

TESTIMONY OF ELIAS HABAYEB
BEFORE THE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
UNITED STATES HOUSE OF REPRESENTATIVES
JANUARY 27, 2010

MR. CHAIRMAN, RANKING MEMBER ISSA, MEMBERS OF THE COMMITTEE.
THANK YOU FOR THE INVITATION TO APPEAR BEFORE YOU TODAY.

FROM SEPTEMBER 2005 UNTIL MAY OF LAST YEAR, I WAS SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER OF THE FINANCIAL SERVICES DIVISION OF AMERICAN INTERNATIONAL GROUP, INC. AIG'S SUBSIDIARIES WITHIN THE FINANCIAL SERVICES DIVISION ENGAGE IN A DIVERSE RANGE OF ACTIVITIES INCLUDING AIRCRAFT AND EQUIPMENT LEASING, CAPITAL MARKETS, CONSUMER FINANCE AND INSURANCE PREMIUM FINANCE. THESE SUBSIDIARIES INCLUDE AIG FINANCIAL PRODUCTS CORP. ("FP"). AS HAS BEEN WIDELY REPORTED, FP IS THE UNIT THAT WROTE THE CREDIT DEFAULT SWAPS (THE "SWAPS") PROTECTING MULTI-SECTOR COLLATERALIZED DEBT OBLIGATIONS (THE "BONDS") THAT HAD EXPOSURE TO THE U.S. SUBPRIME MORTGAGE MARKET AND THAT CONTRIBUTED GREATLY TO AIG'S LIQUIDITY CRISIS IN SEPTEMBER 2008.

BY WAY OF BACKGROUND, I AM A LICENSED CPA AND I PRACTICED WITH DELOITTE & TOUCHE LLP, BECOMING A PARTNER IN 2003, BEFORE I WAS RECRUITED TO AIG IN 2005. I LEFT EMPLOYMENT WITH AIG IN MAY 2009 ON EXCELLENT TERMS, AND CONTINUE TO PROVIDE ADVISORY SERVICES TO THE COMPANY WHILE I PLAN THE NEXT PHASE OF MY CAREER.

MY POSITION WHILE I WAS EMPLOYED BY AIG GAVE ME SOME INSIGHT INTO THE CREATION OF WHAT IS COMMONLY REFERRED TO AS "MAIDEN LANE III". MAIDEN LANE III LLC IS A FINANCING VEHICLE CREATED BY THE NEW YORK FEDERAL RESERVE BANK ("NY FED") THAT HELPED FACILITATE THE UNWINDING OF A SIGNIFICANT PORTION OF FP'S SWAPS BY PURCHASING THE UNDERLYING BONDS FROM FP'S SWAP COUNTERPARTIES. AT THE SAME TIME, THE RELATED SWAPS WERE TERMINATED.

I ALSO WAS INVOLVED IN AIG'S EARLY AND UNSUCCESSFUL EFFORTS TO REDUCE FP'S RISK EXPOSURE, INCLUDING BY TERMINATING FP'S SWAPS. ULTIMATELY, THE NEW YORK FED TOOK CONTROL OF THE NEGOTIATIONS WITH FP'S COUNTERPARTIES TO THE SWAPS. THE NEW YORK FED COMPLETED THAT PROCESS THROUGH MAIDEN LANE III. AFTER THE TRANSACTIONS WERE COMPLETED, I, ALONG WITH OTHERS, REVIEWED AIG'S FILINGS WITH THE SECURITIES AND EXCHANGE COMMISSION TO HELP ENSURE THAT THEY ACCURATELY DESCRIBED THESE TRANSACTIONS.

I UNDERSTAND THAT THE COMMITTEE IS INTERESTED IN LEARNING MORE ABOUT THE MAIDEN LANE III TRANSACTIONS. THESE TRANSACTIONS WERE CRITICAL TO AIG IN ORDER TO MATERIALLY REDUCE THE RISK OF SUBSTANTIAL COLLATERAL POSTINGS TO COUNTERPARTIES THAT FP WAS REQUIRED TO MAKE UNDER THE SWAPS AND ALSO TO REDUCE THE EROSION TO AIG'S CAPITAL FROM MOUNTING MARK-TO-MARKET LOSSES ON THE SWAPS.

I PAUSE FOR A MOMENT TO RECOUNT SOME CONTEXT BECAUSE I BELIEVE IT SHEDS LIGHT ON WHY MAIDEN LANE III WAS NECESSARY.

FIRST, IT IS IMPORTANT TO UNDERSTAND THE NATURE OF AIG'S EXPOSURE TO THE SWAPS BECAUSE AIG GUARANTEED FP'S DEBT OBLIGATIONS SINCE FP'S INCEPTION IN 1987.

SINCE 1998, FP WROTE SWAPS THAT PROVIDED CREDIT PROTECTION ON MULTI-SECTOR COLLATERALIZED DEBT OBLIGATIONS (REFERRED TO HERE AS THE BONDS). AS OF SEPTEMBER 30, 2008, THE TOTAL NOTIONAL VALUE OF THE BONDS WAS APPROXIMATELY \$72 BILLION.

FP'S COUNTERPARTIES TO THESE SWAPS WERE MOSTLY LARGE US AND INTERNATIONAL FINANCIAL INSTITUTIONS. THE COUNTERPARTIES PURCHASING THE SWAPS PAID FP PERIODIC PREMIUMS IN EXCHANGE FOR FP ASSUMING THE RISK THAT THE COUNTERPARTIES HAD OF NON-PAYMENT OR

LOSS RESULTING FROM CERTAIN "CREDIT EVENTS" (E.G., FAILURE TO PAY, BANKRUPTCY, ACCELERATION, RESTRUCTURING) WITH RESPECT TO THE UNDERLYING BONDS.

FP WAS ALSO REQUIRED UNDER CERTAIN CIRCUMSTANCES TO POST COLLATERAL TO THE COUNTERPARTIES – SECURING FP'S ABILITY TO PERFORM IN THE EVENT OF A DEFAULT OR OTHER CREDIT EVENT TRIGGERING A PAYMENT OBLIGATION ON THE SWAP.

GENERALLY, THE AMOUNT OF COLLATERAL REQUIRED TO BE POSTED BY FP UNDER THE SWAPS WAS DETERMINED BY A FORMULA THAT TOOK INTO ACCOUNT AIG'S CREDIT RATINGS, THE UNDERLYING BOND'S CREDIT RATINGS, AND THE MARKET VALUE OF THE UNDERLYING BOND. TO SIMPLIFY, IF THE VALUE OF THE BONDS COVERED BY THE SWAP, THE UNDERLYING BOND'S CREDIT RATING, OR AIG'S CREDIT RATING DROPPED, FP HAD TO POST COLLATERAL "FOR THE PROTECTION" OF ITS COUNTERPARTY.

DURING THE SUB-PRIME MORTGAGE CRISIS, THE BONDS UNDERLYING FP'S SWAPS BEGAN TO DECREASE IN VALUE. AS A RESULT, BEGINNING IN LATE 2007 THROUGH 2008, FP REPORTED BILLIONS OF DOLLARS OF MARK-TO-MARKET LOSSES ON THE SWAPS UNDER THE FAIR VALUE ACCOUNTING RULES. (AS CFO OF THE FINANCIAL SERVICES DIVISION, I WAS INVOLVED IN ACCOUNTING FOR THE SWAPS, EVEN THOUGH I WAS NOT INVOLVED IN WRITING THE SWAPS –

INDEED, THE MAJORITY OF THE SWAPS WERE ON FP'S BOOKS BEFORE I JOINED AIG.) THESE VALUATION LOSSES COULD (AND INITIALLY WERE EXPECTED TO) REVERSE IF THE FAIR VALUE OF THE SWAPS RECOVERED AND FP STILL HELD THE SWAPS.

FP ALSO POSTED BILLIONS OF DOLLARS IN COLLATERAL TO ITS COUNTERPARTIES UNDER THE SWAPS AS A RESULT OF THE DECLINING MARKET VALUE OF THE BONDS AND DECLINES IN AIG AND THE BONDS' CREDIT RATINGS.

IN LIGHT OF THESE MOUNTING LOSSES, BEGINNING IN THE SUMMER OF 2008, BEFORE THE FEDERAL RESCUE, I WAS ACTIVELY INVOLVED, ALONG WITH OTHERS AT AIG AND ITS ADVISORS, IN EXPLORING POSSIBILITIES TO REDUCE THE LIQUIDITY AND MARK-TO-MARKET RISKS POSED BY FP'S SWAPS.

HOWEVER, AIG LACKED THE FINANCIAL RESOURCES TO COME UP WITH A LARGE SCALE SOLUTION INVOLVING A \$72 BILLION BOOK OF SWAPS. EVEN THOUGH AIG HAD MANY ASSETS, MOST WERE ASSETS HELD BY ITS INSURANCE COMPANY SUBSIDIARIES, AND STATE INSURANCE REGULATIONS SEVERELY LIMITED AIG'S ABILITY TO ACCESS THEM. BECAUSE AIG IS NOT A BANK, IT DID NOT HAVE ACCESS TO FUNDING THROUGH THE FEDERAL RESERVE IN THE NORMAL COURSE. INSTEAD, AIG HAD TO RELY ON THE CAPITAL MARKETS. BUT AIG WAS UNABLE TO OBTAIN ADDITIONAL LIQUIDITY FROM THE CAPITAL MARKETS.

ADDITIONALLY, OUR EFFORTS TO STEM THE TIDE OF COLLATERAL CALLS AND REDUCE FP'S RISK EXPOSURE BY NEGOTIATING WITH COUNTERPARTIES DURING THIS PERIOD WERE UNSUCCESSFUL. UNFORTUNATELY, WE HAD LITTLE NEGOTIATING LEVERAGE WITH FP'S COUNTERPARTIES TO EXTRACT DISCOUNTS. THE CONTRACTUAL COLLATERAL POSTING PROVISIONS IN THE SWAPS WERE A SOURCE OF CHEAP CASH FOR THEM. IT WAS ALSO MY UNDERSTANDING THAT EVEN IF FP OR AIG FILED FOR BANKRUPTCY, THE COUNTERPARTIES WOULD KEEP THE COLLATERAL FP HAD POSTED TO DATE, THEY WOULD KEEP THE UNDERLYING BONDS (AND ANY FUTURE UPSIDE), AND THEY COULD MAKE A CLAIM AGAINST FP FOR DEFAULTING ON THE SWAPS.

BY AUGUST 31, 2008, FP HAD POSTED \$19 BILLION IN COLLATERAL TO FP'S SWAP COUNTERPARTIES. AND BY THE BEGINNING OF SEPTEMBER 2008, FP'S COLLATERAL PAYMENT OBLIGATIONS (AS WELL AS CASH REQUIREMENTS IN CERTAIN OF AIG'S OTHER BUSINESS SEGMENTS) WERE PLACING INCREASING STRESS ON AIG'S LIQUIDITY. ON SEPTEMBER 15, 2008, THE RATING AGENCIES DOWNGRADED AIG'S CREDIT RATING, TRIGGERING AN ONSLAUGHT OF NEW COLLATERAL CALLS.

EVEN AFTER THE FEDERAL RESCUE ON SEPTEMBER 16, 2008, AIG STILL NEEDED TO DO SOMETHING TO REDUCE ITS EXPOSURE TO THE MARK-TO-MARKET LOSSES AND COLLATERAL CALLS ON FP'S SWAPS. THE FEDERAL

RESCUE DID NOT STOP THESE LOSSES OR PAYMENT OBLIGATIONS. INDEED, FP POSTED APPROXIMATELY \$12.5 BILLION IN THE MONTH OF SEPTEMBER ALONE. AND AS THE LOSSES AND PAYMENTS CONTINUED, AIG FACED YET ANOTHER RATINGS DOWNGRADE THAT COULD HAVE FURTHER STRAINED AIG'S LIQUIDITY BY TRIGGERING YET MORE COLLATERAL CALLS OR PERMITTING COUNTERPARTIES TO TERMINATE SWAPS AT PRICES FAVORABLE TO THEM.

IN OUR ONGOING DISCUSSIONS WITH COUNTERPARTIES DURING THIS PERIOD, THE COUNTERPARTIES WERE UNWILLING TO ACCEPT LESS THAN PAR VALUE. SOME COUNTERPARTIES WERE WILLING TO TERMINATE THE SWAPS, BUT ONLY IF AIG PURCHASED THE UNDERLYING BONDS FROM THEM – SOMETHING AIG COULD NOT DO WITHOUT THE NY FED'S HELP.

ON SEPTEMBER 30, 2008, I, OTHERS AT AIG, AS WELL AS AIG'S FINANCIAL ADVISORS AND LEGAL COUNSEL, PRESENTED TO THE NY FED AND ITS FINANCIAL ADVISORS, SEVERAL OPTIONS FOR ADDRESSING THE LIQUIDITY AND MARK-TO-MARKET LOSSES. THE OPTIONS AVAILABLE TO AIG WITHOUT NY FED SUPPORT WERE LIMITED GIVEN AIG'S LACK OF FINANCIAL RESOURCES AND ACCESS TO THE CAPITAL MARKET. BUT A LARGE SOLUTION WAS CRITICAL TO REDUCING THE LIKELIHOOD OF A FURTHER DOWNGRADE OF AIG'S RATING.

ONE OF THE OPTIONS PRESENTED WAS FOR FP AND THE NY FED TO CREATE A SPECIAL PURPOSE VEHICLE FUNDED LARGELY BY THE NY FED AND

FP'S EXISTING COLLATERAL POSTINGS THAT WOULD PAY TO ACQUIRE THE UNDERLYING BONDS AND TERMINATE THE RELATED SWAPS. (THIS OPTION WAS VERY SIMILAR TO MAIDEN LANE III.) THIS OPTION WOULD REDUCE FP'S EXPOSURE TO MARK TO MARKET LOSSES AND COLLATERAL CALLS BUT WOULD NECESSITATE A LARGE UPFRONT FUNDING REQUIREMENT.

UNDER THE FINAL MAIDEN LANE III STRUCTURE, THE NY FED WOULD LEND UP TO \$30 BILLION AND AIG WOULD PROVIDE \$5 BILLION IN EQUITY FUNDING TO MAIDEN LANE III AND MAIDEN LANE III WOULD BUY THE BONDS UNDERLYING THE SWAPS FROM FP'S COUNTERPARTIES. MAIDEN LANE III WOULD COLLECT CASH FLOWS FROM THE BONDS AND PAY A DISTRIBUTION TO AIG FOR ITS EQUITY INTEREST ONCE THE PRINCIPAL AND INTEREST OWING TO THE NY FED ON ITS LOAN HAD BEEN PAID DOWN IN FULL. UPON PAYMENT IN FULL OF THE NY FED'S LOAN AND AIG'S EQUITY INTEREST, ALL REMAINING AMOUNTS RECEIVED BY THE ENTITY WOULD BE PAID 67 PERCENT TO THE NY FED AND 33 PERCENT TO AIG.

THIS ARRANGEMENT ALLOWED BOTH THE NY FED AND AIG TO RETAIN THE UPSIDE FROM THE BONDS – FUTURE CASH FLOWS.

ON OCTOBER 31, 2008, I WAS TOLD THAT THE NY FED AND ITS FINANCIAL AND LEGAL ADVISORS TOOK OVER NEGOTIATIONS WITH THE COUNTERPARTIES AND ALL EFFORTS WERE NOW FOCUSED ON IMPLEMENTING THE MAIDEN LANE

III SOLUTION. I PERIODICALLY RECEIVED UPDATES ABOUT THE NY FED'S PROGRESS IN THESE NEGOTIATIONS.

UNDER THE FINAL TERMS NEGOTIATED BY THE NY FED, MAIDEN LANE III (THE FINANCING ENTITY CREATED BY THE NY FED), BOUGHT THE UNDERLYING BONDS AT THEIR THEN MARKET VALUE – NOT AT PAR. SEPARATELY, FP AGREED TO TERMINATE THE SWAPS FOR AN AMOUNT EQUAL TO THE DIFFERENCE OF THE BONDS' NOTIONAL (PAR) VALUE AND ITS MARKET VALUE. THE COLLATERAL THAT FP HAD POSTED TO DATE WAS USED TO PAY THE COST OF TERMINATING THE SWAPS. SO, THE COUNTERPARTIES ENDED UP WITH PAR.

AS AIG DISCLOSED IN AN SEC FILING ON DECEMBER 2, 2008, MAIDEN LANE III PURCHASED APPROXIMATELY \$46.1 BILLION NOTIONAL AMOUNT OF BONDS UNDERLYING FP'S SWAPS AND TERMINATED THE ASSOCIATED SWAPS ON NOVEMBER 25, 2008. THE AGGREGATE COST OF THE PURCHASES AND TERMINATIONS WAS FUNDED THROUGH APPROXIMATELY \$15.1 BILLION OF BORROWINGS UNDER THE NY FED LOAN TO MAIDEN LANE III, AIG'S \$5 BILLION EQUITY FUNDING AND THE SURRENDER OF APPROXIMATELY \$25.9 BILLION OF COLLATERAL PREVIOUSLY POSTED BY FP TO THE SWAP COUNTERPARTIES.

ON DECEMBER 18 AND 22, 2008, MAIDEN LANE III ACQUIRED \$16 BILLION IN PAR AMOUNT OF ADDITIONAL BONDS. AS DISCLOSED IN AN SEC FILING ON DECEMBER 24, 2008, THIS PURCHASE WAS FUNDED WITH A NET PAYMENT TO

COUNTERPARTIES OF APPROXIMATELY \$6.7 BILLION. ADDITIONALLY, FP SURRENDERED APPROXIMATELY \$9.2 BILLION IN COLLATERAL PREVIOUSLY POSTED TO FP'S SWAP COUNTERPARTIES TO TERMINATE THE SWAPS. IN CONNECTION WITH THE TERMINATION OF THE SWAPS, FP GOT BACK \$2.5 BILLION IN EXCESS COLLATERAL IT HAD PREVIOUSLY POSTED UNDER THE SWAPS.

IN SUM, MAIDEN LANE III PURCHASED APPROXIMATELY \$62 BILLION IN NOTIONAL AMOUNT OF BONDS UNDERLYING FP'S SWAPS FOR A MARKET VALUE OF \$29 BILLION. FP PAID THE COUNTERPARTIES IN PREVIOUSLY POSTED COLLATERAL, \$33 BILLION, TO TEAR UP THE SWAPS.

I UNDERSTAND THE COMMITTEE IS ALSO INTERESTED IN AIG'S DISCLOSURES ABOUT MAIDEN LANE III. AFTER THE MAIDEN LANE III TRANSACTIONS WERE COMPLETED, I, ALONG WITH OTHERS, REVIEWED AIG'S FILINGS WITH THE SEC TO HELP ENSURE THEIR ACCURACY BECAUSE OF MY FAMILIARITY WITH THE TERMS OF THE MAIDEN LANE III TRANSACTIONS. I DID NOT DECIDE WHAT EXHIBITS OR SCHEDULES WERE DISCLOSED. AIG HAD OUTSIDE LEGAL COUNSEL WHO GUIDED THE COMPANY THROUGH THAT PROCESS.

TO CONCLUDE, MAIDEN LANE III WAS CRITICAL IN HELPING AIG TO ELIMINATE MOST OF ITS CONTINUED EXPOSURE TO THE SIGNIFICANT MARK-TO-

MARKET LOSSES AND COLLATERAL CALLS ON THE SWAPS THAT WERE
DRAINING AIG'S LIQUIDITY.

I AM HAPPY TO ANSWER ANY QUESTIONS THE MEMBERS OF THE
COMMITTEE MAY HAVE. THANK YOU.