart attack"
7 comment because I have berated myself over many months to
8 try and recall the first part of the discussion of that
9 November meeting. I've been asked many times, and
10 unfortunately I simply can't recall. But you may rest
11 assured I have berated myself over that.

12 On the second part of your question, the first
13 that I recall hearing about negative basis points and the
14 lack of being auditable was, to the very best of my
15 knowledge, in early February.

16 COMMISSIONER GEORGIU: Okay, all right. I'm
17 just going to leave it there. The PWC partner's, Henry
18 Daubeney's, handwritten notes from the November 29th meeting
19 includes a notation that Mr. Cassano said we need to
20 quantify the CDS spread to the cash. Could be 10 percent,
21 but subject to change.

22 And that was the modification that you utilized
23 as the negative mitigation to effectively reduce the \$1.5
24 billion loss, unrealized loss, to significantly--to report
25 that loss to the public, when in fact just two months later

1 you've decided that the loss is \$10 billion more, as of
2 December of '07.

3 And also on 12/1 of '07 Mr. Cassano sent an e-
4 mail to Messrs. Habayeb, Dooley, Bensinger, Lewis, Herzog,
5 and McGinn in which he wrote that: We make an adjustment
6 for cash versus CDS we derive from the market, and that this
7 adjustment was discussed with PWC, with Price Waterhouse
8 Coopers, and CEO Sullivan.

9 So all of these documents, which our staff
10 discovered, suggest very strongly that the representation
11 that was made on December 5th was shaved, effectively, as to
12 the unrealized loss on these CDS. And, that ultimately you
13 ought to have disclosed to the public a more accurate
14 number.

15 And I guess I would suggest to you that this
16 appears that AIG was as forthcoming to the investment public
17 about its losses at that time as British Petroleum has about
18 the amount of oil that's been spilling into the Gulf.

19 I mean, it's astonishing to me, and I suppose I
20 really ought to ask Mr. Cassano: Does this reflect your
21 recollection? Did you disclose this to Price Waterhouse
22 Coopers and to your senior management in December?

23 CHAIRMAN ANGELIDES: All right, and then we're
24 going to move on. Mr. Cassano, quickly, because we want to
25 go to Mr. Holtz-Eakin.

1 WITNESS CASSANO: My recollection of the meeting,
2 I don't remember the comment of Mr. Sullivan saying I'm
3 having a heart attack. I do remember that I was asked about
4 projecting what I thought the potential loss could be as of
5 December 31st.

6 So I was asked to look forward. And we were in
7 that meeting initially discussing the Goldman collateral
8 call with senior management and PWC. When I was asked to
9 project the numbers that we had in front of us with a
10 Goldman call, and I did a very back-of-the-envelope
11 calculation and said, look, let's look at this. Just
12 calculate this out. Multiply it by the notational--the
13 amount of the book, four times what the number is, and it
14 could be as high as \$5 billion.

15 I do remember that Mr. Sullivan said that may
16 wipe out the quarter. I said, it is what it is. And he
17 said, yes, I understand. And we went on.

18 COMMISSIONER GEORGIU: Right. But then you
19 reported it as \$1.5.

20 CHAIRMAN ANGELIDES: Let's move on. We're out of
21 time.

22 COMMISSIONER GEORGIU: The point's been made.

23 CHAIRMAN ANGELIDES: Yes, the point has been
24 made, and effectively.

25 Mr. Holtz-Eakin.

1 COMMISSIONER HOLTZ-EAKIN: Thank you,
2 Mr. Chairman. Thank you, gentlemen, for taking the time to
3 do this with us today.

4 One of the disadvantages of going last is that,
5 when you don't understand things you prove that you're
6 really very slow, because it's been asked and I still don't
7 quite understand the story that I've heard today, which is
8 that that Taxpayers are out hundreds--over \$100 billion, but
9 if I get the collective testimony right, you, Mr. Cassano,
10 ran a Financial Products Division that had such impeccable
11 underwriting standards that the CDSs would never have shown
12 cash flow outflows, and indeed the economic value of the
13 underlying securities is 100 cents on the dollar to this
14 day, which means that for the remainder of the company the
15 crash of AIG was being an unfortunate bystander of the
16 freezing up of commercial paper markets so you couldn't meet
17 your short-term liquidity needs? And this is all just a big
18 accident?

19 Or, maybe it's because of large losses in the
20 securities' lending area, which seemed to go on, Mr. Lewis,
21 despite the fact that the Financial Products Division had
22 clearly signaled that it was unwise to continue to be in
23 that market.

24 And I still have not heard a clear answer of how
25 the judgment was made to continue to stay in that? So for

1 the record, one more time, why is it that, after Financial
2 Products and the company as a whole had reached a decision
3 that it was after 2005 not going to be in subprimes to the
4 degree that you allowed Securities Lending to go forward?

5 WITNESS LEWIS: I believe your question refers to
6 the investments by AIG Investments in residential mortgage-
7 backed securities?

8 COMMISSIONER HOLTZ-EAKIN: Yes.

9 WITNESS LEWIS: The concerns that we had and
10 discussed in the corporation about the deterioration of
11 underwriting standards and lending practices in the banking
12 industry were discussed with the Investment area.

13 And as I said I think in my testimony, or
14 earlier, the Investment Department, who was tasked with
15 investing AIG's cash, and also specifically the securities'
16 lending business, they discussed those concerns with us.
17 And there was a compromise reached.

18 The Credit Committee of AIG agreed to allow up to
19 a certain amount of investments in residential mortgage-
20 backed, or asset-backed securities, which included
21 residential mortgage-backed securities.

22 And the tradeoff that the Investment Department
23 determined was to purchase only the highest quality
24 investments available in the marketplace. And furthermore,
25 their investment research people were concentrating on

1 trying to select those securities by loan originators, by
2 sponsors, by managers that they thought had a lower
3 percentage of concern in the area of underwriting practices
4 in the originating banks.

5 But it was a tradeoff, a balancing of risk and
6 return opportunity, and there was a tradeoff made.

7 In the FP situation, it was a different business.
8 The super senior credit default swap business was one of--

9 COMMISSIONER HOLTZ-EAKIN: But to be clear, it's
10 a different business but it is still conditional on the
11 underwriting, the origination standards in the mortgage
12 business. And in the end, that was what FP identified as a
13 weakness and said let's get out, and you decided to go
14 ahead.

15 WITNESS LEWIS: The underlying assets were
16 clearly very similar, and therefore correlated. However,
17 the risk profile that was taken in both of these areas was
18 quite different.

19 COMMISSIONER HOLTZ-EAKIN: The other part of
20 this, to just listen, is quite puzzling. And this is for
21 you, Mr. Sullivan.

22 Why the siloed and disconnected risk management?
23 The liquidity management over with the CFO. Mr. Lewis not,
24 or his predecessors as chief risk officers not engaged in
25 that. When in the end it was the combination of liquidity

1 risks and these losses in lending, leaving aside Financial
2 Products which is still evidently 100 cents on the dollar,
3 that did your company in.

4 In retrospect, did you have adequate risk
5 management and coordination across the units?

6 WITNESS SULLIVAN: Well I think as Mr. Lewis
7 responded to your earlier question, the dialogue took place
8 with the Credit Risk Committee. Nobody brought to my
9 attention that the Investment Company was doing something
10 that it should not have been doing.

11 And I think as he articulated, there was dialogue
12 between the Credit Risk Committee, ERM, and the AIG
13 Investments.

14 COMMISSIONER HOLTZ-EAKIN: Well I'll just take
15 the liberty of making an observation, because Commissioner
16 Thomas is not here, but that in the end you are the head.
17 And the fact that they're having a dialogue doesn't excuse
18 you from the responsibility to make sure the enterprise is
19 not at risk as a whole. And that's just an observation.

20 One of the things I find amazing about this is
21 that there are evidently no limits placed on the amount of
22 CDSs that can be--the total amount of insurance that can be
23 outstanding.

24 Mr. Lewis, how did you get comfortable with the
25 idea that FP could have an unlimited amount of CDS exposure?

1 WITNESS LEWIS: AIG Financial Products did not
2 have an unlimited amount of capacity to write this business.
3 The--

4 COMMISSIONER HOLTZ-EAKIN: Did it have a dollar
5 limit?

6 WITNESS LEWIS: It did have a dollar limit, but
7 not in the--not in the dimension of total notional size.

8 As Mr. Cassano mentioned earlier, the
9 underwriting criteria and analysis that was done by FP was
10 to determine, based upon the underlying risk of the assets
11 in a CDO pool, what the--what a loss could rise to under a
12 very stressed situation.

13 And so we agreed on a set of criteria that said
14 that if Financial Products wished to incur risk in the
15 structure that exceeded a certain confidence level, given
16 the stresses that we put on those portfolios, that we would
17 limit the total amount of exposure that FP could incur for
18 that amount that exceeded that worst-case scenario that we
19 utilized. So there was a limit. It just was not in the
20 dimension of total notional amount.

21 COMMISSIONER HOLTZ-EAKIN: Thank you. The other
22 thing I've found puzzling is, Mr. Cassano, you evidently
23 were a one-man army against an invasion of Huns wanting
24 collateral posted. And your performance evidently staved
25 off what afterwards turned into a real rush on the cash.

1 That would appear to make Mr. Cassano a very,
2 very substantial and important part of this process. So the
3 institutions at risk, when he is unable to perform his
4 duties--it makes me wonder, Mr. Sullivan, why did you not
5 retain him? Why was he replaced?

6 WITNESS SULLIVAN: Well as I testified earlier,
7 following the issuance of the 8K we determined that changes
8 needed to be made in AIGFP, changes with regard to
9 compensation, changes with regard to matrix reporting. And
10 in that very short meeting that Mr. Cassano and I had, we
11 determined that at that time he should retire and a new
12 leader should be recruited to push through those changes in
13 the organization.

14 COMMISSIONER HOLTZ-EAKIN: So it was his capacity
15 to manage organizational change, not the FP product line?

16 WITNESS SULLIVAN: Could you repeat that, sir?

17 COMMISSIONER HOLTZ-EAKIN: So the decision was
18 made on his capacity to management the organizational
19 change, not actually his capacity to manage the FP product
20 line?

21 WITNESS SULLIVAN: The decision was made that it
22 was an appropriate time for Mr. Cassano to retire on the
23 basis that we needed to push through changes, various
24 changes, through AIGFP.

25 COMMISSIONER HOLTZ-EAKIN: Mr. Cassano--

1 VICE CHAIRMAN THOMAS: Would the gentleman like
2 an additional two minutes?

3 COMMISSIONER HOLTZ-EAKIN: Please.

4 I just want to make sure I understand.
5 Mr. Hennessey I think went through this pretty clearly, and
6 I think I understand your position, which is that, given the
7 credit analysis, the CDSs never in fact would have had any
8 cash outflow; there was no real reason to expect that, and
9 to this day you maintain that's true; and that, moreover,
10 anyone who was doing fundamental analysis, or in liquid
11 markets these things would be trading at 100 percent on the
12 dollar to this day. The underlying securities were that
13 sound?

14 WITNESS CASSANO: It's probably my background,
15 but the conflation of the hundred cents on the dollar--

16 COMMISSIONER HOLTZ-EAKIN: There's a CDS out
17 here, and there's an underlying security. This one never
18 would have cost you a dime--

19 WITNESS CASSANO: Because these would have
20 continued to meet the cash flow up to the level where we
21 were attaching--

22 COMMISSIONER HOLTZ-EAKIN: Agreed. And,
23 moreover, because these were correctly assessed by you, they
24 would not diminish in value unless they trigger the demands
25 for collateral that you actually achieved. That, you don't

1 believe, is a true market-based phenomenon, that was your
2 counterparties trying to pick your pocket.

3 WITNESS CASSANO: The estimated diminution in
4 value was created--the, the very, very large estimated
5 diminution of value was created by other people. There was
6 no trading going on, so there was no price discovery in
7 these instruments.

8 That meant that it was hard to determine what
9 the--there was a market disruption. You couldn't determine
10 it. So I think you needed to rely on the actuarial analysis
11 to tell you whether or not these would be money-good assets.

12 COMMISSIONER HOLTZ-EAKIN: And your actuarial
13 analysis said these were money-good, 100 cents on the
14 dollar? Obviously there's disagreement about that. There
15 are other marks out there that put these things at 50 cents
16 on the dollar, or even less, if I'm right.

17 How did you manage that risk as an organization
18 and as a unit that you might in fact face different
19 estimates and have to post collateral? You said you had \$50
20 billion in collateral inside FP alone. Why was that
21 insufficient? And how did you end up, ex poste, having done
22 such a poor job of managing this valuation risk and thus the
23 collateral calls?

24 WITNESS CASSANO: I can only talk about when I
25 was there.

1 COMMISSIONER HOLTZ-EAKIN: Talk about when you
2 were there.

3 WITNESS CASSANO: And I can talk about what I
4 think needed to be done in--

5 VICE CHAIRMAN THOMAS: Yield the gentleman an
6 additional minute.

7 WITNESS CASSANO: --what needed to be done in the
8 analysis when people were asking for collateral calls.

9 COMMISSIONER HOLTZ-EAKIN: Since I only have a
10 minute, I'll cut it. I've heard what you say. You used the
11 full contractual rights --

12 WITNESS CASSANO: Yes, sir.

13 COMMISSIONER HOLTZ-EAKIN: --I understand that.
14 And that's good bargaining, agreed. But AIG somewhere in
15 this game must have realized they might not always get
16 everything they wanted, even the full execution of their
17 contract rights. Where were you provisioning for losses?

18 WITNESS CASSANO: We had credit reserves built
19 into the FP business. They wouldn't have been enough for
20 the valuation losses.

21 COMMISSIONER HOLTZ-EAKIN: Why not?

22 WITNESS CASSANO: The reserves that we had, the
23 valuation losses, right, the fair value, what I think of as
24 the--

25 COMMISSIONER HOLTZ-EAKIN: This is the market

1 risk that evidently was so uninteresting that no one
2 bothered to account for it anywhere.

3 WITNESS CASSANO: I--

4 COMMISSIONER HOLTZ-EAKIN: We did have a market
5 event, so it was historically very important.

6 WITNESS CASSANO: But there was a market
7 disruption that occurred that would have said that you
8 should assert your contractual rights that would have
9 reduced or increased the value of the portfolio in a
10 negotiated settlement. And that is what I am saying should
11 have been done.

12 I think greater adherence to the underlying
13 rights in the contract would have served the Taxpayer better
14 than what happened.

15 COMMISSIONER HOLTZ-EAKIN: One more second, one point
16 five--

17 COMMISSIONER HOLTZ-EAKIN: How would the Taxpayer
18 be better served?

19 VICE CHAIRMAN THOMAS: Yield the gentleman three
20 seconds.

21 COMMISSIONER HOLTZ-EAKIN: How would the Taxpayer
22 have been better served?

23 WITNESS CASSANO: Because I think if you brought
24 people to the table--it's my opinion that there was a market
25 disruption, that you would not get any market quotes for

1 these underlying instruments.

2 Basically that process would have failed. The
3 counterpart would've had to come back to the table to
4 negotiate with you, because then you had to come to a
5 negotiating settlement. But now you were in a stronger
6 position because they would no longer be arguing that
7 there's a fair-value estimate out there.

8 COMMISSIONER HOLTZ-EAKIN: I just want to make
9 sure I understand the argument, whether it's right or wrong.
10 So rather than doing a hundred cents on the dollar to the
11 counterparts, a better deal would be struck, fifty cents on
12 the dollar, so less money goes into AIG in order to satisfy
13 the counterparts, and in that logic the counterparts are
14 also then just fine?

15 Whereas, the logic for intervention at the time
16 was AIG must be bailed out so that markets as a whole don't
17 fail. So if we would give them only fifty cents on the
18 dollar, aren't they just going to come around AIG and need
19 another fifty cents from the Taxpayer anyway? Or do you
20 really think you were not that important to markets and
21 could have been allowed?

22 WITNESS CASSANO: I didn't quite follow your
23 analysis.

24 COMMISSIONER HOLTZ-EAKIN: You're saying that we
25 could have plowed half the money into AIG that we did,

1 because we didn't have to send all this money out to the
2 counterparts.

3 WITNESS CASSANO: Right.

4 COMMISSIONER HOLTZ-EAKIN: And everyone would
5 have been fine after that?

6 WITNESS CASSANO: I don't believe the
7 counterparts--in the negotiation, the counterparts would
8 have terminated the contracts. They would have looked and
9 said, yes, we still want this protection. Because,
10 remember, they were getting the protection now from the
11 United States. Basically the owner of the company was the
12 United States Government. Therefore, with the support of
13 the Government, and the negotiation that said there is no
14 ability to determine future value here, the counterparts
15 would have said, fine--I believe they would have said, fine,
16 we can live with the provisions as we have them right now.

17 Does that make sense?

18 COMMISSIONER HOLTZ-EAKIN: Oh, I understand that
19 part. The question was whether they would have also been
20 financially whole and been able to continue. That's the
21 question we will not know the answer to.

22 CHAIRMAN ANGELIDES: Well we may never know the
23 answer, but we do have two more panels to probe the answer.

24 (Laughter.)

25 CHAIRMAN ANGELIDES: Ms. Born, you had a very

1 quick question, and then we will wrap up. We've got to take
2 a break and get on to our next panel, and we will shorten
3 our break substantially.

4 COMMISSIONER BORN: I just wanted to continue on,
5 Mr. Lewis, a little bit with you about the losses that
6 relate to the securities lending operation of AIG
7 Investments.

8 There have been some suggestions that the real
9 problem for AIG was that securities lending program and not
10 the credit default swap portfolio of AIG Financial Products.
11 I wondered if you would comment on that.

12 WITNESS LEWIS: In the securities lending
13 portfolio, there were some losses that were realized in the
14 nature of the Investment Department selling securities in
15 order to meet the liquidity needs to return the cash
16 collateral to the securities borrowers.

17 Those losses were covered, because those losses
18 were actually the responsibility of the Insurance Company,
19 the AIG Insurance Company subsidiaries that were lending the
20 securities. Those losses were covered by AIG, Inc.

21 The issue that I think you raise is the fact that
22 in this market where there was a huge change in fair value,
23 or market value of the residential mortgage-backed
24 securities, investments could not rely on liquidating those
25 securities to honor the obligation to return the cash

1 collateral.

2 So AIG had to come up with liquidity elsewhere in
3 order to meet those obligations. And that liquidity need
4 was in part funded by the Federal Reserve Bank.

5 COMMISSIONER BORN: If we are looking to what the
6 primary cause of AIG's failure and the need for the
7 government bailout is, which cause was it? Or was it just
8 equally both, the credit default swap portfolio, or the
9 securities lending diminution of the RMBS?

10 WITNESS LEWIS: From my point of view, I think
11 that looking back on it now, from my point of view the
12 disparity, or the gapping out, if you will, of what we risk
13 professionals and insurance professionals thought was the
14 underlying value of the credit quality, or the intrinsic
15 value of the portfolios, whether it was in securities
16 lending or in FP, that value diverged just tremendously in
17 this marketplace where liquidity dried up.

18 And if you will the failure in my view is that,
19 clearly knowing what we know now, we did not stress the
20 disparity between our underlying views of credit quality,
21 which was shared by others, including rating agencies, et
22 cetera, that we did not stress enough how much the market
23 value and liquidity could diverge from people's view of
24 intrinsic value.

25 And as we went through this decline, there were

1 many changes by all of the experts and economists around the
2 globe as to how bad this could get, and how much
3 deterioration in housing there could be. And we adjusted as
4 we went along. But the intrinsic value was not the issue.
5 The issue was the divergence of intrinsic value or credit
6 quality and liquidity available in the market for those
7 instruments.

8 CHAIRMAN ANGELIDES: All right?

9 COMMISSIONER BORN: Thank you.

10 CHAIRMAN ANGELIDES: Thank you, and we will now
11 adjourn this session. I will just say this, in concluding.
12 I want to thank the panels for being here, or the witnesses
13 for being here, but I do want to say something.

14 There are many questions yet to be answered, but,
15 Mr. Sullivan, I must say this to someone who was a CEO, that
16 I have found the kind of lack of knowledge and lack of
17 recollection disturbing. It just seems to me I need to say
18 it, not to be conclusionary, but we will probably debate on
19 this panel many, many issues, but I do not think that the
20 failure of leadership and effective management at AIG will
21 be a matter of much debate in this Commission.

22 Thank you very much, gentlemen, for being here
23 today. Thank you. We will recess until 3:25.

24 (Whereupon, a recess was taken.)

25 CHAIRMAN ANGELIDES: The meeting of the Financial

1 Crisis Inquiry Commission will come back into order. We are
2 now in our third session of the day, Goldman Sachs and
3 Derivatives.

4 I want to thank Mr. Cohn and Mr. Broderick for
5 joining us today. Thank you. We will start our session, as
6 we usually do. I am going to ask both of you gentlemen to
7 please rise and be sworn, which is customary for all
8 witnesses.

9 If you would please raise your right hand, do you
10 solemnly swear or affirm under penalty of perjury that the
11 testimony you are about to provide the Commission will be
12 the truth, the whole truth, and nothing but the truth, to
13 the best of your knowledge.

14 MR. COHN: I do.

15 MR. BRODERICK: I do.

16 (Witnesses duly sworn.)

17 CHAIRMAN ANGELIDES: Thank you very much,
18 gentlemen.

19 Now we are in receipt of your written testimony,
20 and we thank you for that. As we have indicated, we would
21 like each of you to make a five-minute opening statement, no
22 more than five minutes, and then we will move to questions
23 and answers by the Commission.

24 As you know, we are examining today the role of
25 derivatives in the financial crisis, and that will be the

1 context for the questioning today.

2 In front of you there are monitors. And when
3 that monitor goes to yellow, it means there is one minute to
4 go. When it goes to red, it means your time is up. And so
5 I would obviously appreciate it if you can keep it within
6 the designated time.

7 So what we will do is, we will start with Mr.
8 Broderick. Why don't you commence your testimony, and then
9 we will go to Mr. Cohn. Microphone on, please.

10 WITNESS BRODERICK: I'll get it yet. Chairman
11 Angelides, Vice Chairman Thomas, and Members of the
12 Commission:

13 Good afternoon. My name is Craig Broderick. I
14 have been the Chief Risk Officer of Goldman since 2007, and
15 prior to that I was the firm's Chief Credit Officer.

16 I would like to start by addressing the role of
17 risk management within Goldman Sachs. Our firm assumes risk
18 as an integral part of its business of market making,
19 underwriting, and otherwise providing a wide range of
20 financial services to our clients.

21 The nature of our role of financial intermediary
22 means that we take this risk only--very willingly, but only
23 subject to basic principles which define our overall
24 approach to prudent risk management.

25 First, we must understand the risk that we're

1 taking--how we measure it; how much we're taking; in what
2 form; with whom; for how long; and by how much that risk
3 might change as market conditions change.

4 Secondly, we must determine how we can control
5 the risk. That is, how we can mitigate it through hedging
6 and other means; how we can ensure that it does not become
7 too concentrated, and so forth.

8 Third, we have to feel comfortable that we can
9 achieve a return for our shareholders, that it's appropriately
10 aligned with the level of risk that we're taking.

11 To ensure disciplined risk management across our
12 businesses, we've built a substantial risk organization
13 within Goldman Sachs. In concept, it is built around four
14 components:

15 The first is effective governance, of which
16 independence is the cornerstone. The entire control side of
17 the firm comprising roughly 50 percent of Goldman Sachs does
18 not report to, and has complete independence from, the
19 revenue-generating divisions.

20 This independence is critical. For example, our
21 controller's group, not our business units, has the final
22 say on the marks of all of our positions. Effective
23 governance also comes from extensive participation by all
24 levels of the firm, including our most senior management,
25 and through the use of formal committees, informal postings,

1 and the rapid escalation of risk-related matters.

2 The second component is information. We firmly
3 believe you cannot manage what you cannot measure. A
4 central tenant is our daily discipline of marking all the
5 firm's positions to current market levels, not where we wish
6 the prices were, or should be, or where we think they will
7 be tomorrow; but, rather, where we can trade them today.

8 We do so because we believe it is one of the most
9 effective tools for assessing and managing risk, providing
10 the most transparent and realistic insight into our
11 exposures.

12 We have invested heavily in our risk technology
13 over the years and today have systems that, while certainly
14 not perfect, are able to comprehensively capture our
15 positions and track and analyze these positions in a
16 multiple of ways that provide valuable insights into our
17 overall portfolio.

18 The third component is people. Even with the
19 best technology, ultimately effective risk management
20 involves individuals making continual portfolio judgments.
21 The daily monitoring of our credit market risk limit is
22 informed by constant dialogue between our traders and our
23 risk managers. Especially during abnormal market conditions,
24 it's the experience of our business and risk management
25 professionals and their appreciation for the nuances and

1 limitations of each risk measure that help guide the firm in
2 assessing its risk exposures, and maintaining these
3 exposures within prudent levels.

4 The fourth and final component is the active
5 management of our positions. As part of this, we believe
6 that proactive hedging of our market and credit risk is
7 beneficial both to our clients and also our firm, most
8 notably by minimizing the potential need for us to take
9 outside actions during periods of stress.

10 More broadly, effective risk management,
11 including hedging, serves to reduce systemwide risk,
12 minimizing the likelihood that a counterparty failure of any
13 size could adversely affect the system.

14 In hedging our market and credit risks we make
15 active use of a variety of derivatives which I know is of
16 particular interest to the committee. We do so not because
17 they're the only means of hedging, but because they're often
18 the most efficient.

19 Credit derivatives, for example, are often useful
20 in helping us to facilitate the extension of credit to
21 clients and may make the difference as to whether a
22 transaction can be executed or not.

23 Given the focus on the role of derivatives in the
24 financial crisis, I want to note my view that this crisis
25 occurred primarily as a result of inadequate risk management

1 and, at its heart, a deterioration in lending standards.

2 The effects of poor lending decisions were
3 multiplied through the use of securitization and other off-
4 balance sheet structures which reduced not only the
5 transparency into these risks, but also the capital
6 available to cover any losses.

7 Certainly derivatives facilitated further
8 leverage in the system, but from the data I've seen they
9 were relatively small competitors given that losses in this
10 area were a fraction of cash-lending related figures.

11 Even so, derivatives exposures need to be managed
12 carefully, and that is why we approached the use of these
13 instruments in the same way that we manage other types of
14 risks, by applying disciplined fair-value accounting,
15 employing multiple types of risk metrics, and managing
16 individual counterparty exposure so that, in the aggregate,
17 the firm's overall level of risk is kept at prudent levels.

18 Notably, we approached our interactions with AIG
19 exercising these very same principles and conservative risk
20 management practices.

21 CHAIRMAN ANGELIDES: How are you doing in terms
22 of time to wrap up, Mr. Broderick?

23 WITNESS BRODERICK: One-half a page.

24 CHAIRMAN ANGELIDES: Great. Okay.

25 WITNESS BRODERICK: To be sure, we have all

1 learned valuable lessons from the market events in recent
2 times, and it is clear that no approach to risk management
3 was without its limitations.

4 However, we believe the four basic principles
5 that I noted were largely effective in the face of
6 unprecedented market turmoil.

7 Thank you. I look forward to answering your
8 questions.

9 CHAIRMAN ANGELIDES: Thank you very much, Mr.
10 Broderick. And now we will move to Mr. Cohn.

11 WITNESS COHN: Chairman Angelides, Vice Chairman
12 Thomas, and Members of the Commission:

13 Thank you for the opportunity to contribute to
14 the Commission's work to understand the causes of the
15 financial crisis.

16 I would like to begin my testimony with an
17 apology. You have stated that we have not been sufficiently
18 responsive to the FCIC's request for information. We
19 apologize for any failure on our part. We have redoubled
20 our efforts to provide the documents and information you
21 want, road maps to those documents, and extensive engagement
22 with your staff.

23 We recognize the significance of your mission, to
24 examine the underlying causes of the financial crisis, and
25 we will work hard to help you fulfill it.

1 In examining the crisis, one area that has
2 attracted considerable attention has been derivatives.
3 Although derivatives can be complex, in essence they are no
4 different from any other financial instrument or product.

5 Derivatives are used to lock in prices and to
6 hedge, or protect against events like inflation or credit
7 risk associated with a company. The name "derivative"
8 implies these types of instruments derive their value from
9 prices of underlying assets like stocks, bonds, commodities,
10 and interest rates.

11 For financial intermediaries like Goldman Sachs,
12 activity and derivatives is interrelated with our activities
13 in the underlying instruments. Whether calculating the
14 value of our position, marking our books, or managing our
15 risk, we look at our operations in aggregate, which means we
16 include cash and derivatives.

17 This is important because it goes to the heart of
18 how we view risk. Concentration of risk within financial
19 institutions can be very dangerous. But they can also be
20 brought about through the most basic of products, like bank
21 loans or mortgages, as was the case with many institutions
22 that failed in 2008.

23 For Goldman Sachs, the cornerstone of risk
24 management is fair value or mark-to-market accounting. This
25 commitment to fair value accounting in all types of markets

1 is important with respect to two main issues--the first
2 being AIG.

3 We bought credit protection from AIG against the
4 value of financial instruments on which we, acting as an
5 intermediary, had provided protection to other clients.

6 As the housing market deteriorated, Goldman Sachs
7 began to mark down the value of some of these positions. We
8 believe our marks reflected the realistic value that the
9 market was placing on these securities and the price at
10 which we and others were willing to trade.

11 The markdowns resulted in collateral calls to AIG
12 consistent with our mutual agreement. Because AIG disputed
13 some of these collateral calls, we spent a considerable sum
14 to insure against the risk that AIG would not pay us.

15 The second area where marking to market proved
16 vital was in the residential mortgage related market.
17 Although this business accounted for less than one percent
18 of our net revenue in 2007, a lot of attention has focused
19 on our decision to reduce risk beginning in 2006.

20 There is a view that we anticipated the crisis to
21 come. We did not. In fact, there were many different views
22 within our firm, let alone in the wider market as to the
23 future direction of housing prices. But having observed a
24 series of losses in our mortgage business through the daily
25 marking to market of our position, it seemed prudent to

1 reduce our net exposure to the subprime residential housing
2 market. When a pattern of losses occurs in the business, we
3 attempt to reduce our risk.

4 Given the focus and seriousness of the charge
5 that bets were made against clients, certain clients, we
6 have reviewed every RMBS and CDO that we underwrote from
7 December 2006 till today.

8 During the period, we underwrote approximately
9 \$14.5 billion of CDOs. At the end of June 2007, we held
10 approximately \$2.4 billion of bonds issued by these CDOs.
11 Against this, we bought protection representing about one
12 percent of the total amount underwritten.

13 In the same period, the firm underwrote nearly
14 \$47 billion of RMBS. At the end of June 2007, we held about
15 \$2.4 billion of bonds issued by the RMBS Securitization
16 Trust.

17 Again, the total amount of credit protection we
18 bought was one percent of the amount underwritten.

19 During the two years of the financial crisis,
20 Goldman Sachs lost \$1.2 billion in its residential mortgage
21 related business. We did not bet against our clients, and
22 these numbers underscore that fact.

23 It is always useful with hindsight to examine
24 actions taken. Of course we regret that we didn't do many
25 things better, like having less exposure to leveraged loans

1 which caused us approximately \$5 billion in losses; having
2 less exposure to mortgages; and of course we wish we had
3 seen more proactively the effects of the housing bubble.

4 We believe that the most important conclusion
5 from a review of the crisis are that the system, and
6 individual institutions, needed more capital, more
7 liquidity, and more transparency, and better risk
8 management.

9 Mr. Chairman, thank you once again for the
10 opportunity to appear before you today. I look forward to
11 answering the Commission's questions.

12 CHAIRMAN ANGELIDES: Thank you very much, Mr.
13 Cohn.

14 We will now begin our question period. As is
15 customary, I will begin the questioning, followed by the
16 Vice Chairman, and then the Commissioners who led this part
17 of our inquiry.

18 But before I start, I do want to pick up on some
19 information requests and just put these on the public
20 record.

21 First of all I will acknowledge, as our staff
22 would, that since the issuance of the subpoenas we have been
23 provided--before, but particularly after the issuance of the
24 subpoenas--significant information.

25 There are a couple of additional items I would

1 like, though, to note for the record here and ask if we can
2 please get this information as soon as possible.

3 We asked for some information, as complete as
4 possible, on the basis for the marks you made, particularly
5 with respect to mortgage-backed securities or synthetic
6 CDOs, all the mortgage-related securities for which there
7 was not essentially an active trading market.

8 So we would like to get the basis for the marks
9 you made during 2007-2008, particularly with respect to
10 those marks provided to AIG.

11 And also, I know that you've provided us some
12 information about the marks that were given with respect to
13 the Bear Stearns Asset Management Funds, and you have
14 provided that. We do not believe it is complete at this
15 point, but we would like to follow up with you on that
16 matter.

17 So can we have your commitment that we can get
18 that information so that we can understand the basis of your
19 marks, how you marked to market, very specifically?

20 WITNESS COHN: Absolutely.

21 CHAIRMAN ANGELIDES: Okay. Thank you.

22 Secondly, we have requested information because
23 you've stated many times that you were fully hedged against
24 events at AIG. Clearly, Goldman did purchase credit default
25 swap protection with respect to AIG. And you have provided

1 us in a sense in aggregate the counterparties from whom you
2 purchased that protection. But you have not yet provided us
3 the specific amounts from those counterparties. You know,
4 for example there may be a purchase of \$100 million of CDS
5 that lists the counterparties, but it doesn't break it into
6 the specific amounts. And we are particularly interested,
7 since the company stated it was fully hedged, in the level
8 of CDS protection that existed pre-essentially Federal
9 Reserve loan to AIG, so that we can understand the nature of
10 your hedging, whether it was full hedging or phantom
11 hedging, or who the counterparties were and what their
12 position was.

13 So can we have your commitment to get that
14 information?

15 WITNESS COHN: Absolutely.

16 CHAIRMAN ANGELIDES: Thank you.

17 WITNESS COHN: And it would have all been pre.
18 So that's fine.

19 CHAIRMAN ANGELIDES: Good. Next, and this may
20 take a few minutes to go through. We have asked for
21 information so we understand the extent--and Ms. Born may
22 follow up on this also but this is on my time right now to
23 alleviate some of your burden--is that for revenues and
24 profits from derivatives trading as a business.

25 Now I know Mr. Viniar in his statement has said,

1 well, we don't really have a derivatives business, so to
2 speak. And to date I think Goldman Sachs has told us that
3 providing revenues and profits from derivatives' trading and
4 dealing business isn't possible. But we would like that
5 information.

6 And let me just say, it seems to me that from a
7 management perspective you've got to be able to cut your
8 revenues and your operations in many different ways--
9 horizontally, vertically, diagonally. So maybe there's been
10 a miscommunication.

11 Is it possible to get from you the management
12 reports that would indicate the size and nature of the
13 revenues and profits from derivatives' dealing?

14 WITNESS COHN: We would not have management
15 reports that would break it down that way. As I said in my
16 opening statement, we look at our risk aggregate. And
17 whether you're looking at a cash security or a derivative of
18 that cash security, it's the same underlying risk. And
19 therefore we manage it in one bucket.

20 So when--

21 CHAIRMAN ANGELIDES: So you have no breakdowns
22 for any of your managers in which you can segregate out your
23 derivatives activities and the cash flows that come from
24 that activity from your other activities? So in other
25 words, you might have an underlying security, and you might

1 have derivatives, and you don't separate that in any way,
2 shape, or form in any of your operational reports for
3 managers?

4 WITNESS COHN: We don't. We look at our net
5 delta, is what I would call it. So I'll use a simple
6 situation.

7 If you're long 100 shares of stock, you're long
8 100 shares. If you're long one at-the-money option, it's
9 got a 50 delta. So it's 50 shares. So if you had those two
10 positions, you'd be long 150 shares. And we look at that as
11 a 150-share risk.

12 And now we run some other risk parameters, saying
13 if the market moved 5 percent up, or 5 percent down, what
14 would the risk parameter look like, but it's virtually
15 impossible for us to separate those two because the same
16 exact underlier will determine the profit and loss and
17 actually you'll use that to show the risk.

18 CHAIRMAN ANGELIDES: What about revenues apart
19 from profit and loss? Fee income generated by derivatives
20 dealing?

21 WITNESS COHN: We could break out underwriting
22 fees, because they are actually distinct fees.

23 CHAIRMAN ANGELIDES: All right, because I'm doing
24 this for the benefit of the Commission, I don't want to eat
25 up all my time. Not I--I believe we want to pursue this

1 matter, and so I think probably the best way is we need to
2 have a more fulsome discussion to see how you do break it
3 down. It just seems to me you're pretty smart guys. You've
4 got to have a lot of ability in your management reports to
5 see how you're doing in different divisions, who's
6 performing, who's not; what spreads are. So we would like
7 to pursue this discussion.

8 WITNESS COHN: We are happy to work with your
9 staff and give them as much transparency as we have. But
10 I'll be honest with you, we can dig and dig, we won't find
11 that report.

12 CHAIRMAN ANGELIDES: All right. So the last
13 thing I said, there are other items, and our inquiry is
14 ongoing, and I will leave it at that.

15 So let me jump right into what I would like to
16 address today. I don't know if you had a chance to hear the
17 previous session with the AIG folks?

18 WITNESS COHN: We heard some of it.

19 CHAIRMAN ANGELIDES: Okay. Well I do want to--
20 you know, I do want to pursue what people did in the
21 marketplace and why they did it. And to particularly pursue
22 this matter of the relationship between AIG and Goldman
23 Sachs, and the valuation of the CDS book, and the collateral
24 calls, and the posting of collateral with respect to that
25 book.

1 And at a certain level I am looking not for a
2 "who done it," but trying to understand who built this bomb,
3 who might have built bomb shelters, and who and when the
4 fuse was lit for all this.

5 So we have established already--and I don't think
6 we need to go over it--but just for the record, that you
7 were clearly very active in the creation of mortgage-backed
8 securities, synthetic CDOs, by our account I think from July
9 '04 to May '07 you did about 48 synthetic CDOs; about 3500
10 tranches that were referenced. I think Mr. Georgiou is
11 going to talk about this in more detail.

12 In 2007, by your own account you were very active
13 in CDO issuance and RMBS issuance. So clearly this was a
14 market with which you were very familiar. And my
15 understanding is that, Mr. Cohn, in your interview, and Mr.
16 Broderick, in your interview, you did stipulate that the
17 creation of synthetic products did allow for more leverage,
18 possibly inflating the bubble some.

19 What I wanted to really focus on, though, is I
20 wanted to focus on the other side of this equation, the
21 protection you were buying from AIG, and to understand how
22 this worked.

23 Particularly, given that it was an over-the-
24 counter market, it was opaque, there appeared to be
25 disruption in the market, very hard to get price discovery;

1 you may have known that in our earlier session I entered
2 into the record a chronology of essentially your decisions
3 in December 2006 to, quote/unquote "get closer to home," to
4 reduce your exposure to subprime, to begin to reposition
5 yourself, a chronology that starts there and then really
6 marches through the collateral calls you made to AIG, the
7 responses to those, the postings that were made. Also that
8 chronology includes the protection you bought against AIG.

9 If you look at the chronology--and I think you
10 are aware of this--Goldman was first going in the door
11 asking for collateral. Goldman was by far the most
12 aggressive in terms of the time frame and the amount asked
13 for.

14 As of 12/31/07 you were about 27 percent of the
15 CDS book, and you had had posted on your behalf 89.4 percent
16 of the total collateral posted. By June 30th of '08 you had
17 48 percent of the total collateral calls were yours versus
18 27 percent of the total book.

19 I mean, you were way ahead of everyone else in
20 terms of amount being demanded and the time frame for that.

21 Your marks were consistently lower than other
22 participants in the marketplace. And so as I said earlier,
23 I am trying to understand. I think it became quite a matter
24 of discussion here about how this worked.

25 Does the setting of marks move the market? Did

1 you have reasons, because at least according to some
2 accounts you were net short in 2007 to move the market down.
3 And as I said earlier, you know, I wondered whether this was
4 just pure straight-up business negotiation, or whether there
5 was in fact like a Discovery Channel the Cheetah hunting
6 down the member of the herd. Or whether, in some respects,
7 knowing or unknowing, motivation aside, that the Goldman
8 calls against AIG were the first dominos in a chain that
9 began to drag down at least market valuations versus
10 economic losses of these portfolios.

11 So let me start with this: You go in the door--
12 first of all, I know you made very aggressive marks. You
13 made your decision in December of '06 to reposition yourself
14 to get closer to home, to reduce subprime risk, to start
15 marking the inventory.

16 In March of 2007, in one of the offerings out in
17 the marketplace--and this was a standard offering--you said
18 there's no established trading market for the securities.
19 That was in a synthetic CDO, one of the Timberwolf CDOs.

20 May 11th, Mr. Broderick, this is where you send
21 your memo saying we're in the process of considering making
22 significant downward adjustments to the marks on their
23 mortgage portfolio and that, quote, "this will have
24 potentially big P&L impact on us, but also our clients due
25 to the marks and associated margin calls."

1 In May you send to the Bear Stearns Asset
2 Management Group, according to reports--and that's what I
3 want to verify--marks that are at 50 to 60, where other
4 marks are in the 90s.

5 When you make your collateral call to AIG, the
6 shear amount of it stuns them. It's \$1.8 billion. The
7 marks are dramatically, as they say, Goldman's prices were,
8 quote/unquote, "ridiculous," that's Mr. Forster.

9 On August 1st there's an e-mail from Mr. Athan to
10 Mr. Forster at AIGFP saying that Goldman was, quote, "not
11 budging and are acting irrational." And of course that
12 collateral call was pulled down significantly, because it
13 was based on bids not the midpoints, apparently.

14 But--and I go through more of this, and I will,
15 but all through the next several months you're asking for
16 more. You're marking it significantly below the rest of the
17 market. Why is this?

18 What do you know? What do you know about the
19 market that everyone else doesn't know that puts you in a
20 position of marking these securities at significantly lower
21 levels and making these kinds of calls?

22 WITNESS COHN: Chairman Angelides, let me start.
23 First of all, on your point that we had called for more
24 collateral from AIG and had collected more collateral than
25 anyone else, I think you should go back and reference the

1 different trading documents.

2 I'm not sure all the counterparties had the
3 ability to call for collateral. AIG was a highly rated
4 counterparty and was not easily--did not like to sign two-
5 way margin agreements. So you should check with that first
6 to see if anyone else had the ability to collect margin.

7 CHAIRMAN ANGELIDES: And I will say, we will do
8 that. But the charts that are in the documents that we put
9 out do reflect others marking margin calls.

10 WITNESS COHN: I understand.

11 CHAIRMAN ANGELIDES: Like SocGen who accelerate
12 theirs, about a year after you are.

13 WITNESS COHN: Okay. There were different
14 provisions in different trading agreements. Let's not spend a
15 lot of time on that.

16 CHAIRMAN ANGELIDES: But we'll do that.

17 WITNESS COHN: Okay. Let's go to the second part
18 of your questions, which was why were our marks where our
19 marks were.

20 And if you look at our trading agreement with
21 AIG, it very clearly states our marks are to be determined
22 by fair value, not fundamental value. Our determination of
23 fair value is where things are transacting, or one would
24 interpret a transaction to take place, based on other
25 relevant transactions going on in the market.

1 So until there is a transaction, or until there
2 is some transaction that equates to a security you have, it
3 is difficult to mark the book. But what was happening
4 during this period of time, you went through a period of
5 time where you had increased volatility.

6 In increased volatility what normally happens in
7 markets is bid offers widen, because people are unsure of
8 the real underlying value. Bid offers widen, and then
9 eventually some trades start taking place. As more and more
10 trades start taking place, the market tends to converge
11 around an area of value.

12 So what we did is, as trades took place we used
13 those actual real live trades as reference points to create
14 fair value in marking our book.

15 CHAIRMAN ANGELIDES: So you're telling me in the
16 spring and summer of '07, leading up to those collateral
17 calls, you have actual trades at those values substantiating
18 not just an episodic but substantiating the market?

19 WITNESS COHN: Yes.

20 CHAIRMAN ANGELIDES: Okay, we'd like to have that
21 provided to us. Because what we're seeing from other
22 documents is we're seeing the fact that it was a disrupted
23 market, and that there weren't real trading values. And in
24 fact, if you heard the testimony earlier today, when Goldman
25 first makes its collateral call, as I said, it was revised

1 from 1.8 down to 1.2 on the basis that it was--yes, sir?

2 WITNESS COHN: It was revised from 1.8 to 1.2,
3 and then they paid us the money--

4 CHAIRMAN ANGELIDES: They paid 450--

5 WITNESS COHN: Exactly.

6 CHAIRMAN ANGELIDES: Exactly, exactly. But it
7 was revised downward, and you did settle temporarily but
8 with a stand-still agreement for 450, but according to Mr.
9 Cassano, Mike Sherwood at Goldman admitted that when he and
10 Cassano spoke in September, Cassano recalled that Mr.
11 Sherwood said that Goldman, quote, "didn't cover ourselves
12 in glory."

13 Then he goes on to say that, quote, "The market
14 is starting to come our way," which implies that you had a
15 position in the market, indications at least from Mr.
16 Blankfein and others that you were net short. And at least
17 Mr. Cassano took it that he interpreted Mr. Sherwood's
18 comments as an implicit admission that Goldman's initial
19 collateral calls were too low.

20 And I guess my question is: In this kind of
21 marketplace, if someone is net short, if you were, someone's
22 net long, at some point you criticized AIG's mark saying,
23 well, it's in their interest to keep them high because
24 they're in their position. Were you at all motivated by the
25 fact that you were net short to begin pushing prices down?

1 WITNESS COHN: No. We had transactions on the
2 other side. We were paying out the equal and opposite
3 margin to our clients on the other side.

4 So as I said in my opening statement, in AIG we
5 sat in the middle of buyers and sellers. We had one set of
6 books, one set of marks. We collected on those marks. We
7 paid on those marks.

8 So to the extent we were moving marks up or down,
9 it was money in the door going right back out the door to
10 the other side.

11 CHAIRMAN ANGELIDES: Just--I know I've been
12 talking fast, but collateral calls too high marks, too low.
13 That's what I meant.

14 WITNESS COHN: Yes, I knew what you were saying.

15 CHAIRMAN ANGELIDES: Yes, I knew you knew what I
16 meant. But let me explore this a little more. There are
17 actually three additional documents I'd like to enter into
18 the record, which were provided by your counsel and cleared
19 by your counsel today, I might add, in our discussions with
20 our counsel.

21 There's a memo that ultimately floats up to Mr.
22 Lehman. It's from a Ram Sundaram (phonetic) in your shop.
23 And it's on actually the very day you're making the
24 collateral call to AIG. And he says: The extent of
25 collateral calls being generated overnight is embarrassing

1 for the firm, \$1.9 billion from AIGFP alone. We need to
2 focus on developing a process for ensuring accuracy for all
3 marks, especially those which are being sent to clients and
4 those that are the basis for margining open transactions.

5 And it looks as though there's a lot of dispute.
6 SocGen, apparently, according to AIG, was contacted by
7 Goldman Sachs, as AIG would have it, to encourage them to
8 make a collateral call, but they end up not making it and
9 disputing your marks.

10 I have two other documents here I'd like to enter
11 into the record. The first one, by the way for the record,
12 starts with an e-mail from Mr. Lester Brafman to David
13 Lehman dated July 27th. The second document is from David
14 Lehman to Daniel Sparks, and it's about some feedback. It's
15 an e-mail string from J. Lee to David Lehman about AIOI
16 Insurance. They are objecting to your marks. This is on
17 July 31st, saying: Our marks--meaning Goldman's marks--are
18 more than twice as bad as the second-worst dealers, and all
19 their positions are super senior. It sounds like getting a
20 margin call out of them will be an issue.

21 It goes on to say: Earlier, also about the same
22 organization, he said, our margin call based on our MTM was--
23 --mark-to-market--was totally unaccepted; warned he will
24 strongly protest against this.

25 And there's another e-mail from an Alana Ash to,

1 it comes to you, Mr. Broderick, in which it indicates that
2 both CIBC and AIG are contesting marks.

3 I guess I really do want to get to the root. In
4 this non-traded market, I'm trying to get the extent to
5 which you are making a market in marks by what you're doing.
6 By your pushing these marks down, are you pushing prices
7 down?

8 WITNESS COHN: We are not pushing prices down
9 through marks. The market itself is setting pricing levels.

10 And most importantly, we were prepared, openly
11 prepared, to trade at those marks.

12 CHAIRMAN ANGELIDES: But did you?

13 WITNESS COHN: We have traded at those marks.

14 CHAIRMAN ANGELIDES: Okay, this is why we wanted
15 the information, and have asked for the information. And
16 I'm not saying you withheld it, but to see the actual basis,
17 on actual marks for that time period I think is crucial to
18 this discussion.

19 All right. I am going to stop at this moment. I
20 will return to this subject, but I want to leave time for
21 the other Commissioners.

22 Mr. Vice Chairman?

23 VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman.
24 I will apologize to my fellow Commissioners because I did
25 not ask the last panel if they would answer questions in

1 writing. I am sure they will.

2 So I won't be negligent with you fellows.

3 Obviously we're going to have additional questions. I would
4 very much like for you to respond in the positive to my
5 question of: If we get questions to you in writing, would
6 you get them back to us?

7 WITNESS COHN: Yes.

8 WITNESS BRODERICK: (Nods in the affirmative.

9 VICE CHAIRMAN THOMAS: She can't record a nod.

10 WITNESS BRODERICK: Yes.

11 VICE CHAIRMAN THOMAS: Thank you. My assumption
12 is there won't be a subpoena necessary to follow up on that.

13 WITNESS COHN: No.

14 VICE CHAIRMAN THOMAS: Your apology I guess was,
15 you know, nice. I actually just thought that we were
16 engaged in business the way your reputation indicates you
17 engage in business, and you were going to do what you were
18 going to do until we could trump you in a way that you
19 couldn't keep doing what you were doing.

20 So it was a business relationship. We weren't
21 getting answers, so we issued a subpoena. You're now being
22 responsive. And if that's the ground rules, we operate by
23 the ground rules.

24 This morning--I don't think you were here earlier
25 enough to hear the first panel of economists--we were just

1 talking about fundamental derivatives, what were they, how
2 did they come about, how do we wind up with what we were
3 doing in the housing market.

4 And I want to kind of shift it to a much broader
5 questions, only because you guys are big in almost every
6 field you go into, and you're good at what you do, and I
7 would like to ask you some questions:

8 If you think there's any validity to the
9 statement of one of our panel members, Dr. Kohlhagen. I
10 asked him at the end: What did you think was the
11 fundamental cause, or one of the principal causes of the
12 financial crisis?

13 And he focused very tellingly and directly on the
14 government's desire to get people into their own homes. You
15 can look at the Community Reinvestment Act, with both
16 Republican and Democratic Administrations, in attempting to
17 get people into their own homes through Fannie Mae and
18 Freddie Mac. And his statement was, he said that the
19 government went to Wall Street and asked them to lend to
20 more people.

21 Wall Street responded: So you want us to lend to
22 people with lower credit quality? Watch us, in terms of
23 having an opportunity to move vigorously in a particular
24 area.

25 So I assume you would answer yes to the question:

1 Did Goldman help facilitate the new mortgage market? I
2 mean, once we started moving away significantly from
3 originating-to-hold to originating-to-distribute, you've got
4 to wind up with some structures.

5 I'm trying to figure out where you guys were,
6 looking at opportunities. Your chairman came before us on
7 our original panel and said your job was to make markets.
8 And so I assumed you looked at this opportunity, and you
9 looked at what was going on your general field, and you came
10 up with some ideas to make markets like CDSs and CDOs.

11 What was your mindset in terms--were those
12 necessary devices? Were they the best ones available? I
13 don't know anything about you guys' business or how things
14 operate. So were there other ways to do it? Or were those,
15 based on your valuation, the best way to get into the
16 business of what we wound up getting in over our heads on?

17 WITNESS COHN: Mr. Vice Chairman, let me explain.
18 Our business is pretty fundamental. We are a client
19 facilitator.

20 VICE CHAIRMAN THOMAS: Um-hmm.

21 WITNESS COHN: We have clients that we interact
22 with all over the world. They come to us on a real-time
23 basis all over the world trying to buy or sell certain risk,
24 certain assets, certain securities.

25 We respond to what they want--

1 VICE CHAIRMAN THOMAS: Could I pause on that
2 basis? Because one of the things about advertising, plus or
3 minus, is that they help create markets by getting people to
4 want something they didn't know they wanted.

5 Are you engaged in creating markets on that basis
6 at all, where you come up with an idea and see if people
7 like it? Or are you simply a sponge, soaking up what people
8 come to you with?

9 WITNESS COHN: We're not that smart to anticipate
10 what people are going to want.

11 VICE CHAIRMAN THOMAS: I'm going to put that
12 statement in the category with the apology, but that's okay.

13 WITNESS COHN: Okay. What we are smart enough to
14 do is listen to our clients and react to what they tell us
15 they want.

16 So when a client calls me and says, hey, I have a
17 long mortgage exposure. I need to find a way to go short.
18 Please work with me. We work with the client. And that's
19 how our business evolves over time. It is really
20 facilitating our client franchise.

21 VICE CHAIRMAN THOMAS: Okay, and so you start
22 with something that's kind of more fundamental, the CDO,
23 CDSs. Did they come to you with the idea of synthetic CDOs?
24 Or did you come up with that as a way to better facilitate
25 what they had originally asked for? How did you get into

1 synthetic CDOs?

2 WITNESS COHN: I don't know precisely the moment
3 that a synthetic was created. I'm not sure we did the very
4 first. The half life of creativity in the financial service
5 industry is about 30 seconds. The minute you publish a new
6 transaction or do something, because there are underwritings
7 and you have to publish prospectus, the entire world gets to
8 see what you did.

9 VICE CHAIRMAN THOMAS: I wasn't interested in
10 giving someone an award for being first. You were into it.

11 WITNESS COHN: We respond--

12 VICE CHAIRMAN THOMAS: You got into it for
13 reasons that allowed you to do more of, better than?

14 WITNESS COHN: We did it for reasons that our
15 client franchise demanded us to be there.

16 VICE CHAIRMAN THOMAS: Boy, for you guys not
17 being very clever, you make a lot of money.

18 In looking at two groups who were here before us
19 today, the AIG group, and you guys, and activities that
20 other folks are going to talk about in that more narrow
21 relationship, you have a lot of clients. And obviously one
22 of your concerns would be to make sure that you spread risk
23 over as broad a basis as possible because you don't want to
24 concentrate it?

25 Would you describe the relationship between

1 Goldman and AIG as probably concentrating more risk than you
2 would otherwise have liked, but they were there and, you
3 know, you play tennis with who shows up at the court
4 sometimes, not who you wanted to play tennis with?

5 WITNESS COHN: It's impossible for me to say what
6 AIG had on the other side. AIG was an important client, and
7 an important relationship to us. They constantly wanted to
8 be more and more involved in this market.

9 VICE CHAIRMAN THOMAS: And you were facilitating
10 your customers.

11 WITNESS COHN: We were facilitating our
12 customers.

13 VICE CHAIRMAN THOMAS: So you did more of it.

14 WITNESS BRODERICK: Commissioner, may I comment
15 on that?

16 VICE CHAIRMAN THOMAS: Sure.

17 WITNESS BRODERICK: If you think about AIG at the
18 time that we were dealing with them, which was primarily in
19 this space in the '04 and '05 period, they looked like the
20 perfect customer for this.

21 They were not by any means our only customer, or
22 even our majority customer, but they were--

23 VICE CHAIRMAN THOMAS: Who was bigger than them?

24 WITNESS BRODERICK: They were the largest in this
25 space in particular.

1 VICE CHAIRMAN THOMAS: Yes, so that they were.

2 WITNESS BRODERICK: In this particular space,
3 that's right.

4 VICE CHAIRMAN THOMAS: Right.

5 WITNESS BRODERICK: But from looking at them as a
6 suitable, appropriate counterparty, they really ticked all
7 the boxes. They were among the highest rated corporates
8 around. They had what appeared to be unquestioned
9 expertise. They had tremendous financial strength. They
10 had huge, appropriate interest in this space, backed by, you
11 know, a long history of trading in it.

12 So it was, from an assessment of appropriate
13 counterparties' perspective, they looked like the right type
14 of entity to do a substantial amount of business with.

15 VICE CHAIRMAN THOMAS: I don't think I ever got
16 an answer out of you in terms of Dr. Kohlhagen's initial
17 suggestion that this was basically government, and as I said
18 bipartisan, Republican and Democrat Administrations, trying
19 to move people into homes. And people were accommodating
20 that with new inventions, and willingness to move down
21 quality measures to get people into them.

22 And of course we saw the quality move from some-
23 down to nothing-down, to some indication of income that you
24 could cover it, to no docs in which there's no income
25 necessary. And you kept generating these documents based on

1 mortgages that continued to look worse than we've ever seen
2 before, but for some reason the rating companies were giving
3 them high ratings.

4 And I'm getting back to the whole question of,
5 your goal, stated by your chairman, and you again repeating
6 it here, that your job was to make markets, and I assume to
7 make efficient markets, and to be a facilitator to making
8 things happen. So would it be fair for me to look at this
9 relationship that we wound up getting into as, to a certain
10 extent, a market promoted by government, and that you were
11 more than willing to cooperate in that, supporting a
12 government-supported structure helped build a pyramid that eventually
13 collapsed?

14 WITNESS COHN: There is some truth to that, but
15 it's not the whole truth.

16 VICE CHAIRMAN THOMAS: Oh, just some truth is the
17 best answer I've had in a long time. So let's focus on the
18 "some" not the "whole." S-O-M-E.

19 WITNESS COHN: As there was a social agenda to
20 increase home ownership in the United States, many of the
21 bodies that were out there to promote home ownership,
22 including the agencies, were by statute lowering their rules
23 and regulations to accept different and new types of loans.

24 So there was a major decision for the agencies to
25 get into the subprime market; that they would then accept

1 subprime loans.

2 VICE CHAIRMAN THOMAS: But your ability to assist
3 them in creating products which absorbed them, securitized
4 them, and getting people to participate, was there ever a
5 discussion at Goldman that this was also a kind of a
6 positive social policy that we ought to work with to make
7 sure those get soaked up and plugged into the system? And
8 you could make money off of doing that?

9 WITNESS COHN: I wouldn't go as far as to say
10 there was a social policy discussion. It was just the
11 natural ebb and flow of the market. The mortgage
12 originators that were looking to sell mortgage product that
13 they had originated with individual homeowners started
14 looking differently than what we were used to.

15 We went to the traditional buyers of mortgage
16 asset-backed and mortgage security paper and said, are you
17 interested in buying this? What is the price? What is the
18 yield? What is the discount you need to commit capital to
19 that space? And we intermediated between the originator of
20 the loan and the ultimate buyer of the loan.

21 VICE CHAIRMAN THOMAS: So sometimes don't you try
22 to sell? You're just not there as a facilitator and you're
23 playing to manipulate--so if you had these products, and you
24 wanted to sell them, did you ever refer to them in terms of
25 the rating companies, in terms of AAA and other associated

1 descriptions?

2 WITNESS COHN: There were always rating agency
3 descriptors involved. But more important than rating agency
4 descriptors was the actual price. The prevailing price
5 would give you a much clearer picture of what the market
6 would think about the real underlying value and the value of
7 the collateral.

8 VICE CHAIRMAN THOMAS: Okay, and now I'm going to
9 reserve my time, but I just have to go back at you a little
10 bit. And I understand the shtick you go through in terms of
11 who you are and what you do, but if you have brokers making-
12 -traders making calls, and you have flip books showing
13 through your Abacus transactions what people can have, I
14 mean that's basically selling, and advertising, and
15 attempting to get people to accept something that you have
16 created, and offered, and think you can make money on, isn't
17 it?

18 WITNESS COHN: We think we can make money, but
19 the evolution of the flip book was a client response, a
20 reverse-inquiry, as we call it. When a client inquires to
21 us: Can you create XYZ for me? And they may not want the
22 entire structure, but they want a chunk of it that's large
23 enough that we make a business decision, if they take that
24 piece, are we prepared to take the rest and then
25 redistribute it?

1 VICE CHAIRMAN THOMAS: I understand, and I
2 actually can do that, too, having been successfully elected
3 16 times. You ask me something, I can give you an answer
4 exactly the way I want it. And I'll end this session by I
5 better understand our need to have issued a subpoena to get
6 information out of you.

7 Mr. Chairman.

8 CHAIRMAN ANGELIDES: Very quickly, I just, since
9 you raised it, I want to kind of just finish up rather than
10 doing it at the end. I do want to just pick up on something
11 you were on a trail of.

12 The only thing I want to say for the record, and
13 I know the other Commissioners will surely deal with this,
14 is the idea that a synthetic CDO helped to meet a housing
15 goal is still unexplained to me.

16 Other Commissioners I think will probe this
17 issue, but I don't see the way in which it created more
18 capital specifically to create more housing opportunity.

19 But the way I've been looking at it, a bomb went
20 off. And it's pretty clear to me, and you weren't the sole
21 participants here, is that Goldman participated in building
22 the bomb. You were very active issuers of the very
23 securities that ultimately blew up. I don't think that's
24 disputed, and I don't think you were the sole folks in that
25 arena, but clearly you did that.

1 I don't think it's disputed that you built a bomb
2 shelter, starting in December of '06; that you decided,
3 looking at the market, that it was time to protect yourself.

4 What I'm trying to get to is how did this cascade
5 of events really begin. Was it the underlying poor quality
6 of the rotten nature of the subprime loans in the market?
7 Or was it in fact activities of market participants that in
8 the same way that they pushed prices up, and the bubble
9 pushed them down as the bust came. So that's why I'm
10 interested in this interplay between you and AIG.

11 And I just want to ask one more time. If you
12 look at an August 16th e-mail from Andrew Forster at AIGFP
13 to Alan Frost, he said: I've heard several rumors now that
14 GS is aggressively marking down asset types that they don't
15 own so as to cause maximum pain to their competitors. It
16 may be rubbish, but it's the sort of thing GS would do.

17 On September 11th, there's an e-mail from Tom
18 Athan at AIGFP where it says SocGen NY said they, quote,
19 "received marks from GS on positions that result in big
20 collateral calls, but SG disputed them with GS."

21 If you go on, there's an e-mail from Joe Cassano,
22 November 1st, that said that the collateral call from SocGen
23 was, quote, "spurred by GS calling them," and AIGFP had not
24 heard from SocGen since disputing the call, but obviously
25 the allegation is you told SocGen get in there and make a

1 call.

2 So I guess, what do you say to people who ask you
3 the question: How would you tell me you didn't drive prices
4 down? Let me reverse it. What's the objective evidence I
5 can look at to understand this market to see whether there's
6 fair pricing going on, or this is really just a struggle
7 between people, big financial institutions who have a very
8 distinct market position?

9 WITNESS COHN: To me, it's simple. Actual trades
10 and the fact that we were willing, and we were aggressively
11 willing, to liquidate our portfolio back to those clients at
12 those marks.

13 CHAIRMAN ANGELIDES: Well then the proof will be
14 in the pudding. And I think the trail of marks, the trail
15 of transactions, whether it was really a liquid market or
16 whether those were episodic trades I think will be very
17 revealing.

18 All right, let's go to Ms. Born.

19 COMMISSIONER BORN: Thank you very much, and
20 thank you both for appearing.

21 I would like to focus on Goldman Sachs' business
22 in over-the-counter derivatives. Am I correct that Goldman
23 Sachs conducts an enormous over-the-counter derivatives
24 business?

25 WITNESS COHN: We have a very active business. I

1 don't know if it's "enormous." I mean, there's not a lot of
2 details on who does what in the over-the-counter market. We
3 are a very active player.

4 COMMISSIONER BORN: Well I think your Chief
5 Financial Officer, David Viniar, told Commission staff that
6 Goldman Sachs is one of the top five over-the-counter
7 derivatives dealers in the world. Do you think that's
8 incorrect?

9 WITNESS COHN: I think that's accurate.

10 COMMISSIONER BORN: At the end of 2009, isn't it
11 correct that Goldman held 1.2 trillion over-the-counter
12 derivatives in the notional amount of \$45.6 trillion, more
13 than four times the gross national--gross domestic product
14 of the United States?

15 WITNESS COHN: Do you know that, Craig?

16 WITNESS BRODERICK: I don't know the precise
17 number. It's certainly very large.

18 COMMISSIONER BORN: I think Goldman Sachs told
19 our staff that the two of you were the most knowledgeable
20 about your derivatives business.

21 WITNESS COHN: We are quite knowledgeable, but I
22 don't know the exact notionals at any moment in time.

23 WITNESS BRODERICK: And in fact notionals from a
24 pure risk perspective, or any other management perspective,
25 is really not especially meaningful, in fact not meaningful

1 at all.

2 WITNESS COHN: Which goes back to the panel this
3 morning.

4 COMMISSIONER BORN: Well this is the data that
5 the Office of the Comptroller of the Currency has published
6 for year-end in terms of your position in over-the-counter
7 derivatives. Do you think they are inaccurate? I assume
8 they get that data from you.

9 WITNESS BRODERICK: The data may very well be
10 accurate. The point I think we are both making is, that
11 wouldn't be the metric that we would choose to reflect
12 relative size, or relative risk inherent in a business. The
13 example that was provided earlier today by a couple of your
14 Commissioners where they did, on a pretend basis, obviously,
15 \$2 trillion in completely offsetting risk demonstrated that
16 pretty clearly.

17 COMMISSIONER BORN: Well perhaps when you give us
18 your revenues and pre-tax earnings on your over-the-counter
19 derivatives dealing, we'll have another and perhaps better
20 measure of the size of your business, don't you think?

21 WITNESS BRODERICK: Mr. Cohn was very clear that
22 from a firm MIS perspective, breaking out derivatives
23 specifically from the rest of our trading business is not
24 something that we do. It's not something that has any
25 meaning to us from a risk perspective.

1 VICE CHAIRMAN THOMAS: I'm sorry? What is "MIS"?

2 WITNESS BRODERICK: Management Information,
3 sorry.

4 COMMISSIONER BORN: Well it may not be something
5 you do as a regular basis for your management, but I'm sure
6 you have the financial records to do that.

7 WITNESS BRODERICK: I'm not even sure how you
8 would, though, because the example that Mr. Cohn provided
9 was a equity, of cash equity position, and a delta
10 equivalent option position, which perhaps you could take
11 those two trades and say, okay, of a total trading amount of
12 trading gain of X, we can allocate two-thirds to cash and
13 one-third to options, and maybe you could reconstruct
14 something like that. But then take much more complicated
15 positions, which is in fact what we have on our books, where
16 you don't have two longs that nicely aggregate. You have a
17 long and an off-setting hedge, of which part of the long
18 will be cash, and part of the short will be, a hedge will be
19 cash and part will be derivatives.

20 And so allocating complicated dynamically managed
21 positions on an ongoing basis, and allocating specific
22 revenues to them, I frankly don't know how you would do it
23 even conceptually.

24 COMMISSIONER BORN: Well we will certainly go
25 into this in more detail with Mr. Viniar tomorrow, but it

1 seems to me it must be a little difficult to manage the risk
2 in your derivatives portfolio if you're not able to measure
3 the portfolio and the profits and revenues related to it.
4 Isn't it, Mr. Broderick?

5 WITNESS BRODERICK: We don't--

6 COMMISSIONER BORN: I thought you said that to
7 manage things you needed to measure them?

8 WITNESS BRODERICK: Absolutely. But what we
9 manage, and what we measure, is the positional risk that we
10 have across products, and across counterparties, and across
11 all sorts of other parameters. All of those aggregate,
12 cash, and derivatives, and other positions, on the basis
13 that that's what's really meaningful to us.

14 Whether we have exposure in market risk terms in
15 the form of derivatives or in cash products is not really
16 what's meaningful.

17 Now there are exceptions to that, right? So when
18 you're thinking about managing derivatives, there are credit
19 risks which occur in derivatives which don't occur
20 equivalently in cash. And so for credit risk purposes we
21 pull out the current exposure and potential exposure, and
22 other metrics associated with those derivatives.

23 But for the question which you're asking, which
24 is how you allocate--how you think about market risk, it
25 really is not relevant to us the precise form in which they

1 occur.

2 COMMISSIONER BORN: Well the Office of the
3 Comptroller of the Currency reports on an annual basis what
4 the revenues on derivatives are from commercial banks. You
5 have a great deal of derivatives trading through your
6 commercial bank entity that's reported, as well.

7 Do you suppose that you're telling the Office of
8 the Comptroller of the Currency that you can't give them the
9 revenues from that operation?

10 WITNESS BRODERICK: From the--which operation?

11 COMMISSIONER BORN: From the derivatives
12 operation. That's what they report. They reported that the
13 commercial banks in 2009 had \$22.6 billion in revenues.

14 WITNESS BRODERICK: I'm not aware that we can do
15 that. We can certainly follow up.

16 COMMISSIONER BORN: Well I would be interested in
17 seeing exactly what you report on a quarterly and annual
18 basis to the Comptroller of the Currency in terms of your
19 derivatives' related revenues.

20 What proportion of the over-the-counter
21 derivatives' contracts that Goldman enters into with
22 counterparties are standardized? And what portion are
23 customized? And by "standardized," I mean sufficiently
24 standardized so that they would be theoretically capable of
25 clearing on a clearinghouse.

1 WITNESS COHN: It's something that right now
2 we're looking at to some degree. I would not be able to
3 answer that question.

4 COMMISSIONER BORN: You don't even have a
5 ballpark estimate?

6 WITNESS COHN: It would be a bad guess.

7 COMMISSIONER BORN: Would it interest you to know
8 that Jamie Diamond of JPMorgan testified under oath before
9 this Commission that approximately 75 to 80 percent of
10 JPMorgan's derivatives' contracts are standardized? And do
11 you think that would have any comparability to Goldman's
12 activities?

13 WITNESS COHN: It may. I mean, we are in very
14 similar businesses to each other, so I would think there
15 would be a high degree of correlation between what their
16 book of business looked like and what ours did.

17 COMMISSIONER BORN: Well I would ask you to
18 provide to the Commission--and I think we asked you this in
19 January as well--to provide to the Commission the proportion
20 of your derivatives' contracts that are standardized as
21 opposed to customized.

22 WITNESS COHN: (Nods in the affirmative.)

23 COMMISSIONER BORN: Can you tell us what proportion--

24 VICE CHAIRMAN THOMAS: Was that a 'yes'?

25 WITNESS COHN: Oh, sure.

1 VICE CHAIRMAN THOMAS: Oh, okay. Because when
2 you nod, it's really hard to pick up for the record what it
3 was that you respond to. Thank you.

4 COMMISSIONER BORN: Can you tell us what
5 proportion of your over-the-counter derivatives business
6 consists of acting as a dealer with customers, and what
7 portion is proprietary trading on behalf of Goldman Sachs
8 itself?

9 WITNESS COHN: I would say the vast, vast
10 majority of our over-the-counter business is customer-
11 related, ninety-plus percent.

12 COMMISSIONER BORN: Would you also be able to
13 provide us with more exact statistics, please? Because we
14 asked for this in January, as well, and we haven't received
15 it.

16 WITNESS COHN: We will try. Again, it will be a
17 best-efforts to come up with the number.

18 COMMISSIONER BORN: We would also, and I think
19 have requested in January, a breakdown of revenues and pre-
20 tax earnings based on the over-the-counter derivatives
21 dealing business and the proprietary speculative trading.

22 I would like to show you a chart. I don't know
23 that it has a number, but it's the balloon chart entitled
24 "Goldman Sachs' Top Derivatives Counterparties Notional
25 Exposure as of June 2008." Do you have a copy of it?

1 WITNESS COHN: Yes.

2 COMMISSIONER BORN: I would like to ask that this
3 be entered into the record of the hearing, please.

4 VICE CHAIRMAN THOMAS: Without objection.

5 COMMISSIONER BORN: This chart shows Goldman
6 Sachs' relationships with 49 of its top derivatives'
7 counterparties. It's the top 9 or 10 counterparties of
8 Goldman Sachs as of June 2008 in each of 5 major types of
9 derivatives.

10 It does show how complex and extensive Goldman's
11 relationships with this small number of counterparties are.
12 I notice that none of the credit derivatives products top 10
13 counterparties as of then included AIG.

14 I thought you said a few minutes ago, Mr. Cohn,
15 that you think AIG "was or biggest customer in this space"?
16 You must have meant something other than the credit
17 derivatives swaps' space. What did you mean by that?

18 WITNESS COHN: I think Mr. Broderick said that.

19 COMMISSIONER BORN: Oh, I'm sorry.

20 WITNESS BRODERICK: And I think this chart here
21 shows top credit derivatives products by notional amount,
22 and the numbers are very large. The smallest credit
23 derivative product that I see, although it's a little hard
24 to read the chart, is in the hundreds of billions of
25 dollars.

1 COMMISSIONER BORN: \$314 billion.

2 WITNESS BRODERICK: Thank you. And as you may
3 have seen from other information that we provided, the
4 notional exposure of trades that we did with AIG was
5 substantially less than that. I think the numbers that you
6 probably saw were \$23.5 billion or so. And that really gets
7 to the heart of the difficulty of using notional exposures
8 as reflective of real risk.

9 These entities with whom we trade here are very
10 active market makers. We trade back and forth on a
11 countless basis--not a countless, but a very large basis,
12 with in most cases offseting trades, and all subject to
13 collateral arrangements and other risk mitigants which bring
14 the risk down very substantially. But based on notional AIG
15 would not appear in this category at all.

16 COMMISSIONER BORN: And why was it that you
17 traded with AIG without collateral up front?

18 WITNESS BRODERICK: Without collateral up front,
19 we did not feel it necessary to--and, frankly, they would
20 not have agreed to collateral up front. Remember, this is
21 an entity that was AAA until sometime in 2005, and then AA
22 until a whole lot later, dealing with an equivalently rated
23 entity.

24 The arrangements that are customary on that basis
25 are to trade with, on a flat basis, so both sides post

1 margin as mark-to-markets move against that entity, and in
2 some cases subject to trigger levels. And in the case of
3 AIG, the arrangements that we had were substantially that.

4 And then in addition, we had our own separate
5 credit protection mechanism, which we can talk about
6 separately.

7 COMMISSIONER BORN: Well back to the chart. As I
8 said, this shows 49 of your counterparties. In fact, fewer
9 than that because many of the same large institutions are
10 among your top 10 counterparties in each of these sectors.

11 But in fact you have 1.2 million contracts
12 outstanding, at least as of the end of 2009. How many
13 customers? How many counterparties do you have on over-the-
14 counter derivatives' contracts?

15 WITNESS BRODERICK: I don't know the precise
16 number, but it's more than 10,000. It's a substantial
17 number.

18 COMMISSIONER BORN: And so there are that many
19 interconnecting counterparty relationships through the
20 contracts? Correct?

21 WITNESS BRODERICK: I don't know if I would say
22 "interconnecting," because I think that would exaggerate the
23 degree of overlap across those counterparts. Many of those
24 OTC counterparts are single-product in nature, or a couple
25 of products, and many of them are end users dealing just

1 with us and with perhaps a handful of other banks.

2 So that's different I think than the
3 interconnectivity reference in this diagram.

4 COMMISSIONER BORN: Well by "interconnectivity" I
5 mean bilateral. I mean, these are contractual--

6 WITNESS BRODERICK: Yes.

7 COMMISSIONER BORN: --relationships between you
8 and 10,000 other entities.

9 WITNESS BRODERICK: By that definition, right.
10 Yes, thank you.

11 CHAIRMAN ANGELIDES: Five minutes?

12 COMMISSIONER BORN: Yes. And in addition to
13 price risk on these contracts which you manage I'm sure by
14 hedging and other devices, unlike what AIG was doing on its
15 credit default swaps, there's some operational risk related
16 to these contracts as well, and there is counterparty credit
17 risk, which I assume, Mr. Broderick, is part of your job to
18 oversee the management of? Is that correct?

19 WITNESS BRODERICK: Yes, it is.

20 COMMISSIONER BORN: And do you find it a daunting
21 task to oversee counterparty credit relationships in more
22 than 10,000 contracts and relationships, many of which have
23 more than 10,000 counterparties, many of whom have more than
24 one contract with you?

25 WITNESS BRODERICK: I think risk management

1 across a firm such as ours is challenging and dangerous if
2 not done properly. I think we have a very substantial
3 organization supported by the highest levels in the firms
4 that have resourced us extremely well across a number of
5 areas that gives us a confidence that we are able to
6 undertake credit risk management and market risk management
7 and operational risk and other risk management effectively.
8 That's not to say that we do not make mistakes, and we have,
9 but I think by and large we have done it effectively.

10 COMMISSIONER BORN: Warren Buffett appeared
11 before us at our last hearing and testified that he
12 considers it virtually impossible to oversee the size of
13 portfolio. He mentioned JPMorgan, but of course Goldman
14 Sachs' portfolio is almost as big.

15 Do you consider it a daunting task? And what
16 techniques do you use to manage it?

17 WITNESS BRODERICK: Warren Buffett is a very wise
18 person. We'd welcome the chance to get him into our
19 operations and show him exactly how we do think about the
20 risk management of derivatives and other products, and so
21 forth, and perhaps he would change his mind in this regard.

22 But the answer to the question is: We have very
23 extensive groups which are dedicated to risk management as
24 per the components that I mentioned earlier. They are also
25 supported by a vast infrastructure group within the firm

1 comprising about half the organization that includes the
2 Controller's Group, which is responsible--which has final
3 responsibility for the marks of our products and so forth
4 across the firm. The Operations Group, which has many of
5 the operational risk issues, including collateral calls and
6 so forth. And then it's also supported by the business
7 units themselves who have a very direct skin in the game
8 when it comes to risk management generally, and take that
9 responsibility seriously.

10 So the firm as a whole is focused on risk
11 management in all of its component parks.

12 VICE CHAIRMAN THOMAS: Commissioner Born?

13 COMMISSIONER BORN: Yes.

14 VICE CHAIRMAN THOMAS: This side of the panel
15 awards Mr. Broderick a 9 for his answer on the Warren
16 Buffett question.

17 (Laughter.)

18 CHAIRMAN ANGELIDES: And investor relations will
19 be extraordinarily pleased.

20 WITNESS COHN: Exactly.

21 COMMISSIONER BORN: I hope that wasn't on my
22 time.

23 (Laughter.)

24 CHAIRMAN ANGELIDES: No. By agreement of the
25 Chair and Vice Chair, it was, strangely enough.

1 (Laughter.)

2 VICE CHAIRMAN THOMAS: It was a nominal amount of
3 time--notional, I'm sorry, that's it.

4 CHAIRMAN ANGELIDES: On Ms. Born's time, would
5 you please add two seconds.

6 (Laughter.)

7 COMMISSIONER BORN: I think you mentioned to our
8 staff, Mr. Broderick, that you think the lack of
9 transparency in the over-the-counter derivatives market
10 posed a certain risk management problem because you can't be
11 aware of the potential exposures that your counterparties
12 may have to other obligations.

13 And I wondered whether you were aware of any of
14 AIG's other exposures?

15 WITNESS BRODERICK: The comment is accurate, and
16 the association with AIG is entirely appropriate in this
17 regard.

18 The fact is we were not aware, and really had no
19 way of knowing what AIG's ultimate disposition in terms of
20 risk exposures were, either in respect to the trades that we
21 did direct with them, which is to say they could have laid
22 off all or more than all of the risk of the trades that we
23 did with them specifically--

24 COMMISSIONER BORN: So you weren't aware of
25 whether or not they were hedging--

1 WITNESS BRODERICK: Let alone what--

2 COMMISSIONER BORN: --or otherwise making
3 provision for those--

4 CHAIRMAN ANGELIDES: Two minutes.

5 WITNESS BRODERICK: --let alone what other
6 counterparties were--

7 CHAIRMAN ANGELIDES: Two minutes, and then we'll
8 wrap down. Go ahead.

9 WITNESS BRODERICK: Let alone with other
10 counterparties were doing with them.

11 COMMISSIONER BORN: So were any other people at
12 Goldman Sachs, to your knowledge, aware of either AIG's
13 exposures or how they were hedging--whether they were
14 hedging or not hedging those exposures?

15 WITNESS BRODERICK: No one was aware that I'm
16 aware of.

17 COMMISSIONER BORN: The U.S. Government has
18 bailed out AIG to the tune of \$130 billion with additional
19 pledges, and it has paid \$40 billion on its CDS exposure.

20 Goldman in turn has received something like \$14
21 billion for a number of the CDOs on which AIG had written
22 credit default swaps.

23 Don't you consider Goldman's need for funds from
24 the American Taxpayer and on these transactions, and on your
25 counterparty relationship with AIG a risk management

1 failure? Why did the American Taxpayer need to bail you out
2 on this?

3 WITNESS COHN: Let me start, and Craig will
4 finished because you asked two questions.

5 First of all, the total payment was
6 \$12.9 billion, of which \$4.8 billion was in the secured
7 funding book, which was just repo or reverse repo. It had
8 nothing whatsoever to do with the CDO market.

9 And in the CDO market, the payments that were
10 made there, Goldman Sachs, as we have stated many times, we
11 were acting independently of any other event that may have
12 happened in the market, or may have happened with AIG.

13 We were managing our credit risk, as well as
14 market risk with them, as prudently as we knew how. And the
15 moment they did not make a collateral payment to us, we took
16 precautions. We spent our shareholders capital, and we went
17 out and insured ourselves against an unforeseen and
18 something we couldn't even think about event happening,
19 because that's our rigor and our prudent risk management, is
20 to just go out and insure yourself. If someone owes you
21 money, you must go out and take some protection.

22 WITNESS BRODERICK: What else would you like me
23 to address in that regard?

24 COMMISSIONER BORN: Well, I mean my time is up.

25 CHAIRMAN ANGELIDES: I think she wants to know

1 why you took the money, and wasn't that an indication of
2 failure?

3 WITNESS BRODERICK: I respectfully disagree with
4 the implication. The fact is, as Mr. Cohn mentioned, we
5 took money in one bucket because we were unwinding fully
6 secured trades that we could have liquidated through
7 alternative means and realize the same value.

8 We took money in a second bucket because AIG
9 specifically wanted to change the form of its risk from
10 derivatives into cash, and we facilitated, at their request,
11 that transaction. And we took money in the form of the last
12 bucket, which was CDS related margin payments that they owed
13 us in due course, consistent with the government's objective
14 of making creditors whole through this process.

15 WITNESS COHN: I think Mr. Broderick's statement
16 at the end is the important statement. We did not ask AIG
17 for the money. We were part of a solution where the
18 government was involved trying to mitigate the future risk
19 of AIG. We were part of numerous counterparties that
20 simultaneously entered into a transaction where we would
21 work to get AIG back the securities that were causing them
22 the trouble. We would buy them from the counterparties that
23 we had, and then we would re-deliver them to AIG.

24 COMMISSIONER BORN: So you never asked the
25 Federal--nobody at Goldman Sachs ever talked to the Federal

1 Reserve Bank of New York about the terms of this, and how it
2 should be done, and how you wanted your money 100 cents on
3 the dollar? Is that your testimony?

4 WITNESS COHN: My testimony--no, that isn't what
5 I said. My testimony is, in the 11th hour when the Federal
6 Reserve was trying to strike a deal with the counterparties
7 of AIG, yes, we had conversations with the Federal Reserve.
8 But ultimately we were sent documentation on a Sunday
9 afternoon and asked very vocally to sign it.

10 COMMISSIONER BORN: All right.

11 CHAIRMAN ANGELIDES: By the way, I am not going
12 to ask any more questions, but I am going to clarify the
13 request I made of you earlier.

14 In terms of giving us trading information, I just
15 want to make sure--I don't want to be a broken record on
16 this--when we get that trading information, it is for
17 comparable securities, comparable trades.

18 Because just to be clear, what I am trying to
19 establish is, as I said, following up on the Vice Chair, it
20 is pretty clear that you helped build the bomb. It's pretty
21 clear you built a bomb shelter. And now the question I want
22 to get to is: Did you light the fuse? And this will be
23 very important information in trying to determine what set
24 of events happened and why. Thank you.

25 Mr. Hennessey?

1 COMMISSIONER HENNESSEY: Thank you, Mr. Chairman.

2 I am looking at this chart. Could we put that
3 chart back up again? And I am very interested in this chart
4 because I keep coming back to a few points over and over
5 again. One is just about flawed assumptions about the
6 housing market. One is about highly correlated risk. One
7 is about concentration of risk in large financial
8 institutions.

9 I have already expressed my skepticism about the
10 notional amounts.

11 Mr. Broderick, you mentioned a \$23 billion number
12 with respect to credit derivatives. What does that number
13 represent?

14 WITNESS BRODERICK: That number represents the
15 notional value of trades, CDS across all products, across
16 all the CDS products, by which I mean Abacus trades and
17 other--and other CDOs and CDS transactions that we did with
18 AIG against which they posted collateral. I think that's
19 the answer.

20 COMMISSIONER HENNESSEY: Okay, so that's an AIG-
21 specific--

22 WITNESS BRODERICK: Yes, it is.

23 COMMISSIONER HENNESSEY: --credit derivatives
24 specific notional number?

25 WITNESS BRODERICK: Yes, that's correct.

1 COMMISSIONER HENNESSEY: Okay.

2 WITNESS BRODERICK: And that may be off by a
3 little bit. I don't remember the precise numbers.

4 COMMISSIONER HENNESSEY: Just ballpark. And--but
5 you have some sort of economic measure of your actual
6 exposure of counterparty risk to any firm and any product in
7 this chart, right?

8 WITNESS BRODERICK: Yes, we do. And I think by
9 that you mean credit risk, specifically?

10 COMMISSIONER HENNESSEY: Yes.

11 WITNESS BRODERICK: Yes.

12 COMMISSIONER HENNESSEY: And can you give us a
13 sense of order of magnitude? I mean, we're seeing numbers
14 on here which are measured in hundreds of billions and
15 trillions of dollars in terms of notional amounts.

16 WITNESS BRODERICK: Right.

17 COMMISSIONER HENNESSEY: When you're looking at
18 actual counterparty credit risk with a particular firm, and
19 not concentrated in a line, when you're looking at SocGen or
20 Credit Suisse, or something like that, and you're thinking
21 about the economic credit counterparty risk you face--

22 WITNESS BRODERICK: Yes.

23 COMMISSIONER HENNESSEY: --that number is
24 measured in?

25 WITNESS BRODERICK: So in the case of a typical

1 financial institution, we would have a series of collateral
2 arrangements of, let's say, basic as other trading
3 arrangements, each supported by a collateral arrangement
4 with a trigger level, where that trigger level would be set
5 at very low levels.

6 And so let's say that we have zero triggers
7 across three products where we have a certain amount of
8 business that we're likely to do. What we would therefore
9 do in calculating exposure is say we have theoretically zero
10 exposure, right, because of the collateral arrangements set
11 at that level.

12 However, we know that there is a delay between
13 the time that a market moves against the client, which would
14 trigger a collateral posting requirement on their part, and
15 our calling for them, to them for that collateral, and their
16 posting it or not, as the case may be. And if they don't
17 post it, then we close them out.

18 And so there is an inherent delay in that whole
19 process. And so what we do is take, for the most part, a
20 two-week collateral collection/close-out period, and we
21 calculate a potential market move over that period.

22 That gives us what we call a collateralized
23 potential exposure figure, which is probably the most
24 appropriate reference for this purpose.

25 The numbers vary depending on the details of the

1 trades we do with our clients, but they are, you know,
2 orders of magnitude smaller than what you see in the way of
3 notional exposures here. They're measured in the, for large
4 counterparts, tens or maybe hundreds of millions of dollars.
5 In the case of AIG, it was at the higher end of that range,
6 which is the reason that we supplemented our normal risk
7 mitigants with a separate set of arrangements under which we
8 purchased credit protection externally in the market for
9 essentially this margin shortfall.

10 COMMISSIONER HENNESSEY: Okay--

11 WITNESS BRODERICK: And then you get down to
12 numbers that are quite small.

13 COMMISSIONER HENNESSEY: --two follow-ups here.
14 One is the way that you think about this, the chart here is
15 very colorful, but I notice that a lot of these large
16 financial firms are showing up in multiple colors.

17 WITNESS BRODERICK: Um-hmm.

18 COMMISSIONER HENNESSEY: I presume that the way
19 you think about it is on a firm level, rather than a firm-
20 and-product basis, right?

21 WITNESS BRODERICK: Correct.

22 COMMISSIONER HENNESSEY: What happens if Barclay
23 ceases to exist or doesn't pay us. And then you're looking
24 at your exposure across all of the different transactions?

25 WITNESS BRODERICK: And our risk measures are

1 very comprehensive in that regard. We aggregate on as close
2 to an apples-to-apples basis as we can across the different
3 derivative transactions and different non-derivative
4 transactions that we do. Our systems aggregate that
5 effectively, yes.

6 WITNESS COHN: And to just put some real quick
7 clarity on that. In these big circles, and these circles
8 that appear multiple times are what we would consider market
9 professionals trading counterparties.

10 We have very little exposure to them. When they
11 margin us, we margin them on a nightly basis.

12 COMMISSIONER HENNESSEY: Okay, so--

13 WITNESS COHN: And in a Barclays with
14 \$2 trillion, I would say my overnight exposure would be
15 measured maybe in \$100 million depending on how big of a
16 market move. And it's sort of what we would call "daylight
17 risk."

18 So from tonight's close to when they pay me, I
19 make the call. They agree to the call. We pay each other
20 tomorrow.

21 COMMISSIONER HENNESSEY: Okay. Because what I'm
22 getting at here is that I don't think this chart is helpful
23 to me because it's in terms of notional exposure, for one.

24 Two, it's breaking apart the counterparty risk
25 into different types of financial structure, which I find

1 confusing.

2 And then three is, I think I'm supposed to
3 conclude something based on the relative sizes of the
4 circles, but what I hear you telling me is that when you're
5 measuring--when you're comparing the relative sizes of the
6 circles from an economic standpoint, what is a small circle
7 here may be bigger, and what's a big circle--Barclays
8 circle--may in fact be quite small because of the nature of
9 the risk that you're bearing with respect to them? Is that
10 a--

11 WITNESS COHN: Correct. And in fact I'm looking
12 to see here, I was looking to see because there's a small
13 circle that actually has a lot more risk associated with a
14 big circle because we would have a nonstandardized market
15 making trigger with them.

16 So I don't really see anyone on here that's a
17 small circle, because almost everyone on here is what I
18 would consider a market professional. Market professionals
19 pay each other each day in the market.

20 VICE CHAIRMAN THOMAS: Would the gentleman yield
21 briefly?

22 COMMISSIONER HENNESSEY: Yes, please.

23 VICE CHAIRMAN THOMAS: I was trying to figure out
24 how we might deal with this, and what I was thinking of was
25 maybe a pie chart for each of them so that there would be

1 segments pertaining to, I don't know, maybe there's nine or
2 so, but what I'm hearing you saying is the way that you
3 really keep the balance is more like you do with a buddy
4 where they bought dinner last night, and I'm buying it
5 tonight, and the difference is six bucks.

6 So it's always the difference of what you owe and
7 collect, rather than any kind of total amount? Since you
8 aggregate your risk totally?

9 WITNESS COHN: Correct. So--

10 VICE CHAIRMAN THOMAS: So even putting it into a
11 pie chart to look at the pieces wouldn't necessarily focus
12 this. And I'm throwing us on your mercy to give us some way
13 to really judge what it is that we're looking for.

14 WITNESS COHN: And I'll try and do this easily.

15 VICE CHAIRMAN THOMAS: I thank the gentleman.
16 It's on my time.

17 WITNESS COHN: Take a Barclays. We're picking
18 them because they're in the lower right. With Barclays we
19 probably trade with them in a variety of legal entities
20 across a variety of different products.

21 Each legal entity has to get netted down. So if
22 they have longs and shorts, and we have long and shorts, we,
23 between ourselves, mark to market. We mark it all at the
24 same place.

25 COMMISSIONER HENNESSEY: Within an entity?

1 WITNESS COHN: Within a legal entity.

2 COMMISSIONER HENNESSEY: A subset of Barclays,
3 and so forth?

4 WITNESS COHN: I don't want to get too
5 complicated through all the legal entities, but with
6 Barclays we would mark our book, they would mark our book.
7 They would say, hey, based on our longs and shorts, you owe
8 us \$10 million. We'd say, yeah, we think we owe you
9 \$9.9875. We'll send you ten.

10 And that happens every day. And so we do that
11 with Barclays every day. We do that with JPMorgan. We do
12 that with Morgan Stanley. We do that with SocGen. We do it
13 with Perabot. We don't do that with General Motors.

14 So if we've got a derivative on with General
15 Motors, we would not collect from them until it got to the
16 margin trigger. So these are what we would call zero
17 triggers, daylight risk. We'll trade with you. The market
18 will move. We'll settle tomorrow. And that's how the
19 interdealer market pays each other.

20 So these--if I actually went and took that chart
21 and made it exposure, all those dots up there would be tiny
22 and we'd put up other bigger dots, which would be clients.

23 COMMISSIONER HENNESSEY: Clients, like General
24 Motors, or whoever.

25 WITNESS COHN: Berkshire Hathaway, General

1 Motors, GE. You know, you would go into other corporate
2 type clients. Or governments. There would be a lot of
3 governments in there.

4 COMMISSIONER HENNESSEY: So on any given day,
5 your actual economic risk exposure to various firms is much
6 larger to nonfinancial firms, or to non, what is it,
7 dealers, than it is to these firms?

8 WITNESS BRODERICK: That's sometimes the case.
9 The only point I would note is--and Mr. Cohn was mentioning
10 specifically derivatives exposures because that's what's
11 included here--when you think about banks, the only other
12 significant issue to mention is we have other types of
13 exposures, as well.

14 For instance, deposits which we maintain. Now
15 they're overnight. And so they don't constitute a lot of
16 long-term risk, but certainly some of the numbers can get
17 relatively large.

18 WITNESS COHN: If you were to sit in our Risk
19 Committee, which meets every week, and our detailed risk
20 packet, we have the largest exposures listed there. They
21 would not be the names on this sheet of paper.

22 COMMISSIONER HENNESSEY: Okay. And I think
23 you've already answered one of my questions, which is you
24 will sometimes explicitly hedge your counterparty credit
25 risk with a particular firm. And it sounds like you did that

1 with AIG once you figured out that they weren't as good of a
2 risk as you initially thought?

3 WITNESS BRODERICK: I think that's right,
4 although I would amend the last part of that. We hedged our
5 risk with AIG by agreement going back quite early in our
6 trading when they were a really good--or we conceptually
7 agreed to hedge our risk going back when they were very good
8 credit. We only needed to start acting on that in a
9 material way when they started missing margin calls.
10 Because that's what gave rise to that requirement that we
11 hedged essentially the uncollateralized portion of our risk.

12 COMMISSIONER HENNESSEY: Okay, so can you
13 qualitatively characterize for me in that third week in
14 September when AIG was failing, presumably you all had
15 already started hedging a lot of your AIG-specific risk.
16 How exposed was Goldman? Was the survival of your firm in
17 jeopardy if AIG ceased to exist?

18 WITNESS COHN: No. We were hedged long, long
19 before that. What Craig was saying, at some point you get
20 enough exposure to a company that, just as a natural risk
21 mitigant, you start buying credit default swaps.

22 COMMISSIONER HENNESSEY: Now we heard--

23 WITNESS COHN: So we were hedged long, long
24 before that period of time.

25 COMMISSIONER HENNESSEY: Now we heard from a

1 panel of experts this morning that they believed that if the
2 New York Fed had not dumped \$85 billion into AIG that there
3 would have been massive systemic effects.

4 Understanding your answer on Goldman, do you
5 agree with that, either for other large firms, or for the
6 system as a whole?

7 WITNESS COHN: Yes. I agree with that. And I am
8 surely happy we didn't have to find out.

9 COMMISSIONER HENNESSEY: And why? Was that
10 because other firms were not managing their counterparty
11 risk like you were? Or was it some fear factor? Or what
12 was the reason for that?

13 WITNESS COHN: I think it was both of those. It
14 was other firms had more liberal lines with them. Other
15 firms had less collateral. They were just at the nature of
16 literally billions of dollars of cash flows in securities
17 that would of had to have instantly been replaced.

18 It's not just the fact that they ceased to exist
19 and they owe you money. You've got a huge replacement risk.
20 So if you had a flat book and AIG was on one side, all of a
21 sudden they disappear, you have to go into the market and
22 replace.

23 The market didn't have the capability to replace
24 everything that AIG was on the other side of simultaneously.
25 As we know how big their books were, this was an event that

1 would be too big for the market to deal with in a specific
2 moment of time.

3 COMMISSIONER HENNESSEY: And that's because AIG
4 was too large a share of the total capacity of the market?

5 WITNESS COHN: They were very concentrated in
6 certain financial instruments. And the breadth and depth of
7 those markets would have ceased to exist, and AIG was most
8 likely, in most of these products, one direction. Meaning
9 that everyone would need to replace the exact same thing
10 simultaneously. Anyone who was willing to replace it would
11 know that the market had a huge dislocation, and there was
12 not a normal supply/demand factor.

13 COMMISSIONER HENNESSEY: So everyone did this one
14 kind of business with AIG. With AIG gone, there would be
15 nobody else. And whoever else wanted to get on the other
16 side of that trade would have just charged an arm and a leg?

17 WITNESS COHN: Correct.

18 COMMISSIONER HENNESSEY: Okay. Following up on
19 Commissioner Born's questions earlier, I think I get your
20 answer, which is you are a client service business and that
21 you are in the business of doing what your clients want in
22 providing them with those products and services. I
23 understand that sometimes you can't lay off the risk from
24 one of those transactions and so you've got to hold it. And
25 you're earning gains and losses on that risk that you're

1 bearing.

2 I understand that sometimes you all say, you know
3 what, we are holding too much of risk X that we've
4 accumulated because we've been doing services for clients,
5 so let's try and--you know, let's pay a little more to
6 offload it.

7 Are you saying that sort of at ya'll's level, at
8 the firm level, you're never saying: You know what? Here
9 is a kind of risk where we think we should bear more of it
10 and let's increase our exposure to that risk?

11 I understand that that's a small share of your
12 business, but are you saying, you know, come on, actually
13 this risk is priced pretty cheaply. Let's dial this up?

14 WITNESS COHN: At our level we are always pushing
15 back in the organization. The natural organization will
16 tend to grow and want to do things. At Craig's and my
17 level, our responsibility is prudence to be far enough away
18 from the business to take a macro view and make sure that
19 everything is in line relative to everything else we're
20 doing in the firm.

21 COMMISSIONER HENNESSEY: So you--

22 WITNESS COHN: So it would never come from the
23 office, from the senior management office, to increase risk.
24 It would come--

25 COMMISSIONER HENNESSEY: --from a business unit

1 saying, hey, we think we can make money X because this is
2 mispriced?

3 WITNESS COHN: Yes. It tends to push--the risk-
4 on would push up through the organization; risk-off pushes
5 down through the organization.

6 WITNESS BRODERICK: And that's not inappropriate
7 from a fundamental market making perspective, either, right?
8 Sales people and traders interested in providing the best
9 service to clients from time to time see the benefits in
10 prepositioning, for example, some inventory when they think
11 that it's going to be especially attractive.

12 And so even with a purely market making function
13 in mind, which is what characterizes most of our business,
14 there are entirely consistent reasons for putting in place
15 inventory, or short inventory for that matter.

16 WITNESS COHN: And then there's numerous trades
17 that need to be approved through the organization. And
18 Craig and I, as well as David Viniar, it is our job to not
19 approve those for a lot of different reasons; they just
20 don't meet the hurdles, they don't meet the benchmarks;
21 they're just not prudent for us to have on.

22 COMMISSIONER HENNESSEY: Got it--

23 WITNESS COHN: So there are certain levels where
24 things naturally have to gravitate to us.

25 VICE CHAIRMAN THOMAS: Mr. Chairman, yield him

1 two additional minutes.

2 COMMISSIONER HENNESSEY: Let me ask, a few of us
3 had a line of questioning of the expert panel this morning
4 about naked credit default swaps, or perhaps calling them
5 "side bets."

6 My question was: If a naked credit default swap
7 is properly capitalized and transparent, is there any
8 downside to it from a systemic standpoint? Is there any
9 externality that is created by it by having lots of side
10 bets?

11 And then, is there--Senator Graham's question--
12 what is the benefit to the market and to the financial
13 system as a whole of having these naked transactions exist?

14 WITNESS COHN: "Properly capitalized" was the key
15 words when you asked the question. Properly capitalized, I
16 have no problem. And in fact I think there is a benefit to
17 having a CDS market.

18 Let me first explain to you--and this is a
19 relatively short history--the biggest advent in the mortgage
20 market in the last 15 years was or is the ability to go
21 short.

22 Prior to that period of time, you could have two
23 positions in the mortgage market. You could be flat, have
24 no position; or you could own mortgages.

25 It was really in the modern trading world that

1 you had any ability to take a negative, or contra view in
2 the mortgage market. So what happened?

3 First of all, we attracted more capital in the
4 market. So more people were willing to buy mortgage and
5 mortgage security because they knew if things went wrong
6 they would have an ability to hedge. They would have an
7 ability to get out. They could manage their risk.

8 It was also a risk transference. In all of these
9 securities you were transferring risk. Someone ultimately
10 wanted to own the risk, and so you were transferring risk
11 into another area. More trading. More capital. Means more
12 price transparency. And that is important for a market.

13 These were diversified portfolios. The other
14 thing that you had in the mortgage market prior to these
15 amalgamated securities is if you went out and bought a
16 mortgage you owned that mortgage in that area. And it was
17 very difficult for people to amalgamate mortgages in a
18 variety of different states, a variety of different
19 counties, a variety of different underlying collateral.

20 What these securities did is they allowed you to
21 build a highly diversified portfolio of mortgage exposure.
22 So if you wanted Florida, and you wanted California, you
23 didn't want Ohio, you could do that. If you wanted
24 subprime, you could do that. If you wanted a combination of
25 subprime and credit cards, you could do that.

1 That evolution helped spur this market on. And
2 the ability that that created was really why this product
3 grew, why it grew so fast, and why it allowed home ownership
4 to grow simultaneous.

5 But I go back to the beginning. You needed to have
6 the adequate amount of capital involved.

7 COMMISSIONER HENNESSEY: Okay, so your contention
8 is that the increased amount of capital that increased home
9 ownership that occurred from this new product was a good
10 thing, and that the bad aspects of it are in effect entirely
11 a result of the lack of capitalization and lack of
12 transparency?

13 WITNESS COHN: What really happened here is, as
14 the mortgage market got more--

15 VICE CHAIRMAN THOMAS: Yield the gentleman one
16 more minute.

17 COMMISSIONER HENNESSEY: Just for this answer.

18 WITNESS COHN: As the mortgage market got more
19 sophisticated and we went to higher loan-to-values, and we
20 went to less income verification, and we came up with all
21 these new exotic products, what the end result of that was
22 is you made the performance of the underlying asset that
23 much more important. Especially when you have a 100 percent
24 loan-to-value loan, you don't have a lot of wiggle room in
25 the collateral.

1 So as we expanded these new products, we really
2 expanded the reliance on home price at least holding steady,
3 but mostly appreciating. And what happened is, we didn't
4 increase capital as we increased the sophistication of the
5 underlying mortgage.

6 COMMISSIONER HENNESSEY: So it became more
7 sensitive to the accuracy of the projections of default and
8 assumptions of home prices, those kinds of things.

9 WITNESS COHN: Yes. Look at--I'll give you some
10 examples. Mortgage number one, you buy a mortgage, a
11 \$100,000 mortgage. You put down \$20,000, 20 percent down.

12 Mortgage number two, \$100,000 mortgage, you put
13 no down. Housing market retrenches 10 percent. We still
14 have 10 percent positive equity over here. The bond holder
15 who bought the security, he's still fine. He's got a 10
16 percent cushion.

17 Bond holder over here that bought the security,
18 uh-oh, we already have a negative shortfall of 10 percent if
19 that house gets foreclosed.

20 So, yes, the reliability on the performance of
21 the underlying asset really exploded and we forgot to attach
22 the proper amount of risk capital to that risk when the
23 asset went down.

24 COMMISSIONER HENNESSEY: Thank you, Mr. Chairman.

25 CHAIRMAN ANGELIDES: All right. Thank you. Mr.

1 Wallison?

2 COMMISSIONER WALLISON: Thank you, Mr. Chairman.

3 Was AIG an outlier in terms of the amount of
4 obligations that they took on in relation to others in the
5 market, and without apparently hedging?

6 WITNESS BRODERICK: In retrospect, they clearly
7 were. They weren't the only--it's worth noting, they
8 weren't the only entity that went long subprimes, and others
9 did as well, but they certainly in hindsight were the
10 longest and the least hedged.

11 COMMISSIONER WALLISON: When did you, when did
12 Goldman decide to get substitute, or additional coverage for
13 its exposure to AIG?

14 WITNESS BRODERICK: And by that you mean external
15 hedging in the market?

16 COMMISSIONER WALLISON: Um-hmm.

17 WITNESS BRODERICK: We agreed conceptually to do
18 that at the time we started trading with them in reasonable
19 size. And when I say "conceptual," I just mean putting in
20 place the facilities to start trading. And that really goes
21 back to I think it was '04; it might have been actually
22 earlier than that, but it was well before we had any real
23 risk then, however defined. We actually only started to need to
24 hedge under the GAAP process that I mentioned earlier when
25 they started missing margin calls.

1 COMMISSIONER WALLISON: But you did actually seek
2 coverage even before they started missing any of these
3 calls.

4 WITNESS BRODERICK: We put the structure in place
5 to provide coverage.

6 COMMISSIONER WALLISON: Was this your customary
7 way of dealing? Or was there something about AIG's exposure
8 that caused you to be wary of where they might be going?

9 WITNESS BRODERICK: There's certainly nothing
10 exceptional about their exposure. I would say that this is
11 not an unusual practice. It's not standard across all of
12 our large financial institutions, but it's by no means--by
13 no means unique.

14 What was interesting to AIG--about AIG in this
15 regard was that we had a number of different trading
16 arrangements with them, each of which had trigger margins
17 that were larger than our customary, zero to use the
18 examples which Mr. Cohn did and which are in fact pretty
19 customary among the large financial institutions. These
20 triggers were \$50 million, or they were a percentage of
21 outstanding trades, or some other variation, which on a one-
22 off basis wouldn't have caused us particular concern.

23 But across the totality of many lines, with many
24 AIG entities, it just seemed to us to be prudent to put in
25 place this additional hedging arrangement. And so we did,

1 long before there was any real requirement for it.

2 COMMISSIONER WALLISON: But did you stop placing
3 these requests, or these obligations, with AIG at that
4 point?

5 When you started hedging in effect your AIG
6 obligations, which were already hedging something else, I
7 assume, did you stop dealing with AIG?

8 WITNESS BRODERICK: The significant collateral
9 calls for AIG occurred in the third quarter of '07. We had
10 stopped doing really any material business with AIG long
11 before then.

12 COMMISSIONER WALLISON: "Long before then"? Can
13 you put a date on that? Was it 2005?

14 WITNESS BRODERICK: It was late 2005, early 2006.
15 We did a couple of transactions in 2006 that were not
16 subprime-related.

17 COMMISSIONER WALLISON: That sounds like it's
18 about the same time that AIG itself started turning off the
19 spigot, so to speak.

20 WITNESS BRODERICK: Yes, that would be--

21 COMMISSIONER WALLISON: Was there anything that
22 you all were seeing in the market at that time that caused
23 you to think that maybe you were too exposed to AIG?

24 WITNESS BRODERICK: By--I'd have to go back and
25 look at our records in detail, but I think the answer is,

1 no, at the time in late '05 early '06 the markets had not
2 moved materially at all. Our current exposure was pretty de
3 minimis, and so it would not have caused us any particular
4 concern.

5 They were still a AA credit. They were still
6 extremely well regarded by the market for all sorts of
7 issues, through all sorts of parameters.

8 COMMISSIONER WALLISON: Mr. Cohn, why did Goldman
9 become a bank holding company and go under the wing of the
10 Fed?

11 WITNESS COHN: At the time we became a bank
12 holding company, the market was in severe turmoil and there
13 was a lot of volatility around the market, and a lot of
14 volatility around funding markets, and a lot of volatility
15 around price discovery and everything else going on.

16 At the time, we felt it was prudent to get the
17 imprimatur of the Fed regulation. And having Fed regulation
18 was something that shareholders, as well as counterparties,
19 as well as clients of Goldman Sachs thought was a very good
20 thing to have. And we also agreed it was a good thing to
21 have to be under the umbrella of the Fed regulator was
22 important to us.

23 So at the time we made a decision that we would
24 be Fed regulated. We thought it was something that was
25 going to happen inevitably anyways, and at that point we

1 just decided that it was time to do it.

2 COMMISSIONER WALLISON: Were there any
3 difficulties in short-term funding positions for Goldman
4 Sachs at that point?

5 WITNESS COHN: Not particularly. The funding
6 markets were difficult, but we were getting everything
7 funded. Spreads were wide. You were paying more, but the
8 availability was there.

9 COMMISSIONER WALLISON: What about your--how much
10 were you funding, if any, overnight?

11 WITNESS COHN: I don't know the specific number.
12 We tend to run our book very small on an overnight funding
13 basis.

14 Mr. Viniar, who is here tomorrow, will know those
15 numbers cold. But I think you will see that it was a very
16 small number. We tend to term out all of our repo. And we
17 pay up to term out our repo.

18 COMMISSIONER WALLISON: So even though you
19 weren't doing much funding overnight, you felt threatened by
20 the conditions in the market?

21 WITNESS COHN: The market environment was very
22 difficult.

23 COMMISSIONER WALLISON: And how, exactly? Can
24 you explain that to me? I'm having a little bit of trouble
25 understanding that. I can understand if you were like, say,

1 a Bear or a Lehman, which were funding overnight. I take it
2 you were not doing that very much?

3 WITNESS COHN: We were not.

4 COMMISSIONER WALLISON: You were not under that
5 kind of pressure. So what was the reason to go under the
6 wing of the Fed?

7 WITNESS COHN: As I said, Mr. Viniar will give
8 you detail on our funding book night by night, if you'd
9 like. The--the issue that was going on was, was really the
10 marketplace in some regards really concerned about the
11 regulatory environment, concerned about how you ran your
12 business, concerned--and our clients, and our
13 counterparties, as well as ourself, thought it was a good
14 idea to be under the Fed regulation.

15 COMMISSIONER WALLISON: Did you ever use the
16 Fed's discount window?

17 WITNESS COHN: We used it one night at the
18 request of the Fed to make sure our systems were linked with
19 their systems, and it was for a de minimis amount of money.

20 COMMISSIONER WALLISON: You never had to use it
21 after that?

22 WITNESS COHN: No. And as I said, we used it on
23 the Fed's request for de minimis.

24 COMMISSIONER WALLISON: Why did Goldman Sachs buy
25 credit default swaps from AIG? Was it to protect anything

1 in your portfolio? Or was it to lay off, or hedge
2 obligations that you had already assumed to your clients?

3 WITNESS COHN: Most of it was the latter. Most of the
4 transactions we had
5 with AIG were the other side of client transactions, where
6 we were putting the pieces of the puzzle together and they
7 were one of the pieces.

8 COMMISSIONER WALLISON: I take it that you did
9 not, as you said at the outset--and I thought this was
10 wonderfully candid and valuable to us--that you did not
11 anticipate what was going to happen in the future, but you
12 did begin to reduce your exposure.

13 What is the difference between "not anticipating
14 what's going to happen in the future" and "reducing your
15 exposure"? Why did you do that?

16 WITNESS COHN: We reduced our exposure on the
17 fact that our position consistently, day by day, was losing
18 small amounts of money. And we were uncomfortable with what
19 was going on in the market.

20 So we made what we figured to be a very prudent
21 decision to minimize or negate as much risk in the book as
22 we possibly can, and get closer to home. And literally we
23 were trying to have no position. We were trying not to be
24 long, or not to be short.

25 COMMISSIONER WALLISON: Can you put a little bit
26 more on the term "uncomfortable about what was going on in

1 the market"?

2 This--gut feelings in an organization as data
3 driven as Goldman Sachs doesn't quite feel right. What do
4 you mean "uncomfortable"?

5 WITNESS COHN: Craig will elaborate.

6 WITNESS BRODERICK: I think the simple matter is,
7 we had positions that we thought from a risk metric
8 perspective were low risk, and by that I mean low
9 volatility, and pretty well balanced across, in certain
10 respects across the firm, and yet they lost money, as Mr.
11 Cohn mentioned, for some relatively short period of time,
12 like 10 days in a row.

13 And one of the most important risk metrics that
14 we have is daily P&L. And what we do is sit back and say,
15 given what we understand about the positions that we have
16 on, should we in reference to specific market moves in a
17 specific day, or longer period of time, expect to have made
18 money or lost money for that position?

19 And our answer--you know, our expectation for
20 those positions that we had on was that we should be
21 relatively flat. This was a very low profit-margin
22 intermediation business that we were running. And so long
23 as it was really low risk, then we were happy to run it.

24 Once you start losing money for several days in a
25 row, it causes you to question your basic understanding

1 about the business. It doesn't suggest that you think, gee,
2 there's a lot more going on here than we thought and the
3 bottom is going to fall out, or anything nearly as
4 directionally specific as that. All it means is there's
5 something that we do not understand, and we are sitting with
6 a fairly long position because of the client trades that we
7 talked about earlier. Maybe we should just flatten--maybe
8 we should just reduce the overall risk until we figure out
9 what's going on in the market.

10 Then if we like the market at that point, we can
11 get back in. Or if we don't like it, we can stay flat.

12 WITNESS COHN: I'll be very succinct. Our risk
13 reports and our P&L decoupled.

14 WITNESS BRODERICK: Yes, that's a good way of
15 putting it.

16 COMMISSIONER WALLISON: Please complete that a
17 little bit more. We love the succinctness, but...

18 WITNESS COHN: Okay. Our risk reports were
19 telling us one thing, and our P&L was doing something
20 different than our risk reports said it should do.

21 COMMISSIONER WALLISON: What do you mean by "risk
22 reports"?

23 WITNESS COHN: We run a vast majority of risk
24 reports, scenario analysis, what if, all these moves, all
25 these correlations, uncorrelated, jump to default, jump to

1 risk free, I can go through hundreds of them. But our risk
2 reports would have said--did say at the time, because I
3 remember going through this, that these securities in our
4 portfolio should react like this.

5 It wasn't. There was a breakdown in what was
6 going on in all of our risk reports, which to some extent
7 are all based on historical data, and exactly what was going
8 on in the market.

9 COMMISSIONER WALLISON: What was the time frame
10 on that?

11 WITNESS COHN: That was end of December.

12 COMMISSIONER WALLISON: December of what year?

13 WITNESS COHN: Of '06.

14 COMMISSIONER WALLISON: So at the end--

15 WITNESS COHN: That period where we got closer to
16 home, derisk, started in end of '06.

17 COMMISSIONER WALLISON: So what you're saying is
18 that the numbers that you were expecting to see in the
19 market, which were not otherwise visible to anyone else,
20 were warning you that the market wasn't behaving the way it
21 normally would behave?

22 WITNESS COHN: The numbers I'm talking about were
23 very visible. We had a large position in AAA conforming
24 residential loans. AAA conforming residential loans had
25 never moved more than a point in a month in decades. All of

1 a sudden they were moving in two-point increments in a day.

2 Our risk report said that can't happen. We
3 didn't understand what was going on. When we got to that
4 point, we said: If our risk reports can't say it happens,
5 and we've got the position, we have a duty as caretakers of
6 the firm to get rid of that position and assess what's going
7 on with our risk reports and what's going on in the actual
8 market.

9 COMMISSIONER WALLISON: Well if it was visible to
10 everyone else in the market, why were you the only ones who
11 were acting on it?

12 WITNESS COHN: I can't answer that.

13 COMMISSIONER WALLISON: Was your--I assumed the
14 answer would be that your risk management techniques were
15 better, more sophisticated, or were you doing a different
16 kind of business in some way.

17 WITNESS BRODERICK: I think what I would say is,
18 the question implies that we had some great understanding or
19 expectation of how markets would move in the future, and the
20 fact is we really didn't. We sat there and said, hmmm, the
21 markets are moving in a way that's unexpected. Can we
22 explain it? Not really. But it looks like there's some
23 more down side on a risk/return basis than we had in mind.

24 And so I think the direct answer to your question
25 is: It's not a view of how the market will move or anything

1 else, as merely equating risk to return and determining that
2 at that particular moment there was more risk relative to
3 the return than was expected in the business. And so the
4 prudent thing to do is to reduce the risk.

5 WITNESS COHN: My only inference would be that we
6 are very adamant at marking our books at real prices every
7 night. And we were not in denial. And we are never in
8 denial. Real trades are where we mark the book, whether we
9 think they make sense or not.

10 VICE CHAIRMAN THOMAS: Would the gentleman yield
11 briefly?

12 COMMISSIONER WALLISON: Sure.

13 VICE CHAIRMAN THOMAS: I mean, from what we have
14 heard from everyone else, that to me is the fundamental
15 difference. That those folks who ran up against reality
16 that didn't fit their model, either froze or tended to
17 believe the model far longer than they should have.

18 And your technique of looking at profit and
19 losses and forget the model if it isn't showing up in terms
20 of profit or loss, you get out until you can figure out why.

21 WITNESS COHN: Correct.

22 VICE CHAIRMAN THOMAS: No one, no one has said
23 that was the way they operated. So I now understand one
24 basic difference between you and a few other folk that we've
25 had in front of us. Thank you for the time.

1 CHAIRMAN ANGELIDES: Thank you. And what we're
2 going to do is--

3 COMMISSIONER WALLISON: I'm going to come back.

4 CHAIRMAN ANGELIDES: Yes. Mr. Georgiou, and then
5 we will come back to you, Mr. Wallison. Thank you.

6 COMMISSIONER GEORGIOU: Thank you very much for
7 accommodating me, Mr. Chairman.

8 I would like to suggest, Mr. Cohn and
9 Mr. Broderick, that this characterization of Goldman Sachs
10 as exclusively client driven and having been forced into
11 these postures by clients is somewhat too facile in my view.

12 For example, you say you were hedged on your risk
13 that AIG might fail. Once they failed to put up collateral
14 willingly in connection with the marks that you established,
15 you had to go out and put hedges against their potential
16 failure.

17 But we never had to test the proposition of
18 whether those parties who were your counterparties on those
19 hedges were prepared in the circumstances that you called
20 upon them to actually pay up. You know, nobody will know
21 that.

22 I understand that you put those hedges up, but of
23 course people had hedges with AIG and nobody knows the
24 answer. I guess I wanted to try to get to a point.

25 A few hearings ago I asked Hank Paulson, who of

1 course was your former CEO and the former U.S. Treasury
2 Secretary under President Bush, and one of the architects of
3 the bailout, I said: How difficult is it to reconcile the
4 conflicts associated with the various roles played by
5 Goldman Sachs and other investment banking firms? Not just
6 Goldman Sachs.

7 You know, one, you have a role as an underwriter
8 of securities where you owe fiduciary duties to the
9 investors who purchased the securities, and to the issuer of
10 the securities for which you're raising funds.

11 You act as a neutral market maker creating and
12 placing instruments for clients who come to you seeking to
13 undertake or offload a particular risk. You act as a
14 proprietary trader, acting for your own account. And
15 perhaps also as an advisor representing buyers or sellers in
16 acquisition transaction or either party in a merger.

17 And I asked Hank Paulson how difficult it was to
18 reconcile all those different roles. And he said:
19 Exceedingly difficult. And that's the ultimate challenge
20 for the managers of an investment bank, the shareowners of
21 an investment bank, and ultimately regulators of an
22 investment bank.

23 You know, these are all different roles that you
24 play legitimately within your business structure, and not
25 all of them are consistent.

1 For example, when you asked for collateral from
2 AIG and gave them marks which they weren't satisfied with
3 with regard to your exposure to them, some of your other
4 clients like Bear Stearns Asset Management and others
5 probably wouldn't be too happy if those marks were
6 established in the marketplace either because that might
7 require them to down-price, to mark their own book to
8 market, which would have an impact on them.

9 And I guess we have an e-mail somewhere that Mr.
10 Sparks and the mortgage group on the CDOs and CDO-squares
11 wrote that the marks will potentially have a big P&L impact
12 on Goldman's clients, and that Goldman needed to survey our
13 clients and take a shot at determining the most vulnerable
14 clients' knock on implications, et cetera. This was
15 important to senior management, writing this is getting lots
16 of 30th floor attention right now.

17 I am not suggesting that you were differentiated
18 in that regard from a number of other parties, but this was
19 an instance where you had positions. You were trying to
20 protect your position by getting more collateral. The lower
21 you identified the mark, the more collateral you got.

22 But the consequence to some other clients of
23 yours might have been detrimental, or perceived to be
24 detrimental by them in establishing a mark that was lower.
25 And since nobody knew what the marks, the proper marks were

1 for some of these securities, you are there.

2 So I guess I am just suggesting to you that if
3 ought not be--we ought not to leave this room thinking that
4 it is so easy to establish that there aren't conflicts that
5 have impacts on your clients when you're acting on your own
6 account, or vice versa when you're acting on behalf of a
7 client you might impact your own account in certain
8 instances.

9 And I guess one of the things that I want to
10 identify with the chart, what we have is charts 2 and 3, is
11 sort of the amplification of risk that was created by a
12 number of essentially collateralized debt obligations and
13 synthetic CDOs, and CDO-squared, and a variety of other
14 instruments that created more risk than you would expect.

15 CHAIRMAN ANGELIDES: Chart 2?

16 COMMISSIONER GEORGIU: That's chart 3. That one
17 is coming next. So you can leave it up there if you want,
18 whatever.

19 CHAIRMAN ANGELIDES: Chart 2 is what he's asked
20 for.

21 COMMISSIONER GEORGIU: Chart 2. And this is a
22 chart which shows a lot of deals, basically. And there are
23 underlying residential mortgage-backed securities which then
24 become referenced in collateralized debt obligations.

25 You know, you have the mortgage-backed

1 securities. You have the lowest rated tranche north of
2 equity, the BBB traunch. Then you slice and dice those into
3 a CDO. And then they get used in the creation--some of
4 these tranches get used in the creation of a whole series
5 of other securities.

6 And it has an amplification effect where some of
7 the tranches get used over and over and over again. For
8 example, some securities are replicated. 2537 of the times,
9 of the securities that you folks created, the 3408 were used
10 again. And then 610 were used actually a second time. And
11 170 were used a third time. Even to one that was actually
12 used in 9 deals.

13 Now what that does is of course if the underlying
14 tranche fails, it has an impact on a whole number of deals,
15 potentially. And this amplification effect comes from, in a
16 sense, servicing what you argue are your clients' demands to
17 be in these various instruments.

18 But it ought not to be forgotten that these
19 various instruments also generated fees for the firm, which
20 of course you are entitled to make. Let me look at number 3
21 that also has a--sort of shows it in a slightly different
22 way, which just takes a couple of the things that you did
23 and shows that the original value of the C Tranche for
24 example of a particular funding, Glacier Funding, was worth
25 \$15 million. But if you amplify it through all the other

1 deals that it got used in, it ended up having an \$85 million
2 essentially, in a sense, notional value. But when it failed
3 in any of those--the underlying tranche failed, it impacted
4 all of these securities.

5 I can never figure out why it is that they always
6 use Greek names to construct these securities. It's sort of
7 embarrassing. You know, all these toxic securities. But
8 they do.

9 And I guess then I would like to look at four--
10 you know, so that's just an amplification which I think is
11 really not an answer.

12 CHAIRMAN ANGELIDES: Senator Graham is going to
13 reference the other two charts.

14 COMMISSIONER GEORGIU: Is that right?

15 CHAIRMAN ANGELIDES: Yes.

16 COMMISSIONER GEORGIU: Okay, well that's fine.
17 Let me just leave it.

18 I just wanted to make one last--I guess I didn't
19 really get to ask you a question, for which I'm sorry
20 because I've got to go off to another appointment. I guess
21 I would just ask you all to reflect upon the dilemmas faced
22 by regulators, and really within your own firm, of trying to
23 ensure that the various roles that you play are
24 appropriately recognized and appropriately tempered.

25 I guess, could I just have 30 seconds for them

1 each to respond to that?

2 VICE CHAIRMAN THOMAS: Or you could ask them to
3 respond in writing.

4 WITNESS COHN: I can do it in 30 seconds.

5 CHAIRMAN ANGELIDES: Go ahead.

6 VICE CHAIRMAN THOMAS: Oh, come on. It's a very
7 difficult, complex response to all those charts.

8 WITNESS COHN: I'll be succinct. It's 47 total
9 deals is what you're talking about there. 3400 securities.
10 This is no different than the tens of thousands of swaps
11 that are written every day on the S&P 500. There's 500
12 underliers. And if one defaults, all 10,000 of those swaps
13 are affected.

14 This is no different than the tens of thousands
15 of swaps written every day on the U.S. dollar versus another
16 currency. Or, more importantly, on U.S. Treasuries. It is
17 one reference point that is involved in tens of thousands of
18 securities.

19 This is the way that the financial markets work.
20 People choose a specific security that they want exposure
21 to, whether it's pooled or unpooled, and they aggregate it.
22 The Dow's got 25 stocks in it. I guarantee you there's tens
23 of thousands of swaps, or securities written with Dow
24 components.

25 COMMISSIONER GEORGIU: Well whether you push or

1 they pull is always subject to some question, I guess that's
2 is all I would say. And of course you're earning fees each
3 time you do it, and really that's one of the--that's
4 obviously one of your functions. So I'm not suggesting
5 that's inappropriate.

6 Mr. Broderick, just a quick response and then
7 we'll go on to the others.

8 WITNESS BRODERICK: So long as the individual
9 entities entering into these trades are well capitalized,
10 then there is no particular issue. I think the point that
11 has come up again and again in derivatives generally, and in
12 other types of instruments, including securitization, is
13 whether there is adequate capital ascribed against the
14 risks.

15 COMMISSIONER GEORGIU: Right. But everybody who
16 has testified before us has essentially told us they thought
17 they were not adequately capitalized, from Alan Greenspan
18 on.

19 WITNESS BRODERICK: And therein you have the real
20 problem, not so much the reliance on a single outlier.

21 COMMISSIONER GEORGIU: Thank you very much. I
22 appreciate the courtesy.

23 CHAIRMAN ANGELIDES: Senator Graham--oh, I
24 apologize. Mr. Wallison to finish up. I apologize. What's
25 the allocation of time, Mr. Vice Chair?

1 VICE CHAIRMAN THOMAS: Three minutes.

2 COMMISSIONER WALLISON: Three, did you say?

3 VICE CHAIRMAN THOMAS: Yes. For now.

4 COMMISSIONER WALLISON: Good. Thank you. I just
5 wanted to finish up, but I wanted to follow up on some of
6 the things that my brother Byron was just talking to you
7 about.

8 Why were synthetic MBS created, mortgage-backed
9 securities, synthetic mortgage-backed securities? Would you
10 like to answer that, Mr. Cohn?

11 WITNESS COHN: Well, I'll answer it. Again,
12 there were participants in the market that wanted exposure,
13 that clearly leverage is one of the components that drove
14 their decision. But the leverage available in these
15 synthetic CDOs is no different than leverage that is
16 available in many other markets today, and many other listed
17 markets today.

18 So in trying to compete with other listed
19 markets, this market-by-market participation desire to get
20 more leverage, they created a more and more levered product.

21 It also was created for real customization,
22 really being able to slice and dice up different sections of
23 the mortgage market, different regions, different asset
24 classes, different securities. It's very difficult. It's
25 impossible to do them in cash form. If you do them in cash

1 form, someone actually has to go out and buy it. That's a
2 way to get long. But a way to get short, you need the
3 synthetic security to get short.

4 COMMISSIONER WALLISON: These were imitating real
5 nonsynthetic securities? Is that right?

6 WITNESS COHN: Just as the S&P 500 does. It
7 imitates real, underlying stocks. These were imitating real
8 underlying mortgages.

9 COMMISSIONER WALLISON: So there was demand for
10 this exposure by some group?

11 WITNESS COHN: Correct.

12 COMMISSIONER WALLISON: Why was there demand for
13 this particular kind of instrument? Why synthetic rather
14 than, I'll call them, "real"?

15 WITNESS COHN: Well, again, if you take a real
16 exposure you can only create a real exposure from the long
17 side.

18 COMMISSIONER WALLISON: Um-hmm.

19 WITNESS COHN: To have a real exposure, you go
20 out and buy the securities. You go out and buy the
21 mortgages. Okay? If you go out and buy the mortgages, they
22 are in pools. So you've got to buy the whole pool.

23 Maybe you don't want the whole pool. Maybe you
24 don't want the first 10 percent default, you want the second
25 ten percent, and you want the bottom ten percent default.

1 So by creating the securities, you can (a) get
2 short; (b) you can customize the attachment points of the
3 default points.

4 COMMISSIONER WALLISON: So what you were doing,
5 then, one way to look at what you were doing, is you were
6 satisfying a demand for this without creating new weak
7 mortgages.

8 WITNESS COHN: We didn't create any mortgages.

9 COMMISSIONER WALLISON: Right. But my point is
10 that real mortgage-backed securities were created from real
11 mortgages. You imitated them, but it was not necessary then
12 to create more subprime mortgages in order to give people
13 the same exposure.

14 WITNESS COHN: I would use the word "mirror." We
15 mirrored them. We exactly took the pool that existed and we
16 mirrored it in a synthetic form.

17 WITNESS BRODERICK: And I think, Commissioner, it
18 is an interesting question as to whether, if synthetic CDO
19 or equivalent products had not existed whether the demand
20 pool would have been such to in fact increase the supply of
21 subprime mortgages.

22 COMMISSIONER WALLISON: Well that fundamentally
23 is my question. May I have another couple of minutes?

24 CHAIRMAN ANGELIDES: Yes.

25 COMMISSIONER WALLISON: So I just want to be sure

1 that we are focusing on this, because, although a lot has
2 been made about the fact that these synthetics were created,
3 nevertheless these synthetics were between consenting
4 adults. That is to say, they were being sold to people who
5 were sophisticated enough to understand what they were
6 buying.

7 These were not sold to the public. And, that it
8 amounted to an opportunity to reduce the actual--not that
9 you were assuming that this was an opportunity to do it, but
10 they amounted to an opportunity to create the same kind of
11 risk without actually making subprime or other weak
12 mortgages.

13 WITNESS COHN: Correct.

14 COMMISSIONER WALLISON: All right, let me go back
15 then to the final question that I had before, and that is:
16 You were very candid, Mr. Cohn, in saying that you did not
17 foresee the collapse of the housing market, or the housing
18 bubble.

19 And you now are in company with just about
20 everyone who has testified before this Commission. Nobody
21 seemed to see the collapse of the market. So how can we
22 judge AIG as against Goldman Sachs?

23 AIG didn't foresee the collapse of the market,
24 either, but we are treating them as having made some huge
25 mistakes. Whereas Goldman Sachs came out of it pretty well.

1 What is the difference between Goldman Sachs and
2 AIG?

3 WITNESS COHN: It's a good question, and I'll try
4 and do the question justice.

5 I think the big difference goes back to what
6 Craig was talking about. We at Goldman Sachs are in the
7 active risk management business. We are not in the
8 investing business.

9 AIG had shareholder--I'm sorry, had premium,
10 policyholder premium to invest. And they were trying to
11 create a rate of return by buying assets, buying securities,
12 and making investments to create an adequate rate of return
13 so they would have money to redeem their policies or pay off
14 claims.

15 We at Goldman Sachs are not in that business. We
16 are in the active market making business, and we come in
17 every day of our lives and we try and manage our risk, and
18 we try and tailor our risk, and understand it more clearly
19 than we have the day before.

20 COMMISSIONER WALLISON: I just want to ask one
21 final question. You're right of course, but you and AIG
22 were doing the same thing in effect. They had a different
23 purpose than you had, but what was the fundamental
24 difference between you not being able to see what was in the
25 future and they not being able to see what was in the

1 future?

2 WITNESS COHN: As a best guess, we were making
3 our portfolio to market every day, every minute, and taking
4 realistic samplings of the environment.

5 COMMISSIONER WALLISON: Okay. Thank you,
6 Mr. Chairman.

7 CHAIRMAN ANGELIDES: Thank you. Senator Graham.

8 COMMISSIONER GRAHAM: I'm going to reserve a
9 couple of minutes at the end to go back to the consenting
10 adults' discussion, but I would like to--

11 CHAIRMAN ANGELIDES: Senator, why don't you pull
12 your microphone towards you.

13 COMMISSIONER GRAHAM: --but I would like to focus
14 primarily on the Goldman Sachs-AIG relationship. You were
15 selling credit default swaps at the same time that AIG was.
16 Were your swaps essentially the same character as theirs?
17 For instance, did you have in your swaps this provision that
18 if there was a diminution in market value that collateral
19 would be provided?

20 WITNESS BRODERICK: The arrangements that we had
21 for the swaps that we essentially intermediated with AIG
22 were largely--

23 COMMISSIONER GRAHAM: No, I'm not talking just
24 With AIG--you were selling credit default swaps to lots of
25 people, right?

1 basically a fungible CD to what AIG was selling. Is that
2 right?

3 WITNESS BRODERICK: Yes.

4 COMMISSIONER GRAHAM: Mr. Cohn, you have a
5 quizzical look on your face.

6 WITNESS COHN: I'm not sure that it's fung--I'm
7 not sure what AIG was selling, so I'm not sure it was
8 fungible. And I don't want to mislead you.

9 COMMISSIONER GRAHAM: Okay. I'm trying to get to
10 the point. There's been a statement made that you were
11 selling your CDSs at a considerably higher price than AIG
12 was selling its similar if not totally fungible product. Do
13 you know if that's correct?

14 WITNESS COHN: I would doubt that we would ever
15 have the luxury of selling something higher than someone
16 else in the market. It's not the way it typically works.

17 WITNESS BRODERICK: There is lots of room for
18 confusion in those sorts of statements because CDS may look
19 fungible but in fact they may be referencing different
20 seniority underliers. And a single CDS referencing a pool
21 of mortgages where one has an attachment point way up on the
22 risk spectrum, and one has way down the risk spectrum may
23 look, at cursory glance relatively similar, but in fact in
24 risk terms they are fundamentally different. One is very
25 low, and one is very high.

1 COMMISSIONER GRAHAM: Could you put four and five
2 up?

3 CHAIRMAN ANGELIDES: Could I ask a two-second
4 question on my time, quickly? Were you receiving, was there
5 a differential payment between what you were paying AIG for
6 protection and what the arrangement was with our
7 counterparties? Was there a significant economic
8 difference?

9 WITNESS BRODERICK: In terms of premium?

10 CHAIRMAN ANGELIDES: Yes.

11 WITNESS COHN: At the time we were buying
12 protection from AIG, they were the cheapest provider. If
13 someone else had been willing to sell it cheaper, we would
14 have bought it from them.

15 WITNESS BRODERICK: But, Mr. Chairman, the point
16 is--

17 COMMISSIONER GRAHAM: Were they--do you know what
18 the difference--you said they were the cheapest provider.
19 Do you know what--

20 WITNESS BRODERICK: This was not a high margin
21 business.

22 CHAIRMAN ANGELIDES: So your sales to others were
23 higher, but not--in the range of how many basis points,
24 perhaps?

25 WITNESS BRODERICK: I don't know.

1 CHAIRMAN ANGELIDES: All right, perhaps we can
2 follow up. I'm sorry, Senator.

3 COMMISSIONER GRAHAM: Yes. Maybe you can help
4 explain that chart there. Because it looks as if, for
5 instance, that AIG was willing for \$2.1 million a year to
6 sell you coverage on \$1.76 billion worth of underlying
7 assets. Whereas, the other groups were selling at a
8 significantly higher ratio of premium to risk--I mean
9 dramatically higher.

10 WITNESS BRODERICK: Yes.

11 COMMISSIONER GRAHAM: Am I interpreting that
12 chart correctly? And if so--

13 WITNESS COHN: I don't know quite how to
14 interpret that chart, but your question I completely
15 understand. So in the AIG block of the \$1.76 billion, they
16 were selling protection on the super super senior tranche,
17 the least likely and last to default.

18 Other people were selling, or buying protection
19 on different tranches with a much higher probability of
20 defaulting.

21 COMMISSIONER GRAHAM: So you're saying that this
22 chart is apples to oranges because maybe whatever TCW was
23 selling, where you had to pay \$384,000 a year to get \$22.5
24 million coverage may have been a significantly different
25 product than the one that AIG was insuring?

1 WITNESS COHN: The AIG was AAA super senior. The
2 TCW transaction was an unrated security that we traded a
3 swap on. It had no rating on it whatsoever.

4 CHAIRMAN ANGELIDES: Senator, on my time again,
5 can I just quickly ask a question?

6 COMMISSIONER GRAHAM: Yes.

7 CHAIRMAN ANGELIDES: I think the one thing I'd
8 like to ask about this chart, here's the real question. You
9 know AIG's not hedged. But in a sense you are paying \$2.1
10 million a year. I mean, it's the leverage bet. I mean,
11 would you agree that these synthetic CDOs allowed for
12 enormously leveraged bets? To wit, you're putting up \$2.1
13 million a year; you stand to gain \$1.76 billion. Hugely
14 leveraged. Would you agree?

15 WITNESS COHN: Correct.

16 CHAIRMAN ANGELIDES: To both positions.

17 WITNESS COHN: To the event you can cling, just
18 like automobile insurance, just like home insurance, you
19 don't pay the whole price of your home in insurance.

20 CHAIRMAN ANGELIDES: Right. But they're each
21 highly leveraged, correct? I mean, these are all highly
22 leveraged, particularly in a synthetic CDO?

23 WITNESS COHN: They're levered based on the
24 probability of default, of you--in essence, they're
25 leveraged on the probability your house is going to burn

1 down.

2 COMMISSIONER HENNESSEY: Could I ask a question?

3 CHAIRMAN ANGELIDES: And I interrupted the

4 Senator, but I'm going to make up for it some day.

5 Commissioner?

6 COMMISSIONER HENNESSEY: Insurance by itself I
7 don't think the term "levered" is appropriate. I mean, I
8 pay an insurance premium on my car, which is a fraction of
9 the value of the car, right? If I'm also insuring nine
10 other cars that I don't own, I think of that as leverage.

11 CHAIRMAN ANGELIDES: These were--you were buying
12 protection on securities you didn't own.

13 WITNESS COHN: Yes.

14 CHAIRMAN ANGELIDES: Senator, I'm sorry.

15 COMMISSIONER GRAHAM: But my--in most states you
16 are required to have insurance in order to get a license tag
17 for your car, at least that is true in Florida. I think
18 that is true most places.

19 You can buy insurance for the same stated
20 coverage with wildly different cost depending on who the
21 company is. If you want to buy from super cheap insurance
22 company, you can do it, but you understand that maybe when
23 you actually need the insurance they may not be there.

24 Was AIG in the marketplace? Was it the super
25 cheap insurance to credit default swaps?

1 WITNESS COHN: Dependent on product, dependent on
2 day, dependent on market, we would check away.

3 COMMISSIONER GRAHAM: No, I'm talking about
4 keeping apples to apples in terms of the product. Just like
5 the best automobile insurance company has the same contract
6 as the worst. The difference is, if you buy it from
7 Allstate you're pretty sure if you have an accident you're
8 going to collect. If you buy it from a discount, you don't
9 know whether they're going to be there when you need them.

10 Was AIG considered to be a cut-rate CD?

11 WITNESS COHN: I don't think you can say that. I
12 think AIG was on the market, and certain days there would be
13 other people that would have sold the protection at a
14 cheaper price, and certain days that AIG would have offered
15 the protection at a cheaper price.

16 I would be wrong to say consistently 100 percent
17 of the time they were the cheap low-cost provider.

18 COMMISSIONER GRAHAM: Well I am now going to use
19 my remaining minute and fifteen seconds to go to the
20 consenting adult thing.

21 If the consenting adults are two people who are
22 about to get in an automobile and one of them is drunk and
23 the other one agrees to ride in the passenger seat with the
24 drunk driver, that's two consenting adults agreeing to ride
25 together under the circumstances.

1 The problem is, the only people--they are not the
2 only two people who are going to be affected by the drunk
3 driver. It could be that it will be a third party that gets
4 run over by the drunk driver.

5 So the fact that within this arrangement there
6 are two consenting adults is not the end of the story. The
7 question is what happens to the rest of society? And that's
8 what worries me about these, what I call peripheral
9 derivatives. That is, they may be very good for a person
10 who wants to be able to engage in the most leveraged of
11 transactions, but when that activity that is gratifying to
12 that consenting adult ends up affecting the rest of the
13 population by contributing to a financial meltdown of the
14 scale that we are now experiencing, then I think you have to
15 look at it from a different perspective.

16 Now I asked the first panel, and I will ask you,
17 what is the social value of these extreme derivatives? And
18 if there's not a social value, then why aren't they just
19 treated as gambling, and not given the patina of
20 respectability that they have as a security?

21 WITNESS COHN: I would love to answer that.
22 Multiple factors of social value.

23 Number one, pricing transparency.

24 Number two, we brought new capital into the
25 market.

1 Number three, we were able to build more
2 diversified portfolios.

3 Number four, it provided ability to short.

4 Number five, it provided different ways of risk
5 transference through the system which allowed the underlying
6 mortgage market to grow.

7 COMMISSIONER GRAHAM: How many of those could you
8 accomplish if you were doing this on a Nevada Gaming
9 Commission regulated market?

10 WITNESS COHN: I don't think any of them.

11 CHAIRMAN ANGELIDES: All right.

12 WITNESS COHN: I'm not a gaming expert.

13 CHAIRMAN ANGELIDES: By the way, we turn into
14 pumpkins in this room at 6:00.

15 COMMISSIONER GRAHAM: This consenting adult is
16 surrendering his last 29 seconds.

17 CHAIRMAN ANGELIDES: Thank you very much.
18 Douglas Holtz-Eakin.

19 COMMISSIONER HOLTZ-EAKIN: Thank you,
20 Mr. Chairman. And thank you to both of you for your time
21 today and your patience.

22 I just wanted to clean up some details. I found
23 your answers to Commissioner Born's questions about the
24 management information systems, and not keeping separate
25 books for derivatives, it was utterly convincing but it did

1 raise the following question:

2 If you don't track those separately, how do you
3 pay your derivatives desk?

4 WITNESS COHN: We don't have a specific
5 derivatives desk. Everything is commingled. We manage risk
6 per underlier.

7 So I don't have to make that decision how to pay
8 a derivatives desk, because in certain situations you have
9 to look at the whole thing.

10 COMMISSIONER HOLTZ-EAKIN: Second question. It's
11 been said, and I think you even said this, Mr. Broderick,
12 that the CDOs, the credit default swaps, contributed to
13 difficulties in transparency which may have exacerbated the
14 financial crisis. But at the same time, in the presence of
15 exactly those same instruments--however complicated they may
16 be--you were able to assess very well your counterparty risk
17 versus AIG. And indeed at the right points took conscious
18 steps to mitigate those exposures.

19 That seems to be a little bit of a contradiction.
20 Can you help me out with that? Why couldn't everyone do
21 that?

22 WITNESS BRODERICK: I think we have a risk
23 culture which is focused on effective risk management, and
24 it includes the components that I noted earlier, starting
25 with effective mark to market. And when I say, or I would

1 agree that from time to time transparency is less than one
2 might like, it means that marking to market is harder than
3 one might like.

4 And that means that you need the right people,
5 and you need the right processes and procedures, and so
6 forth. But to be an effective participant in this market,
7 you've got to devote those resources. And I think we have,
8 and other successful participants in the market have as
9 well.

10 COMMISSIONER HOLTZ-EAKIN: Just to I understand,
11 that difficulty in marking to market is independent of
12 freeze ups, lack of transactions, things like that. It's
13 just the difficulty in seeing through these instruments and
14 marking them to market?

15 WITNESS BRODERICK: No. It's particularly true
16 during times of market stress. It was particularly true in
17 middle to late '07 for instance when the market was--when
18 the underlying subprime market was highly volatile in terms
19 of payment performance, and so forth, and the underlying
20 asset prices were therefore fluctuating quite a bit, and all
21 the associated derivative products, whether it was the RMBS,
22 or whether it was the CDOs, or whether it was the synthetic
23 CDOs were moving accordingly.

24 It was, you know, it was more challenging than
25 usual to track the--to track what the actionable price

1 across these portfolio of products was.

2 COMMISSIONER HOLTZ-EAKIN: Leading question: If
3 everyone had had Goldman Sachs' risk management regime,
4 would we have had a financial crisis?

5 WITNESS BRODERICK: You can answer that.

6 WITNESS COHN: Pure guess. I think we still
7 might have. Because at the end of the day, it's not a
8 science; it's an art form. So we've got hundreds of years of
9 man-years and women-years dedicated to understanding those
10 reports. Just having the reports doesn't make you a great
11 risk manager.

12 And having the organization that we have with a
13 operations, compliance, controllers function separate, then
14 the trading and the controllers and compliance ultimately
15 having ultimate authority, and having a senior management
16 team like Craig and myself and David Viniar who will be
17 here, and others, living risk management every day of our
18 lives, the systems clearly would have helped them, but again
19 you've got to interpret the system.

20 COMMISSIONER HOLTZ-EAKIN: Okay. Thank you. I
21 mean, that's actually very helpful. It does lead to my next
22 question, which is: Andrew Sorkin reports in his book that
23 Goldman Sachs had for a long time a plan on the shelf to
24 become a bank holding company. Is that true?

25 WITNESS COHN: Correct.

1 COMMISSIONER HOLTZ-EAKIN: And why would you have
2 such a plan in place?

3 WITNESS COHN: We--we are in the risk management
4 business, and we manage all of our risks. We try and have
5 alternative outcomes available to us. And that was
6 something that we had been contemplating for a long period
7 of time, and based on what was going on in the market, and
8 based on where we felt the regulatory environment was going,
9 we decided to execute.

10 COMMISSIONER HOLTZ-EAKIN: So before you
11 executed, when you decided to have such a plan on the shelf,
12 what risk were you managing?

13 WITNESS COHN: Just managing the overall
14 positioning of Goldman Sachs in the world, becoming a bigger
15 firm, becoming a more global firm, dealing with different
16 clients.

17 Some of our clients wanted to trade with banks.
18 We had certain clients that had different capital or margin
19 requirements if they traded with a bank versus a nonbank.
20 And so there were certain business that we had to forego by
21 not being a bank.

22 And you're always going through an analysis of
23 should you become a bank to pick up that additional
24 business? What are the pros? What are the cons? And we
25 always felt like we needed to have an actionable plan on the

1 shelf.

2 COMMISSIONER HOLTZ-EAKIN: How much did access to
3 Fed Discount Window lending in times of liquidity crises
4 figure into having that on the shelf?

5 WITNESS COHN: Not at all. We don't really have
6 assets in our bank that were eligible for the Fed Window.

7 COMMISSIONER HOLTZ-EAKIN: Okay. And then I have
8 just a couple of minutes left and we have to get out of the
9 room, but I want to take this opportunity to just ask you
10 your views on something that we hear very different things
11 about.

12 This morning Professor Kyle from the University
13 of Maryland said very clearly that prior to Bear there was
14 an expectation by large financial institutions that they
15 could shift losses to Taxpayers, that too-big-to-fail was a
16 real thing, that the moral hazard was inaction, and that it
17 affected the behavior of firms such as yours.

18 Others have asserted that, no, that wasn't true
19 until the Federal Government's actions toward Bear Stearns,
20 and then certainly in the aftermath of Lehman there became
21 this cemented notion.

22 What is your view of the Goldman Sachs
23 expectations regarding government intervention prior to
24 Bear, post-Bear, and how do you think the rest of the market
25 perceived this?

1 WITNESS COHN: Prior to Bear I had never once,
2 for one millisecond, thought that there was any backstop in
3 our organization, or business, or in the financial services
4 industry.

5 I felt every moment I was at Goldman Sachs that
6 we needed to run our business independently, and if we made
7 mistakes and did things wrong we would have to suffer the
8 consequences, including all of the unforeseen things that
9 could potentially happen if things really got bad.

10 COMMISSIONER HOLTZ-EAKIN: And after Bear
11 Stearns?

12 WITNESS COHN: After Bear Stearns, there was
13 confusion, to be honest with you. There was confusion to
14 what happened. How it happened. Why did it happen? Was
15 this the new game plan? Was this not the new game plan?
16 How was the world going to react? Which made the Lehman
17 Brothers weekend even more confusing for people.

18 Not only did it make it confusing for financial
19 institutions, it made it confusing for world investors.

20 COMMISSIONER HOLTZ-EAKIN: All right,
21 Mr. Chairman, I yield back.

22 CHAIRMAN ANGELIDES: Thank you.

23 Mr. Vice Chair?

24 VICE CHAIRMAN THOMAS: I have a duty to try to
25 make sure that we have an accurate record. And as I recall,

1 Mr. Cohn, you were talking about AIG in terms of their
2 investment concerns, that they had to get a return on
3 investment that dealt with the premiums.

4 And the discussion that we had was with the
5 subsidiary of AIG, which was the Financial Products. And my
6 understanding is they were completely walled off from any of
7 the insurance activities in AIG. Would that change the
8 statement that you made about their motivation?

9 WITNESS COHN: Yes. That would change my
10 motivation.

11 VICE CHAIRMAN THOMAS: I figured it would, if I'm
12 accurate.

13 WITNESS COHN: Yes.

14 VICE CHAIRMAN THOMAS: So we have it on the
15 record and we work with it whichever way it goes. Thank
16 you.

17 CHAIRMAN ANGELIDES: Ms. Born asked if she could
18 ask a quick clarification before we adjourn out of this
19 room.

20 COMMISSIONER BORN: Mr. Cohn, you said that you
21 thought the systemic harm could have come from AIG if the
22 government hadn't stepped in to backstop it because of its
23 concentration in certain instruments, and you didn't
24 designate the instruments. Did you mean credit default
25 swaps?

1 WITNESS COHN: That was one of them. But they
2 were a huge player in other markets as well. They were a
3 big repo counterparty. They were a big secured lender.
4 They were involved in many different asset classes.

5 They had an enormous amount of paper out being
6 owned by the money market funds. So money market funds were-
7 -I could go through. There were a lot of different
8 chambers, or silos where they would have had an effect that
9 would have been systemic.

10 COMMISSIONER BORN: They were just such a big
11 player in so many markets.

12 WITNESS COHN: Yes.

13 COMMISSIONER BORN: They were too big to fail.

14 WITNESS COHN: In essence, yes.

15 COMMISSIONER BORN: Thanks.

16 CHAIRMAN ANGELIDES: All right. Thank you very
17 much. Just the one thing is, there are some follow up pieces
18 of information, which we have discussed. Like a dog with a
19 bone, on this management information system, we want to
20 press that.

21 I know you had all these contracts. I've got to
22 believe you actually track revenues from contracts, but
23 we'll pursue that.

24 I want to thank you for coming. I want to thank
25 the public who listened in today. And I want to thank

1 Senator Dodd and the Senate Banking Committee for once again
2 allowing us to meet in this hearing room.

3 I want to thank all the Commissioners and the
4 staff for their hard work, and we will adjourn for now and
5 reconvene at 9:00 a.m., in this room, tomorrow morning.
6 Thank you all very much.

7 (Whereupon, at 6:01 p.m., Wednesday, June 30,
8 2010, the Commission meeting was recessed, to reconvene at
9 9:00 a.m., Thursday, July 1, 2010.)

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