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Testimony of

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Thank you Chairman Waxman and Ranking Member Davis for the opportunity to testify before the Committee today. I applaud each of you and the committee members for holding this hearing on the regulatory mistakes and financial excesses that led to the collapse and federal rescue of AIG and what it means for the United States Economy. I ask that my written statement be included in the record.

By way of background, I formerly served as the chief accountant of the Securities and Exchange Commission. Before that, I was an audit partner in the international accounting firm now known as PricewaterhouseCoopers, where I worked on troubled financial institutions during the savings and loan crisis. I also have served as a vice president and chief financial officer of an international semiconductor company, and the vice president and managing director of research of the internationally recognized proxy governance and financial research firm, Glass Lewis. In addition, I currently serve as a trustee on the board of a mutual fund and a public pension fund. I have also served on the boards of publicly listed companies, having chaired their audit committees. More recently I was appointed by Secretary Paulson to the Treasury Committee on the Auditing Profession.

American International Group ("AIG") serves as a reminder and an unfortunate but excellent example of what is wrong with our financial system today. While there are many capital market participants that operate within ethical and legal boundaries, there have been far too many that have not. We began the decade with names such as Enron and Worldcom, followed by the revelations regarding Wall Street analysts misleading investors, then on to the mutual fund late trading and market timing scandal, then the stock option back dating at companies such as United Health, and now we find ourselves in the midst of the biggest and most destructive crisis of all—the subprime fiasco. This is a crisis that could have, and should have, been averted before it cost American taxpayers what appears may be in excess of a trillion dollars before all is said and done.

There is plenty of blame to go around for this current crisis which is resulting in hundreds of thousands of Main Street Americans losing their jobs. This includes:

- Executives engaging in unsound, if not illegal, business practices when they made loans that had a high risk of not being repaid. Predatory lending practices and the making of loans in which lenders fail to determine if the borrowers have sufficient income to repay the loan, are not what American capitalism is about. If reasonable lending practices had been followed, much of this crisis quite simply would not have occurred.
- Incentives designed to pay executives hundreds of times what their average employees made as they engaged in business that would eventually cripple the businesses they ran, placing employees jobs at risk. But some business executives got paid both coming and going as they walked away from the equivalent of a train wreck with huge severance packages their corporate boards had agreed to.

- Credit rating agencies that appear to have been more interested in satisfying the companies who paid them, and facilitating Wall Street's greed, than in protecting investors who clearly relied on them but mistakenly trusted them.
- The accounting standard setters who failed to require that companies provide investors and the capital markets with transparency that might have provided the free markets with the ability and insight to provide discipline that would have reined in abusive and uneconomic practices. And without such standards, companies viewed existing rules as a "ceiling" rather than the "floor." At the same time, as FASB Chairman Herz has noted in a letter to the Chairman of the Senate Securities subcommittee, it appears some accounting and disclosure rules were violated by some public companies.
- The due diligence required of investment banks underwriting securities, including securitizations, appears to have been deficient especially in light of problems in the auction rate securities market.
- "Cheap" debt fueled by low interest rates, which led to higher leverage and debt in this country. And when debt is cheap and easy to get, some business executives tend to take on excessively high levels of short term debt or significant liquidity risks. Unfortunately, as these risks became more significant as evidenced by what was a $62 trillion credit derivative market, the transparency surrounding the market failed to keep pace.
- Regulation also failed to keep pace. At the Securities and Exchange Commission ("SEC"), the Office of Risk management had been reduced to an office of one by February of this year. From 2005, the number of SEC enforcement division personnel was cut by 146 from 1338 to 1192 in 2007. In 2004, the SEC reduced the capital requirements for the largest Wall Street investment banks. The SEC was given insufficient oversight authority over the credit rating agencies when Congress adopted the Credit Rating Agencies Reform Act of 2006. And as Chairman Cox has recently and correctly testified, Congress also failed to give the SEC adequate supervisory powers over Wall Street Investment Bank Holding companies with the passage of the Gramm Leach Bliley Act. Congress also has failed to regulate the credit and other derivative instruments which in some instances are "Toxic Waste" to the financial system.
- Meanwhile, the Federal Reserve and banking regulators examinations failed to identify and rectify unsound lending and banking practices at institutions such as IndyMac, Washington Mutual ("WaMu"), Countrywide, and Citigroup. Often these practices developed as lenders sold loans they had originated, or were able to protect against credit risks through credit derivatives, thereby eliminating any "skin in the game." As these unsound practices grew, the regulators also failed to ensure there was adequate capital in financial institutions that had taken on and retained excessive risks.

Investor confidence is paramount to the success of any capital market. It is indeed the life blood of a capital system. When people believe they can no longer trust those with whom they invest their money, they withdraw it quickly and find safer havens for it. And when they demand their money back from a financial institution for fear of losing it, it can cause a serious liquidity crisis and failure as we have seen at Bear Stearns, Lehman and others. As the money dries up and the demand for investment in the stock of these institutions falls, so does their stock price making capital difficult, if not impossible, to raise.

A Lack of Timely Transparency

Trust and confidence in markets and any company begins with, and ends with, transparency. Transparency that ensures investors can fully understand and assess the risks and rewards of investing in a company. Yet time and time again AIG has failed to provide the requisite transparency to its investors.

In the first part of this decade, AIG's reported numbers were grossly in error leading to a May 2005 restatement of its financial statements for each of the years 2000 through 2004. The company disclosed it had inadequate internal controls and the errors had overstated income by approximately $3.9 billion. Such a huge restatement raises questions about the legitimacy of the value of the stock during these periods. As noted in Exhibit A, the company's stock price went into a sharp decline, losing approximately $8.5 billion in market value as the restatement unfolded.

The restatement was in the wake of settlements with the SEC regarding Brightpoint, inc. and PNC Financial Services ("PNC") and investigations by the SEC, Department of Justice ("DOJ"), and New York Attorney General. The SEC alleged that AIG had failed to produce large quantities of requested documents and failed to provide key documents when requested. AIG also was charged by the SEC and DOJ for its part in assisting PNC allegedly improper shift of $762 million of under-performing loans and volatile venture capital investments to three off-balance sheet structures that had been arranged with the help of AIG Financial Products Group ("AIGFP").[1]

AIG's 2005 Form 10-K was troubling for investors, as it disclosed "In many cases these transactions or entries appear to have had the purpose of achieving an accounting result that would enhance measures believed to be important to the financial community and may have involved documentation that did not accurately reflect the true nature of the arrangements." This is hardly a situation or disclosure that instills confidence or trust.

Subsequent to such serious shortcomings in financial reporting, one would expect the company to "clean up" its act and become more transparent. But in 2006 and 2007, the company continued to report "out of period adjustments" – another way of saying it continued to have errors in its financial statements. It also reported a material weakness in its internal controls in 2006. Then in its 2007 annual report on Form 10-K, AIG reported that internal "…controls over the AIGFP super senior credit default swap portfolio valuation process and oversight thereof were not effective. AIG had dedicated insufficient resources to design and carry out effective

[1] American International Group, Inc. Proxy Paper. Eric Crawley. Glass Lewis. July 22, 2005.

controls to prevent or detect errors and to determine appropriate disclosures on a timely basis with respect to the processes and models introduced in the fourth quarter of 2007."

Such a disclosure immediately raises a question as to the values the company is reporting throughout its financial statements. If a company does not have adequate internal controls to even figure out if its valuation of assets is proper, then how can the company expect to ensure accurate, complete and transparent information is supplied to investors on a timely basis. Yet in August 2007, a former AIG executive, Joseph J. Cassano, had said "It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those transactions."[2] I had also heard a similar response.

If one follows the disclosures made by the company, they also raise questions. For example, in AIG's June 30, 2007 quarterly filing, the company disclosed:

> "…a downgrade of AIG's long-term senior debt ratings to 'Aa3' by Moody's or 'AA-' by S&P would permit counterparties to call for approximately **$847 million** of collateral. Further, additional downgrades could result in requirements for substantial additional collateral, which could have a material effect on how AIGFP manages its liquidity. The actual amount of additional collateral that AIGFP would be required to post to counterparties in the event of such downgrades depends on market conditions, the fair value of the outstanding affected transactions and other factors prevailing at the time of the downgrade. Additional obligations to post collateral would increase the demand on AIGFP's liquidity."

But just six months later in its annual report, the company disclosed:

> "As of February 26, 2008, AIGFP had received collateral calls from counterparties in respect of certain super senior credit default swaps (including those entered into by counterparties for regulatory capital relief purposes and those in respect of corporate debt/CLOs). AIG is aware that valuation estimates made by certain of the counterparties with respect to certain super senior credit default swaps or the underlying reference CDO securities, for purposes of determining the amount of collateral required to be posted by AIGFP in connection with such instruments, differ significantly from AIGFP's estimates. AIGFP has been able to successfully resolve some of the differences, including in certain cases entering into compromise collateral arrangements, some of which are for specified periods of time. AIGFP is also in discussions with other counterparties to resolve such valuation differences. As of February 26, 2008, AIGFP had posted collateral (or had received collateral, where offsetting exposures on other transactions resulted in the counterparty posting to AIGFP) based on exposures, calculated in respect of super senior default swaps, in an aggregate amount of approximately **$5.3 billion**. Valuation estimates made by

[2] Behind Insurer's Crisis, Blind Eye to a Web of Risk. Gretchen Morgenson. New York Times. September 28, 2008.

> counterparties for collateral purposes were considered in the determination of the fair value estimates of AIGFP's super senior credit default swap portfolio."

In this disclosure, the accuracy of the early statement is seriously called into question as the company discloses (1) that counter parties have questioned the company's valuations and (2) required $5.3 billion in collateral, as opposed to the $847 million amount disclosed earlier. The company did not disclose any information with respect to who the counter parties were. For example, if one of the counter parties was Goldman Sachs, a firm that has a reputation for excellence in valuation models, it might even further call into questions the amounts reported by the company.

Six months later, AIG disclosed in its June 30, 2008 quarterly report:

> " As of July 31, 2008, AIGFP had received collateral calls from counterparties in respect of certain super senior credit default swaps (including those entered into by counterparties for regulatory capital relief purposes and those in respect of corporate debt/CLOs). At times, valuation estimates made by certain of the counterparties with respect to certain super senior credit default swaps or the underlying reference CDO securities, for purposes of determining the amount of collateral required to be posted by AIGFP in connection with such instruments, have differed significantly from AIGFP's estimates. AIG is unable to assess the effect, if any, that recent transactions involving sales of large portfolios of CDOs will have on collateral posting requirements. In almost all cases, AIGFP has been able to successfully resolve the differences or otherwise reach an accommodation with respect to collateral posting levels, including in certain cases by entering into compromise collateral arrangements, some of which are for specified periods of time. Due to the ongoing nature of these collateral calls, AIGFP may engage in discussions with one or more counterparties in respect of these differences at any time. As of July 31, 2008, AIGFP had posted collateral (or had received collateral, where offsetting exposures on other transactions resulted in the counterparty posting to AIGFP) based on exposures, calculated in respect of super senior credit default swaps, in an aggregate net amount of **$16.5 billion.** Valuation estimates made by counterparties for collateral purposes were considered in the determination of the fair value estimates of AIGFP's super senior credit default swap portfolio.
>
> The unrealized market valuation losses of **$26.1 billion** recorded on AIGFP's super senior multi-sector CDO credit default swap portfolio represents the cumulative change in fair value of these derivatives, which represents AIG's best estimate of the amount it would need to pay to a willing, able and knowledgeable third party to assume the obligations under AIGFP's super senior multi-sector credit default swap portfolio as of June 30, 2008."

A recent analyst's report highlights the concerns with the lack of timely transparent disclosures to investors, which have weighed on the valuation of the stock as it has plummeted. The report states:

> "According the company's 10-Q, AIG had already posted $16.5 billion of collateral and was required to post an additional $14.5 billion following a downgrade by Moody's and S&P to the mid-A level, bringing total collateral posting requirements to $31 billion if AIG was rated mid-A by both agencies…With S&P taking the company to low-A, AIG faces significant additional collateral posting requirements ***that it has not disclosed*.**"[3] [emphasis supplied]

In one year, the disclosures from the company had gone from not losing a dollar to over $26 billion in valuation losses and counter parties that to this day have not been disclosed demanding over $16 billion in collateral. And on October 3, 2008 the Company disclosed that at the end of September it had borrowed $61 billion from the federal government due to the liquidity crisis such calls on collateral had placed on AIG. Clearly it would seem that in light of this, the company had failed to provide investors with a clear view of the magnitude of the potential demands for collateral. No doubt some investors may question if the SEC's disclosures rules for Management's Discussion and Analysis ("MD&A") have been complied with. In a release in December 2003, the SEC stated:

> "The purpose of MD&A is not complicated. It is to provide readers information "necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations." .The MD&A requirements are intended to satisfy three principal objectives:
>
> to provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management;
>
> to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
>
> to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.
>
> MD&A should be a discussion and analysis of a company's business as seen through the eyes of those who manage that business."[4] [footnotes omitted]

The Financial Accounting Standards Board has recently adopted new disclosure rules that should enhance transparency with respect to credit derivatives. However, it appears additional disclosures may be warranted by companies with respect to credit derivative notional amounts, a

[3] AIG: Debt reduction and Asset Coverage Analysis. Credit Sights. September 30, 2008.
[4] Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations. SEC. December 19, 2003.

roll forward of notional amounts as well as fair values of the derivatives, the terms and conditions that can result in a call for collateral, the weighted average duration of such contracts, and information regarding the counter party risk involved.

In addition, in light of recent events, it appears serious consideration needs to be given to further regulation of these instruments, and the market for them. I wholeheartedly support SEC Chairman Cox's recent call for such regulation. It should include the appropriate mechanisms to increase transparency including transparency with respect to risk exposures, pricing, processing of transactions including timely clearing and settlement with appropriate documentation. Consideration should also be given to whether greater standardization of the market might enhance liquidity. In addition, banking regulators need to give greater consideration to how credit derivatives have contributed to banks being lax on credit risks and lending standards as they can now off lay credit risks with derivatives.

Management and the Corporate Board

The 2005 restatements of AIG's financial statements also raise questions regarding the integrity of management and the competency of the Board. This led to the ouster of Hank Greenberg as CEO and Chairman of the Board. In that year, Glass Lewis recommended a vote against 10 of the 15 members up for election to the Board.[5]

Glass Lewis also raised questions were also raised regarding the newly appointed CEO, Martin J. Sullivan, and the new Chairman of the Board, Frank Zarb. Mr. Zarb had been on the board and a member of the audit committee during the years the misleading financial statements had been prepared. In addition, the Board had quickly appointed Mr. Sullivan, previously the vice chairman of the company and co-chief operating office under Greenberg as the new CEO. The Board did not consider other candidates or do an outside search of potential candidates.

Six of those directors who were at the company during the early years involved with the initial restatement and troubling transactions that gave rise to investigations, remained on the board through the end of 2007. One of these board members served on at least seven public company boards, a number considered excessive by most corporate governance experts. Other directors served as executives at not for profit organizations who had beneficiaries of significant contributions from AIG or its affiliates. Mr. Zarb had indicated in the 2005 proxy that he would step down as interim chair at the end of 2005. However, after getting reelected in 2005, Mr. Zarb remained as chairman until age limits required him to step down in 2008. I believe the board should have gone through a complete and thorough overhaul when the first restatement and law enforcement agency investigations arose.

In addition, the board had also approved a severance package for Mr. Sullivan who stepped down as CEO on July1, 2008. Despite investors suffering significant declines in stock value,

[5] American International Group, Inc. Proxy Paper. Eric Crawley. Glass Lewis. July 22, 2005.

Mr. Sullivan's arrangements include severance of $15 million, a pro rata bonus of $4 million and the continued vesting of outstanding equity and long-term cash awards valued at approximately $28 million. One must question why such a package would have been agreed to, especially when the CEO was hired just three years earlier without an executive search having been performed. In essence, Mr. Sullivan received what many on Main Street would consider a lot of money for very little if any performance.

The competency of the board in overseeing management was also called into question earlier this year when some investors and a former director called for a change in management. When an insider, the chairman of the board, was anointed as the new CEO, an analyst's report stated:

> "Increasingly, investors have lost confidence in AIG's business model and current management…Until AIG is able to regain investor confidence in its business model, we expect to see weakness in spreads.
>
> …We were hoping for an outside appointment of someone who could take an unbiased view of AIG's portfolio of companies. Although we are negative on the appointment, we would note that Willumstad is a highly capable financial services executive. We simply do not see him as a good fit for the company at this moment in its history."[6]

Clearly a question remains regarding the competency of this board to carry out its responsibility on behalf of investors.

Another issue that calls into question the decisions of the board is its selection of auditors. As part of the settlement with the New York Attorney General, AIG agreed to go through a proposal process for selection of an auditor. PWC has been the auditor for AIG for many, many years, and yet despite its knowledge of the company had not caught and reported the errors leading up to the 2005 restatement. During this time period it has been reported that there was a change in audit partners that was challenged by AIG management, and at their request a different audit partner assigned. The CFO was also a former PWC employee. In addition, there has continued to be constant reporting of "new" material weaknesses and errors – out of period adjustments – that call into question how one can have confidence and trust in the financial statements. To PWC's credit, they have appropriately challenged management and highlighted the shortcomings. But one wonders if they have been constantly behind the curve in surfacing problems. I believe the board would have enhanced shareholder confidence by bringing in a "fresh set of eyes" and a new independent auditor.

<u>The Role of Lax Regulation</u>

[6] AIG 2Q08: Brutalized by Super Senior Swaps. Credit Sights. August 7, 2008.

I believe one of the significant contributing factors that allowed management to engage in their unsound business practices was lax regulation. For example, banking regulators have recently taken actions with respect to mortgage lending standards. One must ask why now, why not several years ago when such loans could have been prevented. Certainly the banking regulators did periodic examinations at institutions they did oversee such as Countrywide and WaMu, and must have been aware of the unsound lending practices that were being engaged in.

Yet the lack of action by the Federal Reserve raises a question that should be considered further when the structure of the regulatory system is revisited. If the Fed, as the central bank responsible for setting monetary policy decides on a policy of increasing the monetary supply, and cheap debt, should it also be responsible for the examination of the lending practices of banks to assess if they are conservative enough? It would appear the most recent crisis would seem to support legislation introduced in 1994 that would have transferred the responsibility for examinations and the accompanying supervision of financial institutions to a single agency, consolidating responsibilities that are now split among the Federal Reserve, Office of the Comptroller and Office of Thrift Supervision.

Likewise, there clearly was a lack of transparency as a result of inadequate disclosure standards for off balance sheet financings, credit derivatives and risks associated with lending activities. These shortcomings have contributed to investors questioning the financial stability and liquidity of companies when investors were unable to get sufficient information as to make informed decisions. As a result, if the FASB is unable to act quickly and responsibly to remedy these shortcomings, the SEC should act before further damage is done to the capital markets.

The SEC also needs to take actions to shore up confidence in the agency which I believe has been seriously eroded as a result of the current crisis. For example, the Office of Risk Management should be adequately staffed to allow the agency on a proactive basis to identify risks in the market place such as those created by excessive leverage, or new financial instruments that carry significant system risks such as credit derivatives. Once identified, a plan for promptly and appropriately addressing regulatory and public policy issues should be formulated and an action plan established on a proactive basis before, not after, the train wreck has occurred.

In addition, the SEC needs to once again establish itself as the investors' advocate and a watchdog rather than a lap dog. Constraints put on its enforcement division under the current chairman should be removed immediately. And reductions in staffing should be reversed.

Likewise, Congress should also provide the SEC with necessary regulatory authority to supervise credit rating agencies as well as credit derivatives in a meaningful fashion. Congress failed to give the SEC the statutory authority necessary to properly regulate investment banks holding companies which it failed to do when passing the Gramm Leach Bliley act. In 2004 this contributed to the SEC making a fatal and flawed decision to reduce the capital requirements for the largest Wall Street investment banks, yet failing to provide adequate oversight or supervision subsequently to evaluate the extent of the leverage and consequent risks being taken on. To prevent further such occurrences, Congress should fill a gaping hole created by the Gramm Leach Bliley act which failed to give regulatory agencies including the SEC, the authority to regulate and set standards for conflicts that arise when banking and securities activities occur within the same financial institution. While it may not be immediately apparent, an objective of safety and soundness is not always consistent with protecting investors

<u>Mark to Market Accounting – Don't Shoot the Messenger</u>

I would also be remiss if I did not address today a question which the staff of the Committee has raised with me regarding the use of what has been referred to as fair value or mark to market accounting. I agree with the Federal Reserve Chairman, the Secretary of the Treasury and former SEC Chairman Levitt that it would be a poor decision to permit banks to have a moratorium from market value accounting.

Perhaps a vivid reminder of what happens when banks are allowed to stray from reporting fair values and losses is highlighted in the General Accounting Office report titled "Failed Banks – Accounting and Auditing Reforms Urgently Needed" issued in April 1991. In citing problems that led to the costly taxpayer funded bailout of the banking and S&L industry, the Comptroller General, Charles Bowsher stated that call reports of failed institutions often failed to reflect timely asset devaluations "...resulting in continued operation and losses by unsafe and unsound banks, at considerable cost to the Bank Insurance Fund." He noted that banking examinations at the time often reflected dramatically lower values than the failed banks had reported. The report states "...we believe that market value accounting should be adopted now for debt investment securities held by financial institutions." The costly lessons cited in the GAO report should be avoided or the cost of the current bailout would likely grow due to a lack of accountability.

But regardless of whether we have fair value accounting, we would still have the current financial crisis. The crisis is brought on by the fact the banks and investment banks have leveraged up, having borrowed many times more than the typical business, and have run out of cash - a liquidity crisis as some say. Think of it this way. If you go out and make a $100 loan but the borrower can only repay say $60, then you have got something worth less than a $100. But if you do that hundreds of thousands of times, as was done by the banking industry and Wall Street, it doesn't take a rocket scientist to figure out that sooner or later one runs out of cash. You can't just keep paying out more than you collect without running out of cash and eventually going bankrupt.

In the crisis at hand, too many bad loans were made and put on the books at $100. But they weren't worth that despite credit rating agencies giving them a AAA rating on paper. In addition, because so often the money used to make the $100 loan with was borrowed, but only $60 was repaid, there also wasn't enough money left over to repay those from whom money was borrowed to make the loan in the first place.

Unfortunately, not all the banks and those on Wall Street told everyone, including investors, what they had been up to. And certainly they didn't at first tell them the loans were not worth

$100. But as liquidity and cash ran short, the losses became apparent and some institutions began to report losses. (Some such as Goldman Sachs had been much more transparent reporting fair values and losses much more timely, and have proven to be more astute and successful managers.)

Unfortunately, when investors of companies such as Bear Stearns and Lehman began to doubt the value of the assets that were reported in their balance sheets, uncertainty and a lack of trust developed. Investors chose to move their money and investments elsewhere. In the case of Lehman, investors had already lost money and been burned on their investments in Bear Stearns. As a result, institutions sold shares in Lehman before they incurred the types of losses that had occurred by holding the investments in Bear Stearns until the bitter end. This left a market for the Lehman stock where there were a lot more sellers than buyers, and as anyone who has taken Econ 101 knows that results in the price of the stock going down - quickly. In fact, much quicker than if just short sellers were to be blamed.

While this had occurred, others (like AIG) had agreed to provide credit protections on these loans. As people found out that the loans were only worth $60, investors also began to wonder what the credit protection was going to cost those who agreed to provide it. With trillions in credit protection granted through contracts that had to be honored, an agreement that could call for collateral or cash if the insurer's own credit worthiness was called into question was now a serious risk to the insurers. And of course, as the subprime loans did not pay off, then the insurance would kick in, and someone would have to pay up for the shortfall in the original $100 loan or put up collateral.

As we have seen with all the foreclosures and defaults, the subprime loans predictably did not pay off - (that is why they are called subprime). People or financial institutions who put up the money for the loans were not receiving payments equal to what they had paid out, thereby creating a shortfall that was insured. And the insurers ran short when called upon to make good on their insurance. So regardless of whether one used fair value accounting or not, the lack of cash and liquidity crisis would have occurred.

But if institutions were allowed to continue to report the value of their loans as worth a $100 when only $60 was being repaid, this is just flat out misleading, if not lying to those who own the company or might be buying the company's stock. It certainly results in less accountability.

Only by reporting the loans or investments at what they are worth, does the market and investors learn of the fact managers were making loans they shouldn't have been, and permit the market to discipline them early on when loans first start going bad. With that information in the public domain, investors will pay less for the stock and challenge management. Informed decisions are an aspect of market discipline that works, but only works when there is transparency, not a shroud of secrecy. On the other hand, if this is all done without disclosure, management is able to get away with such unsound business practices for much longer. Especially when there is lax oversight or a void in regulatory authority as certainly has occurred in recent years.

The poor transparency that investors have been experiencing is very similar to what happened during the savings and loan ("S&L") crisis when reporting of bad loans was delayed. It also occurred with Enron, when so much off balance sheet debt was hidden from investors and the markets. Now after these instances, we are seeing a repeat performance yet again. The question is: how often is Congress going to permit this to occur, each time at great cost to the individual American. The S&L bailout cost taxpayers somewhere between half a trillion and trillion depending on whose estimates one uses. During the Enron corporate scandals, the capital markets bottomed out after losing around $7 trillion in market capitalization, and today, the Nasdaq index is still less than half of what it was in 2000. Now Americans are facing a price tab that some predict could reach one and half trillion dollars. At some point, Americans will lose faith in their government if this continues.

Nonetheless, bankers are once again asking for a suspension of accounting that requires them to report to investors and depositors at a minimum four times a year what their assets are worth including any declines in values during the period. This comes at a time when the International Monetary Fund and Bridgewater Associates have reported mortgage related losses will balloon to between $945 billion and $1.6 trillion. But with institutions only reporting a little more than $500 billion in losses to date, it is apparent that more losses should be forthcoming if data from the banks is reliable. To suspend further reporting of these losses to investors and depositors is akin to a student asking for suspension of a report card when a failing grade is coming.

I note the banks are requesting a moratorium on their fair value report card. But they are also requesting $700 billion of American's money to bail them out for the bad loans they made. And they want both. But if the problem was as they assert, fair value accounting, a moratorium on it should solve the problem without the need for a bailout. Yet they are still asking for <u>*ALL*</u> the cash. A true red herring: the problem isn't fair value accounting at all, but rather a lack of cash in the banks themselves because they spent more on assets bought or created than they are subsequently getting paid back on. Ultimately, it is no different than someone who spends more than their paycheck each month. Sooner or later you end up in foreclosure, just as we are seeing with the banks themselves.

And the voice of those who create the problem always becomes loudest when there is a downturn in the markets. We seldom hear such loud screaming and complaining when the markets are rising and gains, not losses, are being recorded under fair value accounting. But when the values of assets have become impaired, managers often don't want to tell their investors that the assets under their stewardship have lost values. That information raises questions about what investors are receiving in return for the compensation being paid, as well as questions about the decisions and competency of management. Instead, companies would just as soon report higher inflated values, even to those who rely on credible financial statements to buy the stock. Companies argue that the stock market will turn around and they will recover the values of their assets. I think that is an argument I have heard AIG saying - that they would not incur losses. Reality has shown that argument and approach does not always work out for investors, like the pension funds who did not and will not recover *their* investments.

Others argue that you can't value these loans and securities, especially those for which there are illiquid markets. These, however, are not the vast majority of investments, that is investments for which prices are readily available. But for those in illiquid markets, one can look to the expected cash flows, using historical data informed by recent market transactions as a guiding

light, to determine what cash is expected to be paid, which is ultimately always the determining factor in setting valuations. Of course values are often adjusted down to reflect the risk a willing buyer takes on in purchasing the assets, and the return that will compensate the buyer sufficiently to entice one to take on those risks. Keep in mind there was a reason some institutions chose not to buy subprime securities in the volumes others did, and whose management these day are getting credit for looking a lot smarter than others. While markets are illiquid at times, as with a thinly traded stock, that is no reason to simply ignore the best estimate of a market value or a calculation of a fair value. The reason markets are sometimes illiquid is there is no one who is willing to pay the price the seller wants because that price provides any buyer an insufficient return on their investment. And while that may be a depressing price, it is not a depressed price – it is just what the market says it is worth. If the price is lowered to a number that provides an adequate return, more buyers will enter into the bidding for the investment.
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At the same time it is relevant that key indices on housing prices continue to decline. Ultimately, it is either the payments on the mortgage or the underlying value of the house which serves as collateral that determines the value of a mortgage loan, or related security instrument. Of the 55 million homes financed with residential mortgages, it is thought that perhaps 12-13 million are now “underwater.” And sales that have occurred in the market place have come at significantly reduced prices, such as sales by E-Trade or Merrill Lynch. Similarly we saw Wachovia received offers that would pay only cents on the dollar compared to its $75 billion net book value.

If the cash payments for a security or loan cannot be determined, one must ask why it is being sold into the public markets or being bought by a bank with depositor’s money in the first place. I don't recall seeing a prospectus or offering memorandum with disclosure to the prospective investor saying the seller of the subprime loans didn't have any idea about what the cash repayment streams would be. Of course such a disclosure would have been a red flag to investors and certainly would not have resulted in a AAA credit rating from the credit rating agency, as many of these investments were rated.

Some say we are experiencing a “distressed” market with abnormally low and unjustified prices that will in time return to higher values. That is like saying the market in some years is up, and some years is down, but we will ignore the down years and only use the prices in the up years. I never have heard anyone say you shouldn’t use inflated bubble level prices because certainly they will fall when the crash comes. I do think prices currently are “distressing” but then they always are when they are not rising. But that doesn’t mean we should give an exemption to companies permitting them to go out and say the markets and the values of their assets are up, when in fact they are not.

Finally, some people don't understand what FASB standard No. 157 is all about and their lack of an informed understanding shows. They often want a moratorium on that standard. But the reality is that it is a standard which in addition to greatly enhancing transparency in the current crisis accomplishes two things. However, one of them is not a requirement for using fair value accounting. That requirement actually rests in other standards.

The two things FASB No. 157 does is that it (1) tells accountants *how* to do fair value accounting when it is required by another standard, and (2) requires some very excellent disclosures on the fair values that have been determined. In fact, this is the standard that requires a company or financial institution to put their investments into three buckets depending on how "hard" or "soft" or independently verifiable those valuations may be. The company must then tell investors how much is in each bucket, so one can understand with greater confidence the nature and types of investments and where greater judgments are required to come up with good and solid valuations. Without such a standard, as we saw during the S&L and banking crisis of the late 1980's accounting sleight of hand is all too common when assets are reported at much more than they are/were worth. To that end, investors can thank the FASB for greatly improving the disclosures.

Closing

In closing, transparency – the ability to get information needed to make fully informed investment decisions – is critical to gaining investors trust in markets. Unless that information is accurate and reliable, investors will not trust it. When investors are provided misleading or incomplete information, they rightfully steer clear of investing in the markets because all too often it leads to losses, as we saw with Enron and more recently, financial institutions. To bring back investors to the markets, they must once again be convinced they are getting reliable information upon which to base informed, not misinformed decisions. Until then, they may prefer Las Vegas where at least the word “Casino” appears on the entrance.

Thank you and I would be happy to take any questions committee members might have.

EXHIBIT A

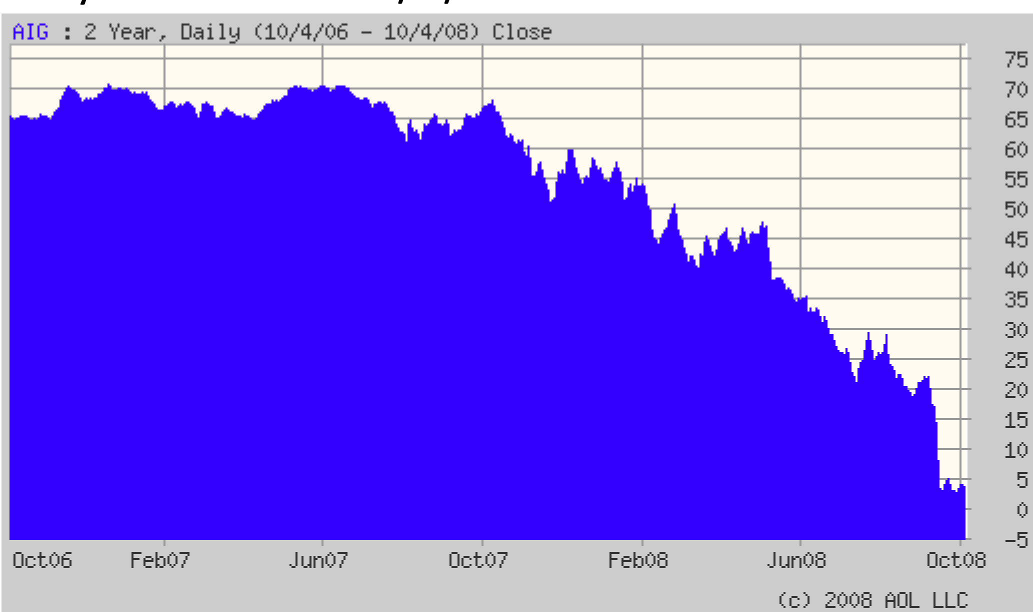
AIG Stock Charts – As of close of business on October 3, 2008

Stock Price $ 3.86

AIG Year To Date stock chart as of 10/03/08

Intraday 1 Mo 2 Mo 3 Mo 6 Mo 9 Mo **YTD** 1 Yr 2 Yr 3 Yr 5 Yr 10 Yr

AIG 2 year stock chart as of 10/03/08

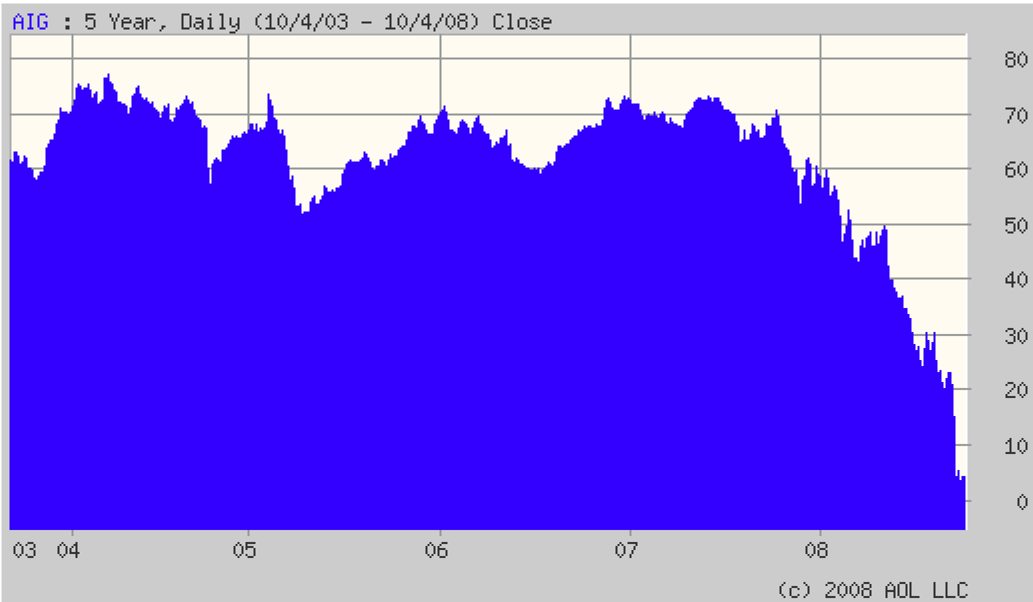


Intraday 1 Mo 2 Mo 3 Mo 6 Mo 9 Mo YTD 1 Yr **2 Yr** 3 Yr 5 Yr 10 Yr

EXHIBIT A

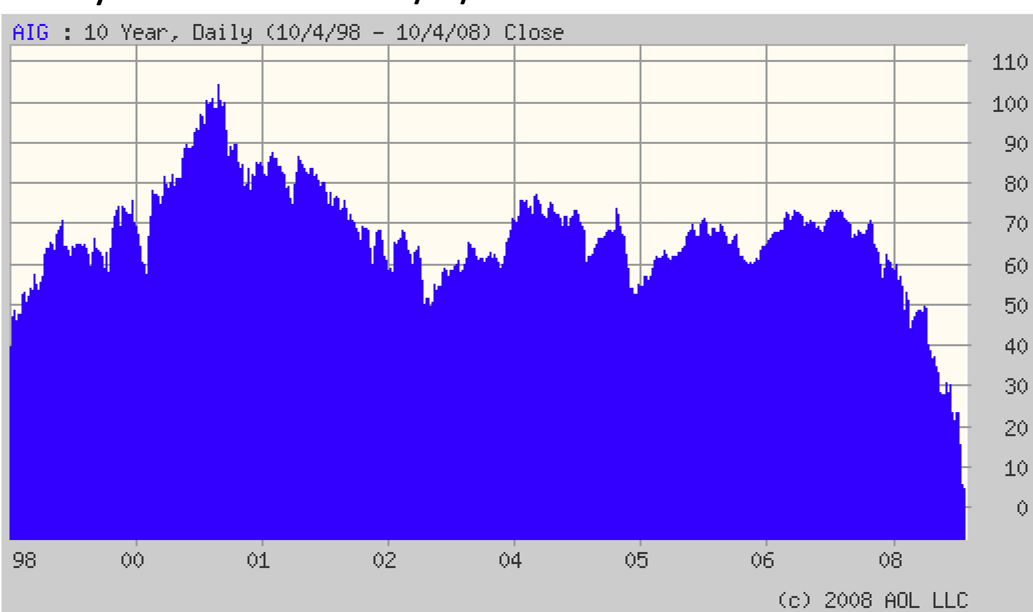
AIG Stock Charts – As of close of business on October 3, 2008

AIG 5 year stock chart as of 10/03/08



Intraday 1 Mo 2 Mo 3 Mo 6 Mo 9 Mo YTD 1 Yr 2 Yr 3 Yr **5 Yr** 10 Yr

AIG 10 year stock chart as of 10/03/08



Intraday 1 Mo 2 Mo 3 Mo 6 Mo 9 Mo YTD 1 Yr 2 Yr 3 Yr 5 Yr **10 Yr**