NCOIL

National Conference of Insurance Legislators

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JOINT HEARING
FINANCIAL SERVICES & INVESTMENT PRODUCTS COMMITTEE
NCOIL STEERING COMMITTEE

REGULATION OF THE CREDIT DEFAULT SWAP MARKET

Saturday, January 24, 2009
Marriott Marquis Hotel
1535 Broadway
New York, New York 10036
11:00 a.m. to 4:00 p.m.

OFFICIAL TRANSCRIPT

LEGISLATORS PRESENT WERE:

Sen. James Seward, NY, NCOIL President
Assem. Joseph Morelle, NY, Chair, Financial Services & Investment Products Committee
Sen. Joseph Crisco, CT
Rep. Robert Damron, KY
Rep. George Keiser, ND
Sen. Carroll Leavell, NM
Sen. Neil Breslin, NY
Assem. Nancy Calhoun, NY

OTHERS PRESENT INCLUDED:

Susan Nolan, NCOIL Executive Director
Candace Thorson, NCOIL Deputy Executive Director
Michael Humphreys, NCOIL Director of State-Federal Relations

WITNESSES

ADDITIONAL COMMENTS

SEWARD: Good morning, everyone. We will start the hearing at this point. Good morning. I'm Senator Jim Seward from New York, and those of you that have traveled from outside of New York, I want to welcome you to New York. I am the 2009 President of the National Conference of Insurance Legislators. And I want to welcome you to our NCOIL Joint Steering Committee and Financial Services and Investment Products Committee public hearing on regulation of the credit defaults swap market. We're delighted to have such a distinguished panel of legislators who have traveled here to join us today. I'd like to…at my far right, Senator Joe Crisco from Connecticut; next is Senator Carroll Leavell; next is Representative George Keiser from North Dakota; Susan Nolan, our Executive Director of NCOIL; Assemblyman Joe Morelle, who chairs the Financial Services Committee as well as the Insurance Committee in the Assembly; on my far left is Representative Robert Damron from Kentucky; Assemblywoman Nancy Calhoun from New York; Mike Humphreys and Candace from the NCOIL staff; and also to my immediate left, Senator Neil Breslin from New York, in fact, the new chair of the Insurance Committee in the New York State Senate. And we're delighted all of you are here this morning. The credit default swap market has been in what I would describe as regulatory limbo for almost ten years, due in large part to a federal decision that was made back in the year 2000. The passage by Congress of the Commodity Futures Modernization Act in December of 2000 spawned what many call an unfettered market. This, combined with the ongoing mortgage meltdown, has produced a perfect storm, destabilizing financial services sectors and accelerating into a global crisis that we all are experiencing. Today we are gathered to explore the credit default swap market and the role, if any, that state officials should have in its regulation. Questions that we should consider today include whether swaps should be recognized as insurance or securities, who should be regulating the swaps, and whether standards regarding reserving, insurable interests and solvency are needed in the market. These are very important financial instruments and at the very least, we as state legislators, need to be fully informed about all aspects of this market. Our slate of experts will discuss regulation of this market and its public policy implications. Our lead-off witness is New York State Insurance Superintendent, Eric Dinallo, who has led efforts to address credit default swaps in New York and at the national level. He's here today, as are representatives of

the International Swaps and Derivatives Association, Assured Guaranty and the Association of Financial Guaranty Insurers, HRF Associates, the National Association of Mutual Insurance Companies, AARP, and the American Academy of Actuaries, among others. We appreciate the participation of all of our witnesses. My New York State colleague, Assemblyman Joe Morelle, who as I said chairs the Assembly Insurance Committee, is a leader in his own right in the investigation of this market. He will chair this hearing today in his role as the Chair of the NCOIL Financial Services and Investment Products Committee. And without further adieu, I'd like to hand the hearing over to Assemblyman Morelle.

MORELLE: Good morning. First of all, thank you to President Jim Seward for convening this hearing this morning, and also to Susan Nolan and Mike Humphreys and the rest of the NCOIL staff for making this possible. I think my good friend and colleague, Senator Seward, articulated well the issues that we hope to be able to have some dialogue around today, and I want to thank, in particular, the panelists for participating. I think as Jim has said, we want to have a conversation about to what degree credit default swaps have contributed to economic struggles at home and financial dislocation around the country…around the world, rather, if at all. And then more importantly, sort of the public policy question of whether or not, particularly as insurance legislators, we are interested in whether or not credit default swaps are sufficiently like contracts of insurance that we ought to both in terms of our statutory and regulatory regimes consider in terms of public policy. I would add to what President Seward said relative to not only the Commodity Futures Modernization Act, but the expediential growth in credit default swap contracts which have gone from essentially zero to, depending on the notional value being measured today, somewhere around the range of $50 to $60 trillion dollars in less than two decades. And in many respects, I think the expediential growth in that marketplace has outpaced, perhaps, the real debate from a public policy point of view on how they ought to be considered and how they ought to be regulated. Obviously, the federal government in the early part of this decade prohibited states from being able to regulate them from the point of gaming, in particular, the so-called "naked" swap. So that notwithstanding, the question of whether or not they're sufficiently like insurance contracts and ought to at least consider questions of

reserving solvency, liquidity, indemnity…we ought to have that public policy debate. I fear it hasn't happened enough, and I am particularly pleased that NCOIL has convened this as a means to further that conversation, that debate and that dialogue. I suspect today will not be the end but perhaps the beginning of our line of inquiry, and also concomitant with that is the question of whether or not any regulatory regime should be done at the state level, the federal level, whether the states individually or as a compact…or some combination of all those things. And I think that's a part of the question that we would want to begin to address today. So again, thank you to President Seward, to NCOIL staff, and certainly to my colleagues who have joined us here from all over the country and taken time out of what I'm sure are very, very busy schedules to be here this morning. I do know, before I ask…call on my colleagues who may have some opening comments, I would like to remind people, we're going to try to limit testimony to ten minutes, and Q and A to ten minutes out of respect for all the people who have signed up to testify. We do have this handy red, white and green series of buttons which is going to tell us that. Obviously we're not going to stop a line of inquiry that's particularly important, but we do want to remind people that's there. And to the extent that you've submitted written testimony, if you can summarize that written testimony, obviously the written record is available for all the members that might give us a little more time to engage in more of a question/answer dialogue. (God bless you, Mr. Neustadt. So those are the rules we'll try to adhere to, now let me call on my colleagues. I don't know if…any particular order…should we start from our far right, Senator Crisco?

CRISCO: That's okay…(weak audio)

MORELLE: No…yeah, okay, well maybe we'll do that. Senator? Senator Leavell? (inaudible background conversation).

KEISER: Well Mr. Chairman and fellow legislators and members of the panel, as our President Seward stated, the Commodities Futures Modernization Act was a player in this thing, but from my perspective, it goes back much further than that. It goes back to Gramm-Leach-Bliley, where we began to modernize the financial services sector and created the opportunity for NAIC to get involved in the financial side of the industry in addition to the insurance side of the

industry. And I would also add…just my own perspective, and I know I've talked to some people this morning and said, "Well I'm not sure that…that these types of transactions that we're here to discuss today are insurance issues." I want you to be on notice that from my perspective they are an insurance- related issue because they have affected the reserves of insurance companies. And as such, we treat them very seriously, need to understand them and need to see what we, as policymakers, can and should be doing relative to insuring that the reserving policies that we have established in our states does the job in terms of protecting our consumers. Thank you, Mr. Chairman.

MORELLE: Thank you, Mr. Keiser. Would any other panelists like to offer any opening comments? Alright, we will immediately move to our panelists. The first witness is someone that Senator Seward and Senator Breslin and I are very familiar with, as many of you are. The Superintendent of the New York State Insurance Department, the Honorable Eric Dinallo. Eric, thank you for being here this morning.

DINALLO: Thank you. Thank you. It's an honor and a pleasure to be here. I'll talk for a few minutes and then welcome any questions or even interruptions along the way if I'm not giving you the information that you want. I think it's important to follow up on what Representative Keiser just said. I think there is no dispute, at least under New York State law, that credit default swaps could…a certain section of them, could be viewed as insurance…unfortunately there's a huge portion of them that really isn't insurance, and so let me just explain and pack some of that thinking, and try to level set, at least for myself. A credit default swap is not really as complicated as a lot of people seem to think or think or say. It's a fairly simple instrument. It's complicated to trade, it's complicated to settle as a financial instrument, but it's basically the following as it was intended at the beginning. You own bonds in, say, Ford. You're afraid that Ford could default on its obligations under those bonds, so you go to a third party, not Ford and not yourself, and you swap the risk of that default with the third party. That's why it's called a credit default swap. It's not, you know, they mean swap like in the old way, okay. So everyone says swaps and you get all confused, that's all it is, is you go over to Goldman Sachs and you say, "I own these bonds in Ford, and I want you to promise to step in and take over the

obligations of Ford if they default on these bonds." And in that way it's a wonderful risk transfer because you've now spread the absolute downside of holding these bonds to another party. And that was the original intent and understanding of credit default swaps. In that formation, when you think about it, and exactly why there is a law on point, a New York State law, having to do with financial guarantee firms or what's often called monolines or bond insurers, they insure that exposure. And when you have that obligation, I don't think anyone can reasonably dispute that what you're basically doing there is you're buying insurance from that third party. Within a few years, the market for these exploded…and they exploded largely on what we call the naked credit default side, which is the side where ironically you don't actually own the bonds or the CDO which you've heard people refer to, the collateralized debt obligation, that can also default on an obligation. That's why it's called collateralized debt obligation. And so you go out and you just decide that you're pessimistic about the future of Ford, and so you enter into a bilateral agreement with another party, saying if Ford defaults, files for restructuring, you owe me X or Y. Now Wall Street calls that a "directional bet." If I say gambling, I get in trouble so I'm just going to call it a directional bet from here on out, okay? But I'll tell you that it sounds a lot like gambling, because you are essentially entering into a relationship where there is a third party event to which you have no direct exposure, and the other side is saying, "If the Giants win or lose, on that day I'll pay you X amount." That part of the market grew to become as much as 80 percent of the market in these credit default swaps. And in that regard, I have a very hard time explaining to all of you what risk transfer that was about. In fact arguably, it was risk creation, not risk mitigation because you had no exposure to the Giants game until you placed a bet on the Giants game. So it's ironic that this marketplace, which legitimately was established to transfer some underlying risk, exploded into a huge undertaking which I would argue was risk creation. It was probably about this time, I'm not exactly sure about the chronology, but it is clear that people, top notch lawyers, at least in New York that I have spoken to, worried that their clients were exposing themselves to the state's gambling or bucket shop laws in that secondary activity where you had no exposure, no actual transaction at base. And so when they did the CFMA, the Commodities Futures Modernization Act, which I think

modernized us into the ice age…get a credit, you know, a freeze and all that. They lobbied very hard and successfully got three areas of law preempted from having regulatory oversight. So a credit default swap for regulatory purposes could have been viewed as a security, but the FTC was preempted from having regulatory authority arguably because it wasn't traded on an exchange, and the FTC's best argument was that it took oversight through an exchange and since these were bilateral agreements, as I described, that went out the window. The second was as a future, so they preempted it as having authority…the CFTC having authority, and then for your all purposes, they explicitly preempted the "bucket shop" laws. But this is not to imply it were a bucket shop law, it sounds so tawdry, "bucket," but what it really is, is in the turn of the century, meaning 100 years ago, the streets of New York and other cities were lined with these bucket shops. They were basically securities gambling parlors, and it was viewed in 1907 when we had our last biggest credit freeze that the one where J.P. Morgan had to get everybody in a room and create a central bank, right, 'cause we had this banking crisis in 1907, that bucket shop activity, this speculative betting on securities and exchanges without any actual purchase or sale of the underlying instrument had contributed mightily to the downfall of our banking system. So by 1909, New York State and other states had passed laws that made it a felony, in fact, to engage in that kind of activity. And those laws were on the books and had full force until the year 2000 when those laws, from a regulatory point of view, were preempted by the CFMA as you pointed out. I am pretty certain that no insurance person was consulted in all of this, because they would have at least pointed out, I think, that if you're headed towards a world where you're guaranteeing payment on something, you're headed toward a largely insurance dominated world. Now I just want to stop for a second and tell you…and tell Assemblyman Morelle, because we talk a lot, my most recent thinking which is not very profound but it's simple. And that is that when you take money, there's really kind of only four ways that I've been able to think of for the purposes of this discussion that you can place that money in someone else's hands, so to speak. And let me explain why I think this is important for regulatory purposes. There's really four ways. You can take it and put it in a bank, and that's a guaranteed transaction up to a certain amount. The bank takes your money, it guarantees you generally a certain base interest rate and the money will

be there with federal deposit insurance. The second way is you can buy insurance. Again, that's a guarantee. It says that if my house falls down, I guarantee you'll get paid for your house if it falls down, and there's state funds that stand behind it, etc. The third way is gambling, which is another form of guarantee in that we actually say if this event happens, you will be paid. And in fact, all of our gambling that's legitimate and regulated has certain core solvency requirements behind them, so gambling houses have the cash on hand if every bet were to go against them. And the fourth is mere…I mean for the purpose of this discussion, mere investment. In other words, you buy IBM stock, it could go to zero. There's no guarantee IBM will be worth anything in the next year. And that is very different than guarantees. The first three I just tipped off had guarantees. The fourth had none. And the reason I think that distinction is core is because as you and the federal government begin to think about how to regulate institutions, it is essential that the question be asked, what is the representation of where the money is going? Is it a guarantee or is it an investment? And why does that question matter? Because it goes to solvency, how much money has to be behind that activity, so that investment banking has a lot of leverage appropriately and therefore, you know, is speculative. The other three, ironically gambling is not speculative in that the guarantor has to have a certain solvency behind the activity. And I think that credit default swaps interestingly are oxymoronic in this. They're like alchemy, like we tried to make gold out of lead. But that's not possible, so they were…at base, in my mind, they are really a security and they were leveraged and used as the largest securitization ever at $63 trillion dollars, greater than all the equity in the entire world. But they required and did not have anything like the solvency requirements of insurance because they were a guarantee. If the Giants lose, or if Ford goes down, or if your bonds are defaulted on, you will be paid. And in that regard, we completely missed it. We created an insurance product without anything of the insurance hallmarks on the capitalization and the solvency side. And so that's why I say they've been the great catastrophic enablers of this economic meltdown because through the worst due diligence underwriting chain we've ever gone through, which I won't bore you because you know the details of the mortgage backed catastrophe that we're going through, at the end everyone thought that through CDS's they actually had insurance at the end of this chain. They told the risk

managers, the traders said, “I’m good on the downside, I’ve got a CDS, I’m insured for default.” But they didn’t have anything like an insurance product at all. Now some will say, and I’m sure you’ll hear from testimony today from ISDA, that the Lehmann clearing happened pretty well, and I actually will compliment that it was a rational unwinding in the CDS’s that were at least the covered ones that we’re talking about, not the naked ones, were publicly cleared. But the only reason that that happened, let’s be clear, is because the federal government put $350 billion dollars into the system. If the apocalypse had really occurred, and Morgan Stanley, and Merrill Lynch, and AIG at the financial holding company, and Lehmann Brothers had all simultaneously gone down, which would have been close to about the right timing, there is no way all those guarantees would have been stood behind. And so we just have to understand that. From a regulatory point of view, the most difficult part is, we had absolutely no idea how much of this was written. So let me explain. I can tell you as a regulator, having come to the scene and discovered the hedge fund that was financial products bolted on to AIG, how much they ultimately wrote in credit default swaps, about $450 billion dollars or something. But I can’t tell you to this day how much credit default swaps was written on AIG, in other words, if Tim Geithner and others had allowed it to file for Chapter 11, there’s no idea how much credit default swaps would have hit, because there’s nowhere where it was enumerated in that kind of a listing. That’s a very dangerous future that I urge all of you and the federal government to make sure can’t happen, even to the point of requiring that all credit default swaps be on an exchange or some kind of an exchange trade or clearing house function, and I understand the argument that some of them are very complicated and what’s called “bespoke,” you may hear that term, “bespoke.” That just means tailored to continue the sartorial context…very tailored to the two parties, but you can get a no action letter or get some kind of exclusion but the presumption ought to be that they’re all on the exchanges so that the regulatory regime can know how much exposure they have. So that’s just kind of…I just think it’s important because you’re going to have a little debate about whether it’s insurance and what role should the states have, etc. But I think that around 1909, you know, there were smart people like, you know, J.P. Morgan, Albert Einstein, Picasso, you know, these are not a bunch of dummies back then. And they kind of got it right. There’s either, in this guaranteed

world, there's either federal depository banking, insurance or gambling. So the bucket shop laws were merely meant to pick up the non-insurance side of that kind of financial activity. And in one fell swoop they were obliterated. And for those…anyone who tells you, "Well we're not really sure they're subject to the bucket shop laws," well then why did Congress need to rush in to preempt them? Obviously there was a lot of debate and discussion and people clearly believed that they were exposed to that kind of regulatory activity by the states. I think that you should also, you know, not be too shy about the fact that, oh, if we, you know, regulate these that everyone is going to flee to London, or something like that. I think right now the hallmark is about transparency and about regulatory expertise, and the arguments that actually drove this kind of activity, this very unregulated activity, are those arguments that we're going to lose business to London, and Europe, and Asia. Those were horribly misguided, if you ask me. The real hallmark of our economic system which we've lost to a large extent is transparency and kind of enumeration, that we can look at publicly filed documents and get an idea what the true financial exposures are for companies and commitments. And to the extent that this was all off balance sheet, Wall Street is appropriately ingenious about finding whatever they can do off balance sheet. The reason? Again, is because it's low capital requirements. If you have it on balance sheet, there's certain capital requirements with that from a regulatory point of view, if it's off balance sheet, it's very different. So when you hear people and you see 60 Minutes talk about shadow Wall Street, they don't really mean it like shadows and you're going to get stabbed in the back and all that, they mean that there's this kind of shadow world that mimics, that reflects, kind of like in a Platonic, you know, on the wall shadow that reflects the real regulated world of securities and they will mimic whatever activities they can mimic, but they'll do it unregulated whether it's credit default swaps or derivatives because the capital requirements are so much less and you get more leverage. But here where you're guaranteeing something, leverage is exactly what you shouldn't be playing with. That's just kind of a quick summary. It might be better to use the balance of my time to just answer questions, you know, I could do some more, I've got pages, but I sense that you might have a lot of questions just by some of the body language, and I have no problem just taking a pause and see if I'm going in the

right direction for you.

MORELLE: Thank you. I'm sure there are questions. One that I'm sort of curious about is, you made reference to the Commodity Futures Modernization Act, the provision that essentially preempts the states from enforcing the bucket shop laws. Is there anything substantively or materially different between what's being traded today than what was happening in the earlier part of the 20th century? Obviously it's different in terms of the speed, it's different in terms of the reach of the markets, but is it fundamentally the same activity or is there…are there new elements to it which would perhaps suggest that Congress was right in preempting the states?

DINALLO: You just asked me two…you asked me a compound question, actually. I don't think there's anything substantively different between the activity going on now and what was pre…what was foresaw, foretold by the bucket shop laws and preempted by Congress, and so just…it's clear…this act shall supercede and preempt the application of any state or local law that prohibits or regulates gaming or the operation of bucket shops other than anti-fraud provisions of general applicability. I…so I don't…but I don't…but I could argue, as you said, that there's speed, there's… there was…is definitely…was important because you could finally have contracts on the swaps, etc., and there was some…through ISDA's good work, some transferability and common language, but I do not think that Congress was correct in preempting these…well, it would have been correct in preempting them if they had stopped and fully understood what they were doing and put into place their own laws. So the argument of federalism and wanting to make kind of a cohesive language around this wouldn't be irrational, especially if you're going to hang so much of federal securities activity on it. But they should have stopped then and said, "Okay, but to the extent we are going to permit this kind of activity, here's the margining requirements, etc." I mean they basically left it completely to private actors to determine what margining, and how much leverage, and how much activity they were going to engage in. And because of the AAA rating disaster, people thought that they were largely safe by requiring no collateral, no capital proof, behind their counterparty commitments on credit default swaps. That was a huge error, I think.

MORELLE: The question that's…or the argument that's made in some quarters is that the presence of an exchange would certainly lend transparency, that doesn't exist today, to the marketplace. And yet, the requirement or the presence of an exchange doesn't necessarily require certain levels of collateral, it doesn't require reserving if you choose to do reserving instead of a collateral requirement. Is that enough, in your view? Is it simply enough to have what are at least alleged sophisticated participants in the market simply to have transparency and let them continue to worry about collateral requirements and reserving?

DINALLO: No…no. So let me…let me say what we did, why we did it, and then why we shelved it for a bit. So New York State's point of view was about 20 percent of this market is clearly some kind of an insurance undertaking. If you look at the financial guarantee law Section 6900, there are many promises, financial guarantees, that are listed there that are all defined by the New York State legislature as being insurance, but three out of four of them, or four out of five are already well-regulated on other exchanges. But the one that was left to be done as core insurance for the states is credit default insurance, financial guarantee insurance. So we looked at that, and we looked at credit default swaps, and said, "This is identical kind of conduct," but we concede that only about 20 percent of it is really what's called an insurable interest where you actually own the bonds, you have exposure, etc. So we essentially said that by January 1st, we were going to start to require the registration and the regulation of those instruments as insurance products. Thereafter, Congress and Chairman Cox of the FTC and the Federal Reserve talked strongly about these exchanges that you're referring to. And we admitted that we could only do 20 percent, so we tried to be cooperative in saying, "Look, if they can come up with a holistic solution that sort of fixes our concerns that there's insufficient solvency for making an insurance promise, then we will hold in advance this registration and regulation undertaking." And indeed, by about…I don't know when it was, probably by November, there was…I testified in Congress, and the FTC and the CFTC and the Federal Reserve who I testified with, all entered into an MOU saying that by the end of the year they were committed to have ICE in New York, which is sort of the New York Fed driven exchange, and the CME in Chicago, and that therefore, we felt it was smarter to be cooperative, step down, because we didn't want to further bifurcate the markets. And the

hallmarks of what they were promising was, as you just eluded to, potentially some kind of central counterparty so you have all the risk kind of fed into one…one brain essentially, so you know who is carrying how much risk at any given time, but clear margin rules. So anything on the exchange that's a credit default swap requires a certain minimum amount of capital behind it. When they say margin, we call it reserves or surplus, etc. A guaranty fund, which is common in insurance but not necessarily common in a mere clearinghouse, but general exchanges have them but it would have to be beefed up because you'd be putting a heck of a lot of cliff risk in this. Clear rules of event determination, so there's no argument about when a reference entity defaulted or filed for reor…what triggers a CDS, rules for conflict resolution so if you have an argument you can do that, and a strong centralized data. So I don't think it's merely enough to know, because you have to know and acknowledge that since these are guaranteed undertakings, they require a different level of solvency and surplus. Now I admit that they really didn't follow through yet. I think the intentions were good, I don't know the entire reason that it hasn't come off the ground, hasn't taken off. I think though still it's prudent, given the new administration, to give it some more time. If you ask me how long, I'll be pressed to tell you, but a couple months, let's say a quarter, to let the new administration take this serious. I know Tim Geithner is very serious about it, and others, to…before we step in and either definitively say we're not going to regulate this, or to step in and say we are because the federal authorities just don't seem to want to close it out. I would prefer that they close it out, because this requires, in my mind, a holistic solution.

MORELLE: Senator?

LEAVELL: Yes, and thank you very much, Mr. Superintendent, for being here today, we appreciate it. One rather simple question, and that is, what will it do to our financial world if we were to require insurable interest on CDS's, on the credit default swaps? Would it put us out, I mean…

DINALLO: I don't know if it would put us out, it would make…it would make it…no, here's…here's what would happen. You'd…by the way, just so we're clear I just want you to know this, because someone will say that it's impossible. I just want to make one thing clear which I should put in the notes.

It is the case that for GAAP accounting, you're required to tell your auditors and enumerate whether you have credit default swaps for hedging purposes or for non-hedging purposes, so it is done. In other words, people do know whether they're holding it to hedge risk, which is essentially insurable interest, or just for a directional bet. So I think it wouldn't do much. It would completely obviously obliterate the side that is directional bets, and I'll just say that there is a little bit of gray area, you know, you can hold bonds or you can take a pure directional bet. There are in-betweens where you might have receivables with a company and want to balance in case they default. You might be very long the equity and want to hold a credit default swap as kind of a hedge, but it's not a perfect hedge but it's indicative. You might have other examples where you're exposed to them but you're buying a CDS less as a pure offset. You don't actually hold the bonds, but you hold other sector exposure. But what would happen, essentially, would be that it would drive up the cost quite a bit so that you'd end up with them having to essentially do them as pure insurance instruments which means that the doers of them, the guarantors, would get a very low return of equity 'cause you have to have a lot of capital held back to do it. So it wouldn't close out CDS's, it would just basically make them insurance products. Our hope was that you could across the board get kind of a compromise outcome, and I'll tell you that if you force all CDS's to be on exchanges with a certain margin requirement, you'll essentially kill off the pure speculative ones because it's too expensive to do it. The reason that Wall Street engaged in so much of it was, it was so cheap it was good to just take a flyer. But if you actually said they all have to be on an exchange, you'd essentially almost be like saying you have to have insurable interest because you have to have enough exposure to want to pay the amount to be on the exchange. Does that make sense?

LEAVELL: Sure. It…and I can see where you're going with that, and I think that's probably better. There are so many different insurable interests, if you will. Sometimes those are hard to identify. Thank you very much.

MORELLE: Representative Keiser?

KEISER: Thank you, Mr. Chairman. A couple of questions, Superintendent, thank you very much for your presentation.

I'm going to just ask you this straightforward, are credit default swaps an insurance product? The way you described them, I think they are.

DINALLO: There's no doubt…I mean, there's no doubt that under New York State law, Section 6900, 6901, Subsection 1A, I think it is, the def…there is a credit default swap that is one where you actually have an insurable interest in the underlying bonds, you're holding them, are absolutely… that's, they're in, they're defined. Let me phrase it another way. Just because you call something…you know, you can use a different name for something, but it doesn't change what it really is. So you call it a red wagon, or a credit default swap, or an insurance policy, but if you hold the bonds and you go to a third party and enter into the transaction we described, that is precisely what is in 6901. If you don't have an insurable interest and you don't have to have proof of fault, then you're into what we've called a naked credit default swap. And that's not an insurance transaction arguably. Although some people would even say that whenever you're guaranteeing an outcome, it's either insurance or gambling, it's kind of one or the other. But I would say that the sartorial ones are indisputably an insurance product under most state laws. I don't know everybody's state law.

KEISER: If I may continue, one comment you haven't made, and it's one that many people feel is a contributing factor in what roll should the states have for transparency, and that is technology. That technology didn't cause it, but it was a contributory factor to the dilemma that transactions could be packaged, moved with the click of a button, and nobody was checking on anything. Is that…what's your feeling about technology and the role that states would play relative to technology?

DINALLO: Technology permitted us to securitize underwriting decisions that were clearly poor and make them so that they were tradable, and…first of all securitizeable and then tradable, with a far distance away from the original underwriting decision, from the bank that gave the mortgage loan that led to kind of where we are today. And to the extent that technology permits us much the way some things like guns in modern warfare permit us to kind of distance ourselves from the gruesome task of taking a life, it is clear that technology did bring us far away from the basic, you know, kind of…it's a wonderful life scenario where a

banker sits across from a loan applicant and really judges his or her ability to pay back the loan, and give that loan, which those loans were securitized, and did very well because they were done through that kind of orthodox due diligence. We then went through seven or eight iterations of that securitizing them, and the final purchasers of those, I clearly through technology…and the wonders of securitization which normally is a good thing, got completely distanced from that core activity. And if one lesson I would have from this is we just completely…I never realized how completed disattached, unattached, we were from anyone ever owning, continuing to own the risk of their underwriting decisions. Gone… gone. And that is also the hallmark of insurance, which is we only permit insurance companies to do so much. We do allow reinsurance, but we only permit insurance companies essentially to lose exposure to their underwriting risk decisions so much. That's a good thing.

KEISER: And my last question, Mr. Chairman, and…we just passed a bill in North Dakota that was brought to us by the bankers, and the bill, I'm going to summarize it very briefly, but what it does is, it says that if appropriate underwriting standards are met at the time of the initiation of the loan, and it's sold downstream, you cannot come back to that institution. If they don't do due diligence, that loan comes back to them and they own it, and they own it at every level. That seems to me to be one…the beginning of an approach to say, start doing your job. And what is your reaction to that?

DINALLO: My reaction is that I agreed with your opening comments. I agreed…and I…I just want to…because you and I seem to share certain views, so I want to agree and disagree to one thing. I think that Gramm-Leach-Bliley did some damage, which it did permit institutions to essentially be run by and run with a philosophy that rewarded leverage over all things. And that's why you often see the investment bankers in vertically integrated firms begin to run them because they look like they have outsized outcomes through revenue. But if you actually look at the long-term profits, there's no distinction. In fact, right now they look positively negative. And so you are correct that anything that makes…that…while you may be tamping down leverage and some ability for commercial banks to come out in that manner, I think that's probably a good thing when you're dealing with depository money. That's the thing,

when dealing with depository money and policyholder money, the approach to me is entirely different than speculative money, than investments. The only thing I would disagree with you about is that I think that Gramm-Leach-Bliley did not do as much damage as some people thought it did in the sense of this: while it did permit the creation of financial supermarkets and created the putting together of activities that had never been placed together before, probably for good reasons, it didn't go so far as to bring down all the walls. So Glass-Steagall was still kind of in effect internally. So what that means is, if when the bombs went off at AIG, thank God the financial products division, the investment bank of it, didn't have access to the policyholder money 'cause it would have sucked $500 billion right out, which is like fortunate that we didn't go that far…'cause a lot of people think that Gramm-Leach-Bliley meant that you could put a bank together and Lloyd Blankfein of Goldman would have access to all those deposits for leveraged activity. That's not what…it increases it by about 10 percent is my understanding. And to that extent, we were wise not to go that far.

MORELLE: Senator Seward?

SEWARD: Mr. Superintendent, I want to share what others have said, and we appreciate your testimony and your being here today, and you've given us a very, very good overview on the issue. You know, based on what we have gone through these last number of months where we here in New York have seen, you know, the collapse of some major financial services, houses, and its impact on this city, and this state, and this country, and everyone feeling the pain, so to speak. Let's cut right to the chase here, and what advice or recommendations would you have to us as state legislators in terms of next actions, or if this was a federal panel, either administration or executive or federal representatives, what advice would you have for a federal panel in terms of next steps or…where we go from here, because based on what we've gone through, there's a great deal of pressure for those of us in policy making positions to do something. And I know you feel that as well, but what advice do you have for us as legislators, either state of federal?

DINALLO: I just want to correct you, I don't feel any pressure at all at any given time, I just want to say that (laughter). My advice would be the following: I think you're on good

footing to lodge a fairly lucid, strongly worded letter to federal authorities saying, "Look, we all know it was done unanimously by partisanship, but the CFMA took away the one lynch pin of state regulation that would have prevented a lot of this activity, and when you revisit what you're going to do, we remind you that in a time before the federal authorities were sort of so dominant in our system, the state regulators and state statutes kind of had it right. There was insurance on one hand, and bucket shop activity on the other, and somehow, one of them just got plucked out and the inevitable…the inevitable stampede went over to that unregulated side." And so I think you'd have a little bit of a reasonable basis to feel scorned a bit, and I don't know…no one intended it, although some people clearly understood it or they would not have asked for the safe harbor and the preemption. And then if I were speaking to the federal side, I would say what I sort of said earlier on, which is to take quite seriously and really analyze what is the…what is the financial obligation for each instrument, which ones have guarantees and which ones are merely investments, and they should be regulated actually very differently. And I would also just add that I think they need to almost acknowledge that naked credit default swaps, in some ways, could arguably be even more pernicious than straight up gambling because they actually impact the outcome of the game. When you and I put a bet on the Giants game, we don't…except maybe of the odds run so against the Giants, you know, poor Mr. Manning gets depressed, you know, that the odds are against him. But other than that, we don't really impact the outcome. But here, credit default swaps were a driver for rating agency decisions and a lot of people put shorts on, then put on credit default swaps, then the rating agencies started to see the spreads in the credit default swaps go up, and kind of like we don't permit people to take out life insurance on people's…strangers' lives or take out property insurance on someone else's home or the way it was prohibited to take out insurance on ships that you didn't have any interest in because you might tell the French that the Spanish ship was leaving port just about now. We shouldn't let that kind of activity go on because it does have a teleological aspect to it that I think definitely exacerbated this financial crisis.

MORELLE: Senator Breslin?

BRESLIN: Thank you very much, Joe. That's the first valid

explanation I've heard of why the Giants lost. Another… another…a bad outcome of credit default swaps. When you said you'd like to wait for the federal government to act in a holistic way, is it your expectation that hopefully in the next three months that that holistic approach would include the 20 percent as well as the 80 percent, and that there would be an approach that would take the initial credit default swap out of the hands of state regulators… because you also suggested that given that they're so…so connected that it would probably not be seamless if they were left apart in regulation.

DINALLO: Yeah, I think we had always said that we wanted to take a look at what the final outcome was before deciding, but it is the case that I don't think the federal…I don't think the federal regulators make a distinction… I don't mean to say…as an insult…I only make a distinction between naked and sartorial or bikinied…you know, in between. I think they view credit default swaps kind of seamlessly, and indeed, an exchange probably has to deal with that way, getting back to the gentleman's point before. There's lots of appropriate gray areas. So I just think that we may end up kind of with a blending that has sufficient margin requirements, but I think also, I've said this a lot, that if you drive them all into exchange, the really naked ones will disappear largely. And so I think we should wait, and I think that because you're dealing…these just have to evolve, so I think one wants to wait and see. That's why we both did what we did and then held it in abeyance because the final outcome and how much solvency and margin requirements are ultimately there will drive what we really think.

BRESLIN: Then transparency will clean it up.

DINALLO: And then…yeah, although just to be fair, there is no major regulator out there, I mean whether it's Mary Shapiro, the Fed, Senator…these are not regulators, but Senator Harkin and Congressman Peterson, they're all saying, "This is going to be regul…" there's not gray in their statements. So I just think under that, it's not inappropriate to give the new administration some reasonable time.

MORELLE: Any other questions? Ms. Calhoun?

CALHOUN: I was just going to ask…so what you're basically saying, I want to insure bonds that I don't own, I go and I manage to

do so, then am I betting on that they're going to go down or…because I don't own them, so therefore I'm betting against a market.

DINALLO: Right.

CALHOUN: And that's the naked, and maybe they should, as you said, find a way that they just disappear.

DINALLO: Yeah, and in fact when I've testified in Congress, I've had two…I've had each of those Congress people, whether it's the senator or the congressman, ask flatly and in fact, interestingly…Kirsten Gillibrand asked, when I testified last time, why shouldn't we just make the naked ones illegal? And the answer is, you could, it wouldn't be inappropriate, but it'd be hard to define what's perfectly naked…although like someone said, you would probably know it when you see it, and so I think that it's appropriate to ask those first-order questions. If you view it as insurance, then we have a lot of reasons where we don't permit you to take out insurance on an event that you have no interest in, you know, as commonly understood. And there are reasons for that, including the ship example that I gave and the Sopranos example. And so I think that's really some learning that has to go on, and that's why you should sit and watch. But I have a feeling that by just making the margin requirements enough, the naked perniciously possible ones would fade away.

CALHOUN: Okay, one follow-up. Have there been any defaults in the defaults? Have there been people who took the credit default swap, and then when they needed to…

DINALLO: Right, we don't…

CALHOUN: …redeem it, have they…

DINALLO: …well we don't know the answer. Now here's why. Now…I… and…ISDA will be here and they will answer you. The ones where you actually held the Lehmann bonds, for instance, when Lehmann went down, that…they…ISDA and others effectively created a market to clear those. There was one day where they all cleared, and they cleared for, I don't know, it was like 15 cents on the dollar, whatever it was, and then people went with that shortfall and went to their counterparties and got paid the balance. But the problem is the only ones who showed up for that dance I believe

were the ones where they actually held the bonds and tendered the bonds into the market. What we'll probably never know is the 80 percent more under the 20/80 rule, the 80 percent more where they were naked and they were bilateral side directional bets between two hedge funds, I don't know how those, if at all, cleared. And that's, I think, one of the major…those need to be as transparently accounted for, if not, even more so than the covered ones.

CALHOUN: Thank you.

DINALLO: You're welcome.

MORELLE: Representative Damron?

DAMRON: I want to make sure that I understood what you said, and I think this is what you said. States currently have the right to regulate bond insurance companies from the covered swap, and that's under our insurable interest laws. We do not have, by federal law, the ability to regulate the naked swaps and a lot of what's going on in the industry that's really created the problems because of the federal action. Is that accurate?

DINALLO: Yes.

DAMRON: And it would seem to me that this goes back to the question of, well then what should we do as state legislators? I don't think we have many options as to what we can do other than regulate that which the federal government has allowed us to regulate. We…but we need to make sure that the federal government has accountability in taking responsibility for not regulating that entity which has created most of the problems. And as we look down the road at optional federal charters and…either mandated or optional, and we look at the federal government's track record on their regulatory schemes, it would seem that this would be a prime example of where states do do it right, the feds didn't, and we really don't need them to get into this business any more than what they haven't done. Maybe what we need to be focusing on is to leave us alone, go regulate the credit default, the naked swaps, before you come back and try to take the regulation away from your department and other departments on what they're doing. I mean that seems to me the focus of what's in my mind as we've listened to the testimony so far. Thank you, Mr. Chairman.

DINALLO: Thank you.

MORELLE: Thank you. I'm going to go to Mr. Keiser in one minute. A quick question I had before he closes, and that is…well first of all just to comment, you made reference to sort of the 16th Century, 17th Century and European ships, which is sort of the old definition of moral hazard, the ability to basically affect a negative outcome to your benefit. But you also mentioned liquidity and the ability to move these contracts around so quickly that it sort of raises the question of whether or not there's some moral hazard there as well, because if you keep moving the risk around or you offload it, when you're taking it on, in a sense, you don't really…ever really intend to be the guarantor, you intend to be transactional and move the transaction around. Is that sort of a modern day equivalent potentially of moral hazard?

DINALLO: Yeah, we're…we're…you and I have had this discussion in a different way, but I just have observed recently that the term moral hazard in insurance and financial services, I think has actually changed. There's two…to me there's clearly two definitions of moral hazard. Most economists think of moral hazard as being what we were talking about before, which is when you backstop someone's activity, or you create a safety net or whatever, you basically take away their responsibilities for their economic decision. So if you take away the impact of poor underwriting, you create a moral hazard where anyone just loans money or insures anything just to get the commission basically, but never to have to own the ultimate loss. There is another definition of moral hazard, which I'm not exactly…I'd love someone to tell me how they're in sync because I don't think they really are, but that…which is what you're also saying, which is where you take out insurance essentially on things to which you do not have a natural vested interest, and then therefore have a vested interest in their outcomes, like taking out life insurance on a stranger, or a ship that you have no goods on, and can presumably, although I hope illegally, impact the outcomes of that person's life or the ship's safety. Arguably, the naked credit default swaps permitted that. You could take out naked credit default swaps on a company, and then there was nothing illegal with going out there publishing against it, shorting it, doing everything you could to drive them into a reorganization. That was clear game, and to me,

there's not such a distinction from what I just described.

MORELLE: And finally, I had a couple of other questions, but in difference of time we'll move on, but the 2001 CFMA, as you've described it, preempts the states from being able to create…enforce the bucket shop laws as they existed at the time. Is there anything under the statute, however, which prohibits the states from requiring either levels of collateral or requiring reserving, even on the naked swaps, arguing that they effectively are guaranteed products even if you don't have insurable interest? Are we precluded under the federal law from doing that as well or could we structure that and say it's not under…we're not doing it under our gaming laws, but we are doing it under our insurance laws?

DINALLO: Wow, okay. So here's what I think about that. Just the very beginning of what you said is technically, arguably inaccurate. You used the word enforce, and the anti-fraud provisions of the CFMA and the bucket shop laws, and the SEC's 10B5, etc. were left in place. In fact, 10B5 and short swing rules, and the classic 34 Act, anti-fraud provisions had to be re-written to include securities or securities related swaps. Just to clarify. The enforcement of fraudulent activity in this area is still in force.

MORELLE: Okay, maybe I meant to say…

DINALLO: No I…I just think it's interesting…I just…I don't think the public actually knows this, I think it's an interesting point. Now, you could…I do not believe that the states would have been preempted from viewing certain financial guarantees as a form of insurance and/or…this would have been the really chilling part that we've never gotten to and I hope we don't get to, one could take…and the argument that while a covered credit default swap is an insurance product and therefore we have the right to require that it be registered and regulated for solvency, everything else is "illegal insurance." Now that is edgy, but cognizable, I think. In other words, what 6900 says is that a monoline is permitted to write this kind of insurance. Then if you go to 1100, which defines what insurance is, and…you could argue that a…naked credit default swap having this guarantee but without insurable interest, etc., but with a guaranteed outcome, is therefore illegal insurance. I probably wouldn't do that, probably, you know, you never

know. But, I think that there is reasons the whole market has sprung up, and that's really not been, but again, getting back to your earlier question, the states kind of understood all this as insurance regulators. They understood what was insurance, what was not insurance, and what was basically "illegal" insurance. So you could…there's different ways you could view this. I don't think the states would have been preempted, but that's a pretty extreme difficult view, and kind of…and our department in particular, having issued that opinion which we can get into, but it's…having basically said that a naked credit default swap without proof of loss was not insurance under the law, but arguably you could have said it was…I mean it was not…was not within 6900, but we never said whether it was in 1100. I think we kind of create some repose there.

MORELLE: But even if we didn't call it illegal insurance, could you, however, still say contracts of this nature need to have certain collateral requirements or reserving for those who are basically issuing the protection?

DINALLO: Yeah, but you could only do that, sir, you could only do that…you'd have to have the authority to…that, what you just expressed, is a classic regulatory requirement, and the CFMA prohibited the states from regulating. So therefore, you'd have to say you're doing that under your insurance powers, and therefore say you're selling an insurance product without appropriate solvency requirements, i.e., illegal, and we're going to require you to do that or enforce against it. I mean, so that's how you do it, I think.

MORELLE: Okay, alright. Mr. Keiser.

KEISER: Thank you, Mr. Chairman, and I would like to follow up on Representative Damron's point and maybe close with that. Superintendent, you said you hope that the states could be patient and give the federal government the opportunity to address this issue. And that's the problem that I have, that the states have done an excellent job regulating an extremely complex industry, the insurance industry. Insurance has no problems. I can talk about Medicare, Medicaid, I can talk about the Insurance Partnership Program which our state does not like. I can talk about GLB and the opt-out provision…not good for our consumers, has cost…I don't know how much. Sarbanes Oxley, it's cost

a whole lot more than the benefit but Congress won't do a cost benefit analysis on Sarbanes Oxley. We've got the Commodities Futures Act as the demonstration of Congress's ability, we've got the Social Security program as Congress's demonstration of ability. Why would we want Congress to address this rather than say to the states, "Get to work," because very honestly stated, one size doesn't fit all. North Dakota is a lot different than New York, you folks have very different problems and you need to be able to address those. And we have our problems, too, and we need to address those.

DINALLO: Yours are starting to look pretty good (laughter).

KEISER: We have a surplus.

DINALLO: That's what I meant.

KEISER: So one of the few states…we're looking to buy states at this point. (laughter) That wasn't a joke. But you know, Superintendent, I just…why do you think the federal government can do this when they have done, in my opinion, less than an adequate job? And I just want to finish, you also made the comment whether or not we can afford to regulate these kinds of transactions. Can we afford the $1 plus trillion dollars that is going to be spent in an attempt to try and slow this problem down? Can we afford what's happened in the loss of people's savings, can we afford what's happening to cities and counties and state governments? I don't think anybody can put a number on it, it is so big. Can we afford that?

DINALLO: I don't…I don't disagree with you that there have been several, especially in the last several years, missteps in the federal government's oversight, especially in sort of the consumer-oriented areas, which they don't…which for a lot of fair reasons they don't do as well, I think, because of the one-size-fits-all issue, the geographic it's just close to the ground, beat on the cop theory, all that. But here, the correct solution to me…I've done a lot of thinking about this, is some kind of centralized exchange function with adequate solvency. The world literally wants to know how much of these instruments are. To segment that, both in New York and then maybe 50 times over, I think is ultimately not going to work. But trust it from someone who has a vested interest in the sense that New York would be a natural place to do it. I could…you could

offer the New York Insurance Exchange, which is still on the books as a place to clear these. I've had ideas along this way, but I've ultimately tried to restrain myself because I think that you need a solution that's kind of of the magnitude of what ICE is talking about or what already exists in the CME, but you need to have strong, extremely strong regulatory oversight in it and high margin levels that will essentially stop a lot of the business that I think we're concerned about. I think that…I am a believer in letting…now these are not quite consumer-oriented issues. These are…there are a lot of reasons, derivatives are not inherently bad things…we all have derivatives in our portfolios probably. They're not extraordinarily bad in all cases. They are bad when we end up with more activity through them then we have under natural securities, but there's a lot of risk management that can be done through them. So I think they are a modern financial tool that has to be dealt with or be regulated. And so I think that's where I'm at. But I'd love to have a cup of coffee with you, it sounds like, you know. Thank you.

MORELLE: Great. Thank you very much, Mr. Superintendent…

DINALLO: It's been a pleasure.

MORELLE: …for your testimony and your ongoing interest in this important subject. Our next witness is Robert Pickel, Executive Director and Chief Executive Officer of International Swaps and Derivatives Association, also known as ISDA.

MORELLE: Good morning, sir.

PICKEL: Good morning, Mr. Chairman. And Senator Seward, Assemblyman Morelle and members of the Committee, thank you for inviting us to testify today regarding the credit default swap business. ISDA is the global trade association that represents what we call the privately negotiated derivatives business. And when we say privately negotiated, we mean that's two parties getting together and agreeing to enter into a contract, whether that be related to credit derivatives, interest rates, equities of various types. And it's important to keep that in mind because the two parties need to understand each other, they need to understand that they're taking on credit risk and perhaps significant credit risk to each other, and take steps to

protect themselves against that credit risk. Also in the context of credit default swaps, people talk about, you know, shedding risk, going short the credit, going long the credit, in every contract because there are two parties, there's implicitly, explicitly one party going long and another party going short. And I think that, from our perspective, is an important thing to keep in mind throughout as we look at these very important issues that your group is considering. Regarding CDS, we've heard numbers mentioned in terms of outstandings, these are notional amounts; I'll talk about what that means. Notional amounts are the amount of activity and volume. It is not the amount at risk. So the numbers that we see cited and we have had numbers as of year-end 2007 in excess of 60 trillion. Mid-year 2008, that reduced to about 55 trillion. There have been further actions taking place in the industry to reduce that even further, and we can talk about that, but those are significant steps so that now it's more probably in 30 trillion. We will have a further survey come the next couple of months based on year-end 2008. But those are measures of volume. If you look at the Bank for International Settlements, which similarly produces information regarding credit default swaps and derivatives generally, they also produce an estimate of the gross exposure from the notional amount, and for credit default swaps, this is gross exposure before benefits of netting or collateral. The percentage is about 5.5 percent of the notional, so a far smaller amount and, again, that's even before the benefits of netting and collateral. We've talked…when the first panelist talked about the Lehman Brothers situation, we look at that and unfortunate as it is that Lehman Brothers was allowed to go bankrupt, what was important from our perspective is that the contractual arrangements that have been put in place both through CDS and for the broader range of derivatives were…Lehman Brothers was a counterparty, that that worked effectively. And we have very clear experience that both on the CDS side where Lehman Brothers was a reference entity and on the master agreement. They used a master agreement governing all derivatives where Lehman Brothers was a counterparty to many, many different users of derivatives that those processes proceeded, and worked, and produced a result that allowed the market to continue. CDS add tremendous value to the economy. They provide an important means of hedging exposures, and we've heard a lot of talk about actually owning a bond, but there are many other ways in which you might have exposure to a company, to a sector, and you

might want to use credit default swaps to hedge that risk. You may be a supplier to a particular company or to a particular industry, and therefore you have credit exposure and these allow you to manage that exposure. They have also transformed the credit business. Previously, if you were interested in a credit position or you had a credit position, it was very difficult for you to hedge that. These products have allowed parties to hedge their positions in the credit markets, and they also provide efficiency and actually transparency in the pricing of credit that is an important indicator, although I would certainly argue that it’s not the sole indicator of the credit worthiness of a counterparty. I think in the same way that credit rating agencies, their AA or AAA ratings may have been relied on too uniformly or universally as an indication of credit exposure. I think as we look at credit default swap spreads, it is important information for anybody who’s looking at the credit markets to understand it’s not the only piece of information that parties consider. They should look at the full range of credit information available in the marketplace. Credit default swaps are a trading instrument, and there are a number of ways in which that means they are fundamentally different from the nature of insurance that we’ve focused on over the course of the discussion so far today. We’ve talked about these questions of insurable interest, risk of loss, indemnification, and those are all important ways in which these products are different. But I would just point out a couple of very unique ways in which they differ from insurance. First of all, either party to the transaction, if a credit event should occur, either party can trigger the settlement of the trade. So the buyer of the protection or the seller of protection can trigger that settlement. In a traditional insurance contract, the owner of the insurance would notify the insurer, there’d be various proofs of loss, there’d be various defenses to those claims, but it would be the one party who would be able to trigger the recovery. Also, keep in mind that as a trading instrument, this is part of…reflects the market fluctuations on any particular trade. So if I fail to pay a premium that I owe on a credit default swap, that is a default under my master agreement with my counterparty, they would be able to terminate the relationship, they would be able to sue me for damages for not having paid that premium on the credit default swap. That’s unlike the situation with insurance where the insured party, if they fail to pay the insurance, they of course lose the benefit

of the insurance, but they're not obligated to the insurer to make any payments. Again, another thing to emphasize is that the participants, people talk about this being unregulated. The participants, and by far the major participants in this market are regulated, and in fact, are heavily regulated…principally by banking regulators, in some cases by securities regulators, and also by insurance regulators. The Fitch survey in 2007 estimated that about 89 percent of the total notional amount of CDS is written, either buyer or seller, by regulated institutions. So it's very important to keep that in mind, and particularly as it relates to banking entities. They are subject to bank capital rules, and credit default swaps are an important feature of the bank capital requirements. So there is a requirement under the bank capital rules that amounts be held as capital against the positions that the party, that the bank has under credit default swaps. There are a number of ongoing initiatives, and Superintendent Dinallo referred to some of those. Certainly the discussions regarding the establishment of a clearinghouse. There's a lot of information that is now registered with the Depository Trust and Clearing Corporation, and in fact, you can find out how much protection is written on AIG by looking at the information that DTCC has provided. And there are also significant efforts that have been going on for the past three and half or four years to deal with a range of operational issues to make the credit default swap market as efficient as it possibly can be. There's certainly a role for state supervision of entities. I think that, you know, setting aside the question of whether these products are insurance or not, nevertheless, insurance regulators in the states would have a very important and relevant interest in the activities of their insured entities in the derivatives world, credit default swaps and derivatives generally. And so I think it's important to look at that oversight. And in situations such as the AIG financial product situation, keep in mind that AIGFP did actually have a regulator, the Office of Thrift Supervision, who was active in that particular company. But I think it would certainly be important for insurance regulators to have a better…have the right to dig down and look at the activities of entities throughout the capital structure of the insurance company because of the very important concern about the effect of those activities on the capital of the insurance company. It is, however, a global product, this is developed globally. We've developed these…this documentation that is used around the

world to facilitate these trades, to make them enforceable, to provide protections, and it is important that we look at this at a global level. We talk about the federal focus, that's certainly important, but we're also actively engaged with the FSA in the UK, the European Commission, the Bank of Japan, HK…Hong Kong Monitory Authority, Singapore, Australia throughout the world to understand their concerns and to make sure that there is a consistent approach to these particular products. I've mentioned briefly the role of netting, collateralization, and I'll talk briefly about the clearing initiatives. But even before that, again, this bilateral arrangement, the parties need to understand, they need to do their due diligence, be satisfied that they're willing to enter into these contracts with each other because of the credit exposure that is created through these products. But over and beyond that, we also have in place arrangements for netting a position, so if you have an active trading relationship across different product types, it's governed by a single agreement that allows you to net out of your exposures and to get the benefits of netting, so that you're…it is a very important risk mitigation tool. Beyond that, many participants in this market will utilize collateral. There will be an exchange of collateral between the parties that is done, in many cases, on a daily basis as market prices fluctuate. And the exposures between the two parties change, there is movement of collateral back and forth, and it is a very important part of the relationship commonly used, but not used in all cases. In many cases where there is a AAA rating, someone will rely on that in order not to provide collateral. But we believe collateral not only provides credit risk protection, but also provides additional discipline in the trading relationship because you're required to move that collateral back and forth as your exposure fluctuates, and it's very important to have that discipline introduced in the trading relationship. There is focus, as you know, on establishing a clearinghouse, and here I think it's important to distinguish between exchange trading of these contracts versus clearing of these contracts. Exchange trading is the means by which parties would enter into these contracts. That is certainly one way in which the product could develop. To date that hasn't been the case because the over-the-counter, the privately negotiated contract has evolved in a way to provide a standardized contract that parties use extensively. So there hasn't been a compelling need for an exchange traded contract. But separately, members of ISDA

and active participants in the market have looked at establishing and using these clearinghouses which are focused on ways in which to mitigate credit risk, you know, counterparty credit risk. All the existing framework of ISDA would remain in place, but this would provide an additional option for parties who are active in this business to look at another way in which they can manage risk. It's something that's used extensively in the interest rate swap market where there is a clearinghouse over in Europe, and parties who are using the bilateral contracts are actively managing their exposure under their ISDA master agreement, and also putting some of those trades into the clearinghouse. And that provides an even more dynamic way in which they can manage credit risk. And I think that's the goal of introducing clearinghouses to the credit default swap market. So I'm very happy to be here today and to have the opportunity to testify before you and I look forward to your questions regarding the credit default swap business. Thank you.

MORELLE: Thank you so much for your testimony, and for being here and for helping us over the last several months. I'm particularly pleased with the time you've taken to educate us. I do have a couple questions. The…first relates to the latter point you made relative to a clearinghouse and exchange, the difference between them, and I appreciate you sharing with us the distinction. Would you, in your view, a clearinghouse or exchange, or combination of them, argue against, if those were in place, the need for specified collateral rules or statutory collateral rules under these contracts?

PICKEL: It would go a long way toward addressing some of those concerns. We think collateral is a very powerful tool, and we generally encourage parties to use it. We don't have a self-regulatory role in our organization so we don't require that, but certainly over the years we have done everything we can to encourage parties to use it, to make sure they have enforceable contracts, that they have legal opinions that they can rely on regarding the enforceability of the collateral. You know, there are reasons that particular parties may wish to not provide collateral. It may be that there's limited trading between the two parties, and the exposures are not likely to fluctuate significantly. If you're lending money to a company and you've done an interest rate swap with that company, the fact that you have the ability to set off your lending

exposure with your derivatives exposure may give you an element of protection that wouldn't require collateral. But I think anyone who's actively trading, you know, and particularly across product areas, should very seriously consider collateral as an important part of the relationship.

MORELLE: Should regulators or policymakers insist on it, and what is to oppose a collateral rule, even if you were to create some exemptions for the small number of cases that you just described where it might not be appropriate for reasons related to the circumstance around it? But in general, should, whether it's the federal or state government, whoever ends up regulating it, shouldn't we have collateral rules, and would you guys…would your organization oppose such a move?

PICKEL: I think that's something we would certainly be looking at as a very positive movement. You know, generally our approach is that, again, these are bilateral contracts. Parties should be free to contract as they choose and putting requirements on how they interact and how they agree to particular transactions is not something that we generally support, but again, because of our view of the importance of collateral, I think that's something we would look very favorably on.

MORELLE: And I would…I just have a couple questions, I think that… and this is perhaps more commentary than question, but the… one of the things, and I know that people have different opinions whether it's insurance or not, but if I take out a life insurance policy or health insurance policy, etc., I don't really have to worry about anybody posting collateral because they have to, you know, under their actuarial rules they have to reserve a certain amount of money. I…although it is a sense of bilateral contract between the insurance company and myself, because there are rules in place, I don't have to…I certainly am not required to do any due diligence on whether they have sufficient amounts of resources to make good on the claims, should I make a claim. And so I'm struck by this, recognizing that there may be more transparency. It still seems to me this is going to be very…remains very difficult to determine whether or not someone who's making the commitment to a payment under a certain set of circumstances, whether it's default, restructuring, etc., has the where-with-all. And they may even have the where-with-all when the contract is

initiated, but as conditions change and their situation may deteriorate, there's a limited ability for you while once the contract is signed you have no ability really to effect, to change the rules of collateral posting. So I have a hard time sort of understanding the basic protections that would be in place for a purchaser of protection if there aren't collateral rules or reserving requirements in place. And maybe you could just comment on that.

PICKEL: Again, the first level of analysis that needs to be done is being satisfied that it's somebody who, as a contractual matter and as a counterparty credit risk matter, you're willing to enter into that transaction. Now obviously that's based on circumstances at the time. You may ask for information that would be exchanged so you can monitor that exposure over the life of the transaction. You may have certain ability to, if there's a downgrade, to ask for collateral, although that often creates separate problems in terms of liquidity as we saw in the AIG situation. So that's the first level of protection. Then, again, if it's an active trading relationship, you're likely to have exposures across…across the board, across different product types, and netting provides that additional level of protection even before you get to the consideration of collateral. Keep in mind, and it's…given the circumstances of the past 18 months, the focus…as credit has deteriorated, those who sold protection a year and a half, two years ago, see themselves far more exposed to possibly having to pay out. But again, because this is a trading relationship, at the time the transaction was agreed to, the buyer feels…has determined that the price it's paying in terms of a premium over the life, typically five years, of the trade is an accurate pricing of the protection that it's getting. And similarly the seller is saying, "The premium I'm receiving is an accurate reflection of the likelihood that I'll actually have to pay out on that," and you know, there's a bid-offer spread there, but basically there's a meeting of the minds. A minute after that trade is done, a day, a week, a year, as prices fluctuate, as credit deteriorates or improves, the exposure between the parties moves back and forth. So, you know, we're looking at a situation now where it's tipped in the way of more likely than not the seller having to pay out, but in fact, over the life of these transactions, and certainly over the history of credit default swaps, spreads have moved in different directions and parties go in and out of the money

over the life of the trade. And it may be the buyer actually who has to post collateral on a particular trade.

MORELLE: No, I appreciate that, and I guess the question is, when you're under stress as we are now, isn't that really what we ought to be looking at to determine whether the system is appropriate is how it fairs when it's under incredible duress as opposed to when it's, you know, when we're certainly in a more growth mode, or as you say, when it's less likely that you have to, if you are the buyer, seek protection from credit events? Any other questions, Senator Leavell?

LEAVELL: Just a very simple question. You mentioned five years. Is that the average life of a CDS?

PICKEL: Typically the standard trade is a five-year trade, and there would be a payment quarterly of the premium by the buyer of protection in return for the possible payment on a credit event by the seller of protection.

LEAVELL: Okay, how does the buyer buy out of this? It just sells… sells the swap?

PICKEL: There could be a few different ways. One is, the buyer might assign its position to a third party, although under the terms of the contract the seller of protection would have to consent to that assignment because the credit exposure changes, a different credit risk. It may also be the case that the buyer would go to the seller and say, "What would I have to pay you, or what would you pay me, to unwind this trade early?" The other way, which is a little less efficient from a capital perspective, is the buyer could enter into an offsetting trade with another entity where it sells the same protection over the same term, but that's likely to be an imperfect hedge.

LEAVELL: Hedge…okay, thank you very much. I appreciate knowing the mechanics. Thank you.

MORELLE: Mr. Keiser?

KEISER: Thank you, Mr. Chairman. A couple of questions for you. You mentioned the notional amounts have gone from 60 trillion to 30 trillion. What's caused the adjust?

PICKEL: Thank you for asking me that, I should have gone into a

little more detail on that. The principal reason is that the industry has focused on mechanisms that exist, some companies develop these mechanisms, to what they call compressed trades or tear-up trades. There is, you know, as the volumes are grown over the past seven or eight years, there are a lot of trades that are essentially off-setting. And so they're not really…they're not creating exposure because they're off-setting trades, but they build up that notional. And so the industry, from a…partly from, you know, just getting some of that excess out of there, almost housekeeping if you will, has torn up a number of those trades. It also is more operationally efficient, and it means fewer trades that you actually have to process, make payments on, and all that. So that's been the motivation behind reducing that amount.

KEISER: Okay. You also…to me, as I listen and learn about CDS's, they seem somewhat similar to reinsurance in a sense. And you made the comment it adds tremendous value to our economy. That's only true if they can pay, isn't it?

PICKEL: It is important that parties understand the credit exposure that they're taking on, the buyer to the seller and the seller to the buyer, and that they do their analysis, that they have the benefits of netting, that they consider very seriously the usage of the collateral, but ultimately yes. When a credit event occurs, the expectation of the parties is that the buyer will receive a payment from the seller, and the seller will make good on that. In fact, and we can share with you the experience that we've had with any number of defaults over the past four or five months, starting really with the Fannie-Freddie conservatorship through to Lehman Brothers, Icelandic Banks, and more recently the Tribune Company, the Country of Ecuador. We have run these auctions together with a company called Market and a company called Credit-Ex. We have run these auctions that price the exposure and allow these to be settled very efficiently, and in fact all of the settlements have moved very smoothly. And the parties…the most important test of any contract is that the two parties get what they expected. And in fact in all these cases they have.

KEISER: And that leads to the next question, where both parties have to understand, somewhere we've had a lot of defaults that haven't been covered. So who's responsible for understanding what was going on?

PICKEL: Well I'm not…let me understand in terms of the defaults. I mean, there have been bankruptcies, clearly, and all those I mentioned have been bankruptcies or similar to bankruptcies. I think the only…there's always a risk in a credit default swap of so-called double default, which is, you've bought the protection, the reference entity goes bankrupt which is the company you're buying the protection on, and you turn to your seller and they don't make good on it. And that is a concern, and it's a reason why, for instance, in the bank capital rules there are, you know, very clear requirements for holding capital even in situations where you're buying protection from Goldman Sachs on the…automobile company where the likelihood of the two occurring at the same time is limited, but in stressed times like this that's certainly possible. That's why there are capital requirements under the bank capital rules. I think the only situations that I can think of where there may have been some loss and nobody has…you know, that kind of double default was, where on the Fannie and Freddie transactions, where Fannie or Freddie was the reference entity, and somebody bought their protection from Lehman Brothers. In the period between the Fannie and Freddie conservatorship and the settlement of those trades, Lehman Brothers goes default, you know, goes bankrupt, and therefore, anybody who bought that protection from Lehman Brothers is at some risk of loss. But I'm not aware that that has flowed through, has produced any significant number of any great magnitude.

KEISER: Two more questions. You said 89 percent are sold by regulated institutions. Who are the other 11 percent that are working this market?

PICKEL: You've got, over the course of the last seven or eight years, you've had a significant involvement of hedge funds. That's probably the bulk of that remaining 11 percent. There are companies who will purchase protection, typically they wouldn't sell protection. They're usually looking to hedge, as I mentioned before, possible exposures they would have to suppliers and things like that. But the bulk of that 11 percent I think would primarily be hedge funds or other asset management firms, but even a lot of those would be regulated by the SEC or others.

KEISER: And finally, if I understood you, one of your arguments was that CDS's are global in nature and therefore, in a sense,

are different from insurance. Don't you believe insurance is global in nature, even though it's regulated at the state level?

PICKEL: I don't…I wasn't suggesting that it was…well you're right. There is that regulation at the state level of insurance, even though it's clearly actually global, yes.

SEWARD: Well thank you, Mr. Pickel, for being here and your calm demeanor gives us a sense of assurance that going forward… Seriously, you mentioned in response to a previous question in your testimony in terms of the decreased CDS…the volume activity in the last six months or so…and the reasons for that. Has that…does that contribute to some improved financial stability going forward, and do you see that trend continuing?

PICKEL: I think that there's a, you know, beneficial effect from that. You know, it is largely motivated by operational concerns and just maybe the perception of the, you know, this being larger than it truly is. So I think there is a beneficial effect from the reductions that have occurred in terms of the concern about possible systemic risk related to credit default swaps.

SEWARD: Has the industry taken steps to, you know, improve, you know, any perceived weaknesses in this…the activity of, you know, CDS and derivatives of the markets in response to what's going on, you know, with the bankruptcies and so on… and some of the pressure that we talked about earlier in terms of from the public policymaking point of view to take some action, does the industry, and those that are in the market, feel a similar pressure, and are you responding in any way?

PICKEL: Yes, I think there are a number of ways, specifically over the last few months. I mean the clearinghouse focus has intensified over the last few months to try and get that in place. We've also…understood the interest in greater transparency regarding the outstanding amounts on any particular name, reference entity and, therefore, the efforts of the Depository Trust and Clearing Corporation to publish information weekly regarding outstanding bought and sold positions as well as trading volumes has contributed substantially. We are also in the process, we have run these auctions that have facilitated the settlement of these trades, but we generally have run those basically at

the…put together an amendment to the contract at the time of the credit event or the bankruptcy, and we've committed to the regulators to what we call hard wire that into the document. So the parties would agree, not at the time of the credit event, but when they do the trade to follow those procedures. And we think that will be a…that will have very positive effects.

SEWARD: Two more quick questions. Does the mark-to-market concept, does that enter into these…these transactions and can you describe what…you know, how that…is…entered into this?

PICKEL: Well it's…yes, it's very important. Mark-to-market, both from an accounting perspective where under the accounting rules parties would typically need to mark these positions to market unless they are clearly identified as a hedge. But also even more importantly, the daily exposure between two parties across the range of derivatives trading activities, that is done…you know, the major institutions will every day mark their entire book. It could be millions of transactions -- or a million and a half I heard the other day from one institution -- mark to market every day. And that will drive the collateral calls that are often made every day and the movement of collateral back and forth. So it is a very important piece of it. I think it's also, and I'm glad you mentioned mark-to-market, because in the AIG situation, what we see, you know, and I'm sure you've all heard the often quoted remark from Mr. Casanno about the fact that he couldn't imagine, you know, possibly losing any money on those trades. The trades, you know, the credit default swaps they wrote, particularly on the super senior traunches of collateralized debt obligations. Now in fact, many of those have not defaulted, but because of the erosion in value of the less senior traunches, the exposure on those super senior traunches, the mark-to-market value, has declined, and therefore, the exposure of AIG on those credit default swaps has increased. And that ultimately led to the downgrades, to their financial problems, to their downgrades that led to the collateral calls, which led to the liquidity crunch, that in turn led to the government intervention. So mark-to-market was a very important factor there, and it was really important to keep that in mind and that…ties back into Chairman Morelle's comment about collateral because layering on the mark-to-market, if you layer on collateral having to move to reflect that, then you've got daily a real incentive to monitor that very

closely and not build up your risk, and if you see your risk building up, to lay off some of that risk or, you know, reverse some of those trades that have been done.

SEWARD: And one final question I will ask you as I did the Superintendent, what advice do you have for this panel of state legislators going forward? Do you have any recommendations for us in terms of action or just stay out of the way?

PICKEL: Well I think…very clearly with the entities that the state insurance supervisors oversee, the insurance companies, they ought to be very focused on their derivatives activities. I think…maybe I think in most cases, states have pretty clear guidelines in terms of how insurance companies should enter into derivatives contracts, how that should be monitored. And I think insurance regulators should have full information available to them, as many bank regulators do, about not just the activities of the regulated entities, but the activities of the unregulated entities, or entities regulated by other regulators, like the OTS with the AIG financial products, to have a clear expansive view of where risk is in the regulated entity. So to the extent that that needs to be enhanced, I think that's certainly a worthwhile focus. I think also the… there's been a lot of work, I think particularly in New York State, since the number of financial guaranty insurers are based and regulated here, a lot of focus on making sure that their activities in the derivatives market are sufficiently overseen by the regulators.

MORELLE: Question, Senator Breslin?

BRESLIN: I'm fine.

MORELLE: Ms. Calhoun?

CALHOUN: No, fine.

MORELLE: Representative Damron?

DAMRON: No.

MORELLE: I would like to finish with one question that I asked the Superintendent which related to the 2001 Commodity Futures Modernization Act, which preempted the states. And I asked him if he thought there was any sort of fundamental

difference between the use of credit default swaps and effectively the situation that occurred at the beginning of the 20th Century in terms of speculation on securities that led to the bucket shop statutes. Can you tell me what you… your observation on that, what differences occurred which led Congress to make that distinction and to allow us not to apply those laws?

PICKEL: Yeah, I think there are a couple of very important distinctions between the circumstances now and the circumstances then. The bucket shop laws were very much motivated by providing protection to retail investors, people who…and as Superintendent Dinallo described, you know, the shops that were set up on Wall Street where people could just walk in and place a bet, and depending on how it happened, they'd go back the next day and maybe the guy had shut down and left town. So I mean very much focused on protecting retail investors. Retail investors are not participants in this particular product area, whether we're talking about credit default swaps or derivatives generally. So there is not that need for protection. I think the equation of the bucket shops in the early 1900s, that were fly-by-night operations, with entities that are, you know, major financial institutions, whatever their faults and mistakes may have been, there have been major financial institutions overseen by regulators around the world. The equation of those two is just, you know, completely INC to me. So for those two reasons, I think that that was the motivation behind providing that protection in the CFMA. And keep in mind, there's a definition in the CFMA of eligible contract participants, which require certain net-worth levels, capital levels, asset levels, and therefore, it's only those entities that can engage in these transactions, effectively sophisticated parties, which is a typical concept throughout financial services law.

MORELLE: I would point out, and I appreciate that there are many, many very sophisticated players in the marketplace. I was reading the other day that M&T Bank, which is an eastern seaboard regional bank of some size, is in the middle of a lawsuit with Credit Suisse over CDS's which they encouraged M&T to participate in, and were on the one hand, at least M&T claims, urging them to go short on one while they were telling other customers to go long. And that's, I think, the focus of the lawsuit. But it does occur to me that some pretty sophisticated people you would think of as

sophisticated instead of certainly retail, certainly have some complaints about the marketplace and the question of whether or not what they're buying is what they think they're buying. So, when I hear that term, "sophisticated," versus "unsophisticated," it often…I'm often wondering who's really sophisticated anymore.

PICKEL: Also keep in mind, as Superintendent Dinallo mentioned, that the CFMA as it relates to, as he referred to security-based swaps, which CDS would generally be considered to be security based swaps, that there are anti-fraud and anti-manipulation provisions of the FCC requirements as well as continuing state fraud laws that would still apply. No one…I don't think the CFMA undid the ability for somebody to bring a fraud action under state law, and I suspect that may be an element of the claim there, perhaps also in addition to anti-fraud and anti-manipulation at the FCC level.

MORELLE: Gentlemen and ladies, any other questions? Mr. Pickel, thank you again for your testimony, for being here, and for your continued work in this area.

PICKEL: Thank you.

MORELLE: Our next witness is Michael Shozer, who's the President of Assured Guaranty, who's speaking actually on behalf of Assured Guaranty and the Association of Financial Guaranty Insurers, AFGI. Not any longer…good afternoon.

SCHOZER: (weak audio) Good morning, Mr. Chairman…good morning, members of the Committee. Thank you, first, for having this hearing. This is obviously a very important topic for a lot of institutions and a lot of regulators, both federal, state, banking and insurance. I'd like to thank Superintendent Dinallo for all the work he's done in the financial guaranty industry, which as you may be aware has had a number of participants have some trouble recently. I'm President of Assured Guaranty, which is, I guess, the only financial guaranty company…I'm sorry…

MORELLE: Could you pull the microphone just a little closer to you?

SCHOZER: Yeah, I'm trying not to bump into it. Is that better?

MORELLE: Yes, much.

SCHOZER: Is there a volume thing?

MORELLE: No, you're good.

SCHOZER: I apologize, I have little bit of a cold, too. Assured Guaranty is the only financial guaranty company other than the Berkshire subsidiary that had stable ratings this time, and the only one that has any AAA stable rating. I'm also Director of AFGI, the Association of Financial Guaranty Insurers, and some comments at the end will be with respect to AFGI, other comments are mostly those of Assured Guaranty. We've been active in both the financial guaranty and credit derivative market for a long time. I'll also note that I have a long track record before that as a banker doing it, and was actually doing interest rate swaps when we first started developing credit derivatives. So I was actually standing there when we first did the first credit derivative transactions…being there at the beginning. A couple things…two things I'd like to do today, one, I'd like to address some common misperceptions that exist in the world, and to quote Artimus Ward, who was a 19th Century humorist, "It ain't so much the things we don't know that gets us into trouble, it's the things we do know that just ain't so." And there's a bunch of things that go around that just ain't so. Let me talk about a couple of things first. One is the notion that credit default swaps developed into some kind of gambling or speculative instrument. Credit default swaps developed as an alternative to bank loan syndications. _____, you know, $40 million dollars for XYZ Corporation, you could sell it in the bank loan market or it could use a credit default swap as an alternative to syndicate that to other banks. Fundamentally a banking product. They're unfunded, just like letters of credit are unfunded. For all the times I hear people compare credit default swaps to insurance, I very rarely hear somebody say, "And gee, they're just like a direct pay letter of credit." A direct pay letter of credit, I give you a direct pay letter of credit, if the importer doesn't pay, I pay you. Sounds an awful lot like insurance, but I don't see a lot of effort to say, "Well letters of credit are insurance, even though they work pretty much the same." Another misperception is that CDS were part of the liquidity problem…were the problem at a number of insurance companies. People talked about AIG this morning. I think it's really important to distinguish between where CDS was the problem and where liquidity was the problem. As somebody mentioned with

respect to AIG, they haven't had losses on those derivatives. They've had liquidity calls on the mark-to-market value that put them out of business, but they have not had losses on the credit derivatives. That's a really important distinction that everybody kind of sweeps up. "Oh gee, these credit derivatives done them in." Well in fact, what done them in was they had to write $100 billion check to their counterparties for liquidity on the mark-to-market. So it wasn't the CDS, it was they entered into agreements that they had to post collateral. Well that's happened before on other types of financial institutions. So it's more about the collateral. And an important point here, from a regulatory standpoint and from a public policy standpoint, is that one of the lessons the banks have taken away from all this, and you've heard Mr. Pickel make this comment, is, "Darn, we always now gotta make sure we get collateral." Well one of the lessons the insurance regulators are taking away is, "Gosh, we gotta make sure nobody ever posts collateral." So I just want to use that to highlight that there's a very different perception sometimes of what's good and what's bad. In fact, collateral works really well inter-bank, as Mr. Pickel would say, in between dealers, between J.P. Morgan and between, you know, Chase and J.P. Morgan, or J.P. Morgan and Citibank. That works really well because they've got collateral coming in, they've got collateral coming out. That's why when Lehman blew up, there was no problems with the swaps books. They were kind of net flat. The problem is, insurance companies like ourselves or AIG, we don't have a big two-way collateral book. You're one way. If the day ever comes when you've gotta post collateral, you know, it's a really bad thing. So, one of my recommendations later, which I know is in the new proposed Article 69 regs is, insurance companies shouldn't be allowed to post collateral. A third assumption is that CDS impacted a lot of the financial guaranty companies' ability to write business. Well, a number of financial guarantors wrote, you know, these transactions which were probably more…more…hard to describe quickly, but these ABSCDO's. Basically, they took ABS pools of mortgages and they made more pools out of them, so there were pools of pools of pools. So they were really far away from the underlying mortgage risk, and it levered up every time. So you started with a million dollars of risk, made a pool, a pool, got ten million of risk, made a pool, a pool, a pool, got 100 million of risk, okay. But they only accounted for it as the original one million of risk. So I think it was

Representative Keiser's comment earlier about making sure you've got the capital for the risk. Well that's what really happened to these insurance companies on the risk standpoint, is they wrote such levered risk and it only got accounted for as single risk in and out of capital. So another one of my recommendations is that risk that levered gets de-levered in figuring out how much capital insurance companies have to hold. Fourth assumption that people assume is that kind of…and Chairman Morelle asked about this a little with Mr. Pickel is, all kinds of people can write credit default swaps. Well, you know, you can't quite go on fidelity.com and do your own credit default swap, okay. There is one gatekeeper to all credit default swaps, and it's the banking system 'cause they're the market bakers. You want to go write a credit default swap, you gotta go to a bank. There's only one way to do a trade with a bank. The bank gives you a credit line. That's it. You know, there's no other way to do it. So the banks unconditionally and absolutely control who does a credit default swap. And well gee, maybe some company in Malaysia…well forget about it, because they've got to get a credit line with some bank who's got a credit line with J.P. Morgan Chase. Nobody does a credit default swap without coming through the banking system. Another important thing is distinguishing between, you know, symptoms and causes. We all say that, but sometimes it's kind of hard to do in the heat of the moment. A really good example, and someone mentioned earlier, I don't know if it was Mr. Breslin, but Sarbanes Oxley. Think about Sarbanes Oxley after the Enron crisis. Okay, pass this really good law, usually expensive, I mean hundreds of millions of dollars were spent complying. And you know what, AIG, Lehman Brothers, Bear Stearns, Merrill Lynch, they all complied with Sarbanes Oxley. They had staff, like dozens of accountants and consultants doing Sarbanes Oxley, because gosh, darn, after Enron, we're never going to let this happen again. Well, the problem with Enron wasn't about the problem that Sarbanes Oxley fixed, so what it encouraged you all to do and…these hearings is a part of that, is to really identify what really the cause of the problem is. 'Cause this problem…what happened, in my view, is pretty straight forward…to be fixed straight forwardly, but also, if it's fixed the wrong way it can do a lot of collateral damage. So that said, there's clearly things that in my view can be done to improve the regulation of CDS. Number one, there's got to be a proper measurement of embedded liquidity risk. And what do I mean by that? This

is more of a banking issue than an insurance issue, but if you look at somebody like Bear Stearns or any financial institution, they've got…what happened to Bear Stearns? Two things. Short term liabilities funding long term assets. We've seen that before…Connell, Illinois, okay. This has happened again and again, and the banking regulators didn't take this into account in an effective way with respect to credit default swaps. So there's got to be a better way put in place on asset liability mismatches for banks. Two, certain insurance companies had problems with downgrade triggers, because they got downgraded and had to post collateral -- AIG. Some of those collateral postings, mind you, were with their GICK businesses. Again, nothing to do with CDS. So another one of my recommendations is, don't allow insurance companies to have collateral postings based on ratings triggers. Ratings triggers create a death spiral because you get downgraded, you've got to come up with collateral, you get downgraded more. So no ratings triggers. Second, mark-to-market accounting. I'm a real firm believer that we should go back to the old accounting of trading book, where if it's a trading asset you mark to market daily; if it's held to sale, you mark it below the line; and if it's held to maturity, you don't mark it. I think the mark-to-market accounting that happened here…and you can disclose anything you want, mind you, disclosure is great. But when it goes to the PML it creates a real problem because what happened was, people had to sell and they had to mark things to market, and they had to do it in an environment of falling prices. Prices fall, makes you sell more, makes you sell more. One of the examples I use is, you know, you've got a house, it's worth…you know, whatever you think it's worth, probably less than you thought last year, but if you had to sell the house by 5:00 today, it's worth a hell of a lot less than, you know, you think it's worth. And that's what mark-to-market accounting does. It really creates a problem, and I think public policy-wise you can handle a lot of things investors want by having better disclosure. In fact, I would tell you from our standpoint as a public company, our equity analysts don't really look at the GAAP financials anymore. They look at them, but they really focus on our supplements and other details 'cause there's so much noise in the GAAP financial statements…because in part because of the mark to market. I also think that banking regulators should recognize that ratings triggers aren't much use. I realize that's not an insurance issue, but in terms of public policy statements… for the reasons

that it creates a death spiral. One of the reasons banks ask for them is because they think it gives them credit. Well if their regulators said, “Guys, by the way, you know, by the time somebody’s downgraded to the point where they’re posting collateral, you know, they might have trouble coming up with it. You will get less credit from us as your regulator for relying on ratings triggers.” You know, ratings triggers I think have to come out of the system. I think regulators need risk regimes that recognize the actual risk of loss. One of the problems here was the embedded leverage in ABSCDO’s. Levered, unlevered, unlevered. It’s…a lot of it is making sure you’ve got the right reserve for your risk. Instead of getting overly nuanced into, well is this, you know, hypothetical, is this an investment, is it this, is it this? You know, if you buy a share of Ford stock, you didn’t own it yesterday, or a Ford bond, well are you gambling on what happens to Ford? Well, you could argue whether you’re gambling Ford’s going to go up, Ford’s going to go down, whether it’s investment. I mean as a public policy matter, I’d ask you why that matters at all. As a public policy matter, I think the question is, what is the risk on the books of this insurance company and how much reserve does it need? And attentive to that is what to scope its business. It’s a credit business, a life business, whatever the case may be. But if you properly measured and required reserves for the risk, then you don’t have to get into these hypotheticals about what is investment, what is gambling, what is this, what is that, because, you know, I could tell you if I go buy Ford stock, am I gambling or am I investing? Well it might depend on your point of view. I mean, you know, if you think Ford’s… Ford’s only got option value as a stock, you might say it’s a gamble. If you think it’s a really good solid company, you might think it’s an investment. I think you just gotta think of the risk and make sure people have enough capital. I think part of that is also that regulators should require, and part of the proposed changes of Article 69 do move this forward to some degree, is a larger framework of risk management for institutions. I mean some risk management in institutions do get really narrow really quick. And people rely on things like value at risk, how much is one basis point move, this, that and the other thing, and they lose track sometimes of the bigger risks that can occur. So I think the regulators should require to become very judgmental but a more holistic risk management framework, instead of just saying, “Here’s your

statutory capital." And some regulators do this, by the way, you know, I know it's not something historically New York State insurance has done, but the FSA and the UK does this, for example, and I run a UK company I've run for a long time. They have that approach and it works pretty well. They come in and they want to see how you think about risk, how you do this, how you do that. So I'd recommend increasing that. Another recommendation would be increased regulation of rating agencies. I mean let's not forget, if you look at the data, between 1990 and 2007, according to Moody's, there were about $525 billion of corporate bonds that defaulted over, you know, basically 18 years. Investment grade, non-investment grade, you know, that includes all the telecoms that went bust, $500 billion in 20 years. This year alone, or this year, I guess '08, there were $225 billion of AAA ABSCDO's that went default. I mean this is not even close to being within any kind of historical framework, and they just got that really wrong. And so we'd recommend some type of increased regulatory oversight onto rating agencies which doesn't…which probably has some degree of increased disclosure, increased transparency. I'd also recommend, as I mentioned before, taking out a lot of ratings triggers, and also taking away some of the…I know the NAIC is looking at this now, taking away some of the regulatory benefit given to a rating, okay? So again, you're trying to take away cliff risk. Moody's comes out and looks at a rating, it shouldn't cascade into a real problem for a company. And we see that all the time, for example, you see investors who have to set something as investment grade, go from BBB- to BB+, probably not as a credit matter a big issue, but then they gotta sell. Well if that happens to enough stuff, I mean that goes into the spiral problem. Alright, turning to something that was asked of AFGI is…I guess the credit cites article that I guess, Chairman Morelle, you asked about, had did actually a really good…I thought it was really excellent, the description of the rise and fall of the monolines. There were two things we have to comment on. One was that CDS caused the problem with some monolines. I would go back to my earlier comments where the problems were really caused by ABSCDO's, which blew up. I mean, you know, whether…if you wrote to changing insurance topics for the analogy, if you wrote a piece of hurricane risk in, you know, Miami, Florida, and you wrote a policy or bought a cat bond, right? You have the same loss. It didn't matter you did through a cat bond or you did through an insurance policy. So these companies wrote

risks on certain types of mortgages, and to give you an idea, and we ran these numbers out, it's in my testimony, if you take $30 billion of ABSCDO's, which are these, you know, mortgages…$30 billion roughly represents $900 billion in mortgages. Now if they had accounted for that, I'm loathed to use the word "properly," but just for technical reasons, but if they accounted for that as $900 billion worth of risk, they never could have written that. And so if you capture the leverage, you don't have to wonder, "Gee, what's going to be the next problem; oh, can I anticipate what new whiz bank somebody comes up with?" If you properly got the risk in there, and properly had the reserves, you don't have to overthink what somebody could do. So I would recommend that everything gets delevered in calculating risk for capital requirements for reserves. The other thing the article talked about was that financial guaranty insurance is usually much higher leverage than banks and to others. And the article is right, but it confused two points. When you measure our leverage generally, a lot of times they look at P and I, which is the par plus the total interest paid over the life of the bond versus capital. And banks usually think about loans to capital, so if you reconvert us to par insure the capital, we're probably about 100 to 1. Your basic banks, you know, 12 or 13 to 1; your basic broker dealers, 25 to 1, ignoring for the fact that other than this year which has been unique, that you know, on December 25th, every bank and broker dealer known to man sits there and does a whole bunch of transactions to pull down their books over quarter end. That's more or less, you know, we're probably five or six times more levered than a typical bank. Now you say, well is that a lot? And go back to the earlier comment about, there's probably been about 500 of corporate defaults, and think the over-simplified banks do corporate loans over the last 20 years. There have been about… putting aside ABSCDO's which were a unique catastrophe unto themselves, $26 billion of ABS defaults and $37 billion of muni default over the same time. So muni and ABS typically default less than corporates, so it would make sense their leverage would be higher, and the other thing is, we don't have liquidity risk. Okay, we don't post collateral, we don't have…raise short-term funding to make long-term assets, so there's no liquidity risk on our books. So for those reasons, it makes a lot of sense for us to be a lot more levered than banks. You know, what exactly the right number is, who knows, but it clearly… directionally is correct that we would have a lot more leverage. Those are

my prepared comments. I think there's a couple of things I note as I listened to other testimony. One of the interesting things, Berkshire Hathaway, as you probably know, had entered into the financial guaranty business. And I didn't look at their 930 10Q so these are second-quarter numbers. But as of the second quarter, about three-quarters of the municipal business they wrote was in derivative form, credit derivatives on municipalities. So just to, you know, despite Mr. Buffett's, you know, weapons of mass destruction comment, if you read the 10-Q, what you'll find is three-quarters of the premium he generated from financial guaranty area was credit derivatives through 630. And also I'd point out, and I was surprised Mr. Pickel didn't make this comment, that when Lehman…when they settled Lehman through DDC, most of it was not guys who actually had bonds. Most of it was cash settlement. Here's evaluation, 15 cents on the dollar, it was not people at bond, it was just…. Those were my prepared comments, and I guess I'll ask, Mr. Chairman, if you have any questions or any of your colleagues?

MORELLE: Well if I didn't have any questions after that testimony, I really shouldn't be up here. That was pretty intense. Go back and explain to me again, you…I have had some conversations in recent days about the question of collateral versus reserving, and the question of whether or not folks were selling protection CDS market ought to be required to reserve, or alternatively whether they should be required to have some collateral requirements. And the argument was made to me the other day that collateral is king, reserving doesn't work, and that we ought to maintain our efforts in insuring that there's adequate collateral. But you seem to be saying the opposite.

SCHOZER: I am saying the opposite. And I'd bet you it was a banker that told you that, right?

MORELLE: Actually it was an insurance company.

SCHOZER: Really, I'm surprised at that. I'll tell you why I have the opposite view. Reserves relate to risk. We have a piece of risk on our books, we need capital in case we have to pay a claim. That's reserving. You gotta have enough capital to pay claims, that just goes without saying… alright, it's a public policy point. Collateral is posted based on mark-to-market. Well, do I really care what the mark-to-market of something is? I mean to go out of my

area of expertise and use it in another type of insurance example, if, you know, I wrote a piece of hurricane risk, and premiums tripled, and I still have the risk on my books, am I going to, you know, care if it…do I quote mark-to-market? Well, not really. So if I wrote a credit derivative on, you know, whatever it may be, you know, I've got the risk of loss, okay? If the market value changed, why would I want to post collateral, and then I've got my whole problem of now I'm posting collateral for the benefit of some policyholders and not other policyholders? I mean I'd really feel very strongly that…collateral posting by insurance companies is just bad public policy. Banks love it because they want the collateral, but you know, I don't like it at all.

MORELLE: But their argument was essentially collateral, if I understood the argument, that reserving was less secure essentially than collateral. Collateral is a day-to-day collateral call, and so it helps mitigate any long-term dislocation because you have the collateral calls on a daily basis. If there's a default, you essentially lose the protection for the day and go back in the markets and… in other words, if the seller of protection defaults not if there's a credit default, you still need protection in place but there's no longer an ability for the seller to underwrite the prospective loss because of the collateral requirements that you basically cash out and you go out and buy another credit default swap that's traded every day in the market. And so you effectively could lose maybe a day's worth of collateral where it was insufficient for the original seller. And that reserving essentially deals with sort of the net value of the company making the protection, but it's not as secure as collateral which has to be posted on a daily basis. It's the first time, frankly, I heard the argument, I'm probably not nearly sophisticated enough to be regurgitating in it because I don't think I understood it fully, but I think that's the basic fundamental, and they said collateral is king. They said it over and over again, and that the notion that we would, sellers of CDS's, be required to do reserving as opposed to collateral was less secure and provided less protection.

SCHOZER: It provides less protection to the bank with whom they've written their credit default swap, but I don't think the… so if I'm a banker and I have a credit default swap with an insurance company, or frankly, I have an interest rate swap on a dead issue with a hospital. You know, I'd love to get

collateral because that means I don't have credit exposure to the insurance company or the hospital. I mean we've seen cases recently in our healthcare book, whereas, swap counterparties, banks, have gotten downgraded. Those hospitals and other…you know, this is more typically a hospital thing frankly, but…for a variety of reasons. They have to go and replace that swap and come up with money. And the banks like it because it gets away that counterparty risk. But as an insurance company, you've got the credit risk. So you want reserves against the credit risk. And I go back to my comment earlier that the only access through the default swap market is through the banking system, and why would I ever want…and we never…we don't like…wouldn't post collateral anyway. Why would I ever want to post collateral to a bank? If they don't give me a credit line, I can't trade with them, that's fine. But if I have to post collateral through some bank, that disadvantages one set of policyholders versus another. I just think it's bad public policy.

MORELLE: Well I did raise that, because that seemed clear, I mean both the Superintendent and I have talked about this, is that when you have different collateral requirements, it does essentially set up classes of claimants, doesn't it?

SCHOZER: Yeah, absolutely.

MORELLE: Whereas, reserving doesn't.

SCHOZER: Right. And frankly, collateral works great within banks. I mean when you think of how much business Citi has with J.P., has B of A, it's massive. I mean they couldn't trade with each other if they didn't all have collateral posted. And it kind of nets kind of flat at the end of the day because they're doing so much back and forth. But insurance companies are one way. I mean they're…you're writing risk. You can't be receiving collateral to offset the collateral you're posting, so.

MORELLE: Yes, Senator.

LEAVELL: Just one comment. Reserving works very, very well, but only where you've got strong regulation. Collateral is much more transparent.

SCHOZER: Well, but collateral…if you're the insurance company, I would argue what you care about is having enough capital to

pay claims. Capital is…me taking, you know, $50 million of my capital and giving it to J.P. Morgan to collateralize a swap transaction with J.P. Morgan. I mean, it does a lot for J.P. Morgan. It does absolutely nothing for the rest of my policyholders. Me keeping, you know, $50 million… and agreed, strong regulation, what should be the right amount of capital you need, me keeping another $50 or $100 million of capital really helps all my policyholders.

LEAVELL: I don't disagree. Thank you.

MORELLE: Representative Keiser.

KEISER: Thank you, Mr. Chairman, and Mr. Shozer, is that correct? You made the comment we need to capture the leverage and have proper reserve to risk. Go through that paradigm of how we manage that capturing, what are the guidelines we should be using or addressing, and considering?

SCHOZER: Sure. I do, just as a point of principle, have a fairly firm view that it's very hard to micro-create some regulations of a big principles…regulation by a principles believer because otherwise you won't have the tax code. So any exposure which you have which is levered in some way needs to take into account the full amount of the risk. A simple example would be, you know, if you go out and do a Treasury future, you know, you put up $10,000 dollars, you've got a million dollar Treasury bond. Well, if you think your risk is $10,000, you're kidding yourself. Your risk is the million. So I think there should be regulations in there that say that whatever risk you write, you have to hold capital and reserves, etc., and measure against the fully grossed up, or unlevered, or however one would wind up drafting regulations exposure that you have. You have to come up with the real exposure, not just the amount of the size of the policy you wrote. It's kind of analogous to, you know, if you write, you know, homeowners' insurance, and it's a $500,000 house, and I write just the first $20,000 in loss. Well if the guy's pipes burst, I'm probably out my full limit, and the house didn't have to burn down. So you've got to recognize you've got that full limit there.

KEISER: And I understand that, but is the risk, the greater the risk changes, how would you suggest the reserving should change? I mean I know you're going to say one-to-one, but…

SCHOZER: Well you'd reserve the full amount…or it may be 10 to 1, or 20 to 1. If you…if you look at Treasury futures, $10,000 is a million dollars. So, I'd say you'd have to take into account per single risk purposes, for capital purposes, for reserve purposes, the full unlevered amount of your exposure. Just gross it up to the total aggregate you got. I don't know if that was helpful, or…. And we have, by the way, they've thought about changes to Article 69, we have, in fact, drafted some language to New York State which we think does this, to gross that up.

MORELLE: Well that was, I mean a large part of our problem is the leveraging here, but that's sort of the large part of every financial crisis in the last thousand years… there's always leveraging.

SCHOZER: That's right, that's right.

MORELLE: Representative Damron?

DAMRON: I just think…I think what I'm hearing you say is that when we enter into these, we need to get our reserves up front and not have to worry about it, getting them as you get additional reserves or collateral, as the writings change on the individual credit. Is that correct?

SCHOZER: I think it's actually the other direction I was thinking about. You don't want the insurance company having to post collateral…because if we insure, you know, the hospital somewhere, if the rating goes from single A to double B, well we insured the hospital. We're not going to get more collateral from the hospital. But if we did a transaction with J.P. Morgan, we don't want to be posting collateral either. So for a financial guarantor, and I would think for most insurance companies, frankly, it's too much about getting collateral as much as not giving it out, because that's what killed AIG. They had to write all these checks of collateral, even without having losses to pay. I mean they didn't have claims to pay, that FP business in Ireland didn't have losses to pay. They just had collateral obligations.

DAMRON: I think that's what I'm trying to say, is that you're saying that we need adequate reserves based on what's written when it's written…

SCHOZER: Correct, correct.

DAMRON: …and not to have to require additional reserves or push… in the collateral issue, you're asking for more and more collateral as the ship goes down. Well, there's no more collateral to get as the ship goes down. So it seems to me that what you're saying is we just need to make sure that we ask for and maintain adequate reserves on the front end as we move forward on putting business on the books as opposed to worrying about it as it's changing.

SCHOZER: Well, I…yes, you've got to make sure up front you've got enough reserves for the full amount of risk you're writing. But, and too, you don't want to be posting collateral with anybody, because that takes capital away from all your policyholders.

MORELLE: So let me ask this…I'm sorry. Representative, were you…

DAMRON: Yeah.

MORELLE: I didn't mean to interrupt. But to follow up on Representative Damron's question, if AIG, the financial service company, had treated their exposure under credit default swaps and were allowed to, by reserving on that exposure they would obviously not have collateral calls. The collateral calls were as a result not necessarily of credit events, but because of the downgrading of ratings of assets that they held that were mark-to-market. Is it possible… that would actually reduce volatility, they wouldn't have appeared as weak and wouldn't have to shed assets, is that essentially right?

SCHOZER: Well, sort of, but if you take AIGFP, with AIGFP, let's just assume, because I have no reason to know different, they had adequate reserves for the exposures they took. It doesn't change what happened at all. The reserve didn't relate to the mark-to-market value of what they had to post collateral. If they had not agreed to post collateral on their downgrade, they'd be here today, okay? It had nothing to do with their credit derivatives, nothing to do with the fact that for GAAP accounting it was mark to market. It was solely because they entered into agreements where they agreed to post collateral. And when they got downgraded and the market was blowing out, and the value of these things got lower and lower, they had to go out and write a check for $100 billion which was the market value. It wasn't even about what losses they might ultimately

have. And so if they had been…not been permitted to post collateral, that couldn't have happened. Now on the other hand, the banking community needs collateral interbank, so there's really two different groups there and they need to be treated separately. But AIG wouldn't have gone "poof" had they not had to post collateral. 'Cause if you look at… and I haven't read their financials in real copious detail, right, just the public stuff, but they had…

SCHOZER: … and it went to the fact that they had to post collateral.

MORELLE: But if we had all the sellers of protection on CDS's have reserving requirements as opposed to posting collateral, would that not limit… would not the argument from that community be that it limits then the effectiveness because it reduces liquidity?

SCHOZER: I don't buy that because I don't think the insurance sector is a big enough player. It might limit how much…

MORELLE: No, no, I'm not just talking about the insurance sector, I'm talking about all… so the federal government…

SCHOZER: I don't think that they could do that, because the banks need collateral inter-bank. The inter-bank market would just come screeching to a halt. Foreign exchange, interest rate swaps, everything. This is much broader than credit default swaps. Banks can't trade with each other without, you know, collateral agreements. And frankly, they weren't a problem with Bear Stearns, or Lehman or anything else. So the banking system needs that to grease the skids… forget credit default swaps, just for foreign exchange trading. I mean, you know, they couldn't do foreign exchange trading without collateral agreements.

MORELLE: So you're essentially talking about non-banking issuers…

SCHOZER: Yeah, absolutely.

MORELLE: … of credit default swaps?

SCHOZER: Right, right. People who are one way. If you… I don't know what the exact numbers are, but if you walked into Citibank and said, "What's your net collateral position, you know, versus J.P. Morgan, and versus Bank of America, and versus HSBC," they're long and short to different ones, but on balance, a lot of it evens out because they're a

market maker. They're not writing a net risk for the most part.

MORELLE: Any further questions on this end? Great. Mr. Schozer, thanks…

SCHOZER: Well thanks very much.

MORELLE: … thank you very much for your participation today. Our next witness is Ryan Wilson, a Senior Policy Advisor to AARP's Public Policy Institute. And just so we're aware, he'll be followed by Mr. Thomas Hoens, CPA Partner, HRF Associates. Welcome, Mr. Wilson.

WILSON: Thank you, Mr. Chairman, Mr. President, and members of the Committee, and thank you for having me here today. I represent AARP, and since we're retail investors, we're not really invested in credit default swaps, so you might be wondering why we care. Because we are… we care about retirement security of our members, our 40 million members, and they're invested in companies that invest in credit default swaps and trade them, and their retirement security has greatly been diminished over the last few months. We care about that. That's systemic risk. Does… when the sky falls, it hits individuals on the head, and that's why we care. And I'll be very brief with my comments because I think Mr. Dinallo set up, you know, what the system is like. These things look a little bit like insurance, they guard against risk, we see reports that they're traded, they look like a security a little bit. We certainly know that their value is derived from something else, so they're certainly a derivative. We just think somebody ought to be managing and regulating that risk. Somebody ought to be overlooking who has a disinterested eye, and the eye of the public in mind, to make sure that that risk is managed properly. And whether that entity is the Securities and Exchange Commission, the Commodity Futures Trading Commission, Mr. Dinallo, who does a very good job in New York, an interstate contact or somebody else, we don't care, but somebody ought to be looking at that systemic risk that's cost to the market when that sky falls and hits us on the head. And that's it. I'll be happy to take your questions.

MORELLE: Very good. Has AARP been invited into the conversations that in the… Congress relative to the regulatory scheme that they're considering or those conversations?

WILSON: We are talking to members of Congress on that, and we do have positions on that, what we think the regulatory scheme ought to look like, and I think we're going to be involved in that, yes.

MORELLE: Well I would just ask if, as your deliberations continue, as AARP continues to develop a more… a position relative to either the regulations being proposed or comes to some more specific set of… more specific, I guess, thoughts or positions relative to the type of regulatory scheme that you'd make sure that this organization would be included. Also to the extent that AARP, and I'm sure they haven't given a lot of thought to this, these are things that we think about often, I'm not sure anybody else would necessarily… the manner in which state regulators could play an important role in this, you know, emerging regulatory discussion, would be I think very helpful to us. And I think to your point, there are an awful lot of people in the world who aren't particularly sophisticated about the derivative world or the investment world, and yet are obviously very much affected and impacted by what's happening. We see, you know, the value of 401K's and pensions diminishing on a daily basis. Those of us in New York, part of the Common Retirement Fund which has lost 30 to 40 billion dollars in value in the last 8 months, and obviously affects public pensioners. So we would certainly invite you to continue to share with us your thoughts and your organization's thoughts, and I appreciate you being here.

WILSON: I would share a thought or two, if you'd like to hear. Just one thought I think you'd be heartened to hear is, we do think states have a role to play. I think states play a much better role as cops on the beat than federal regulators do. And you know, up until a few months ago, I might have said I think federal regulators play a pretty good job at systemic risk, but then you know, the Office of Thrift Supervision brought us AIG, it brought us IndyMac, it brought is Washington Mutual (WAMU). They haven't done so good at that either lately.

MORELLE: And frankly from our point of view, when it comes to the… even the AIG's subsidiary companies that operate in the various states, policyholders have not been affected because of reserving requirements that we demand under our various statutes and regulatory frameworks. So…

WILSON: We think we would hopefully have a role to play in protecting consumers. I think it's an important role, and you know, we'd be happy to work with you all as partners, I think. There are a lot of things that we look at, some things, systemic risk things, that you know, perhaps a… they're even in several of the plans that have been offered. There's been sort of a systemic risk regulator, or "uber" regulator or something like that. But you know, that… to look at societal problems, that might be a good idea. There are some other things in some of the plans that have been offered that we can agreed with, and some things that we wouldn't agree with. And you know, there are some people that we'll agree with on some things and not on others.

MORELLE: Any questions on this side of the table? Mr. Keiser?

KEISER: Mr. Chairman, Mr. Wilson, thank you also for being here today. And trust me, in our state, we know that AARP is concerned about a lot of issues including this one. But you've heard a lot of discussion this morning and I know you can't take a position on behalf of the organization without some kind of policy approval I suspect, but is there anything in particular you have heard today, other than state regulation being more involved perhaps in this arena that you think is important for your membership?

WILSON: I think, you know, really the one thing I would say is that… and you know, we just are in the process of working through our policy right now, and we have some draft policy on this particular issue. And the issue is that the risk should be regulated. A disinterested party, whoever that disinterested party is, should be looking at this, whether it's the… you know, whether it's the Federal Securities regulators to the extent that it's… it's more of a larger issue or broader issue and doesn't relate to states, then fine, let them do it, but they should do it well.

MORELLE: Any further questions on this… Representative Damron… oh, I'm sorry. Senator Seward?

SEWARD: Just a quick comment, Mr. Wilson. We appreciate your being here, and you do make the point by your presence here that at the end of the day that there are real, with what we've gone through these last number of months, are real, shall we say, victims and people that are suffering out there,

individuals. And I was heartened to hear your comment that when you think about what we have gone through in the last few months, that the entities that have actually been under the control of state regulation, mainly the straight insurance products, have faired pretty well. The difficulties come in, in those areas that have… that the states have not had such a direct role in terms of regulating. And I think that makes the case very strong that the state regulation of insurance should continue. You know, I think if NCOIL and AARP, and your 40+ million members can form a coalition in the best interests of consumers, because I think one of the strongest arguments for state regulation of insurance continuing is that we are in fact the states are closer to those consumers and thus can better represent their interests. So I think we have a lot in common here and we appreciate your comments and we look forward to perhaps working together on that particular point.

WILSON: Thank you.

MORELLE: Actually I was going to follow up, but I think Senator Seward said it as well as could be said, so we look forward to partnering with you in the future and being able to share our thoughts, and hopefully having AARP, where they think it’s appropriate, advocating perhaps for a state element to this issue as we go forward.

WILSON: Thank you. I’ll be the guy working on that.

MORELLE: Mr. Wilson… terrific. Thank you very much for being here this morning… or this afternoon. The next witness is Thomas Hoens, CPA Partner, HRF Associates, LLC. He’d be followed by Nat Shapo, Partner of Katten Muchin Rosenmanon behalf of the National Association of Mutual Insurance Companies. Good afternoon, sir.

HOENS: Thank you. Good afternoon, Mr. Chairman. Thank you, members of the Committee. I appreciate very much you taking your time on this matter, especially coming out here on a weekend. I’m sure you all have better things to do, but this is very important topic.

MORELLE: We couldn’t think of anything more fun than to spend Saturday talking about credit default swaps and derivatives. We just couldn’t do it. (laughter)

HOENS: And we've heard a wide range of opinions on them, Mr. Chairman, and just as a matter of background, I'm probably not as well known as Superintendent Dinallo for more than obvious reasons. I've been involved in the credit markets for about 28 years, formally credit trained at Citibank, being at AMBAC Indemnity, and… which was at one point and time in New York, then it was Wisconsin and New York, and back again. So I've seen the financial guaranty industry for a very long period of time. And there was an interim in there where we were part of a management team that recapitalized Fitch Investor Services and brought them back into, I think, the fold of a larger, more well-respected rating agency than when we took it over. As a matter of fact, the statement about Fitch when we bought it was, it was the best rating money could buy. And that, in part, plays some of what's going on here in the market. When I was at ACA Financial Guaranty in the early years during its growth period, I also served as its Chief Financial Officer, so I was there for a lot of the discussions going on around that company and dealing with the competitors in the market place. The first question I'd like to deal with directly is this, should credit default swaps be regulated. Absolutely, without question, and this is the body I think that's got to start that process. I agree with Superintendent Dinallo that you could look at the credit default swap market as being two kinds, the naked credit defaults, the covered credit defaults, and you know, he's being very kind and very generous. To me, a covered credit default swap is a financial guaranty policy. It is no different than when someone would walk into AMBAC, MBIA, FGIC, any one of the alphabet soups of financial guaranty companies, and say, "I own a bond, I own $200 million worth of Dormitory Authority bonds, and I'd like to get insurance." And we say, "But you didn't do them in the primary. But you know what, here's an insurance policy on those." And we have ways long since done to go down the street, get a new CUSIP number for those bonds that were insured by AMBAC, those bonds that were insured by FGIC, but the exact same underlying credit, and get them registered and therefore make them freely tradable with the insurance. And we can take the certificates, wrap it with a policy and give people certificates of insurance which are then freely tradable. Nothing in the covered credit default swap market that I have heard today, or even in the past, has told me that that is fundamentally any different. It is, you know, if it looks like a duck, it walks like a duck, it's probably a duck. The naked credit default swap

market, in my mind, is the one that is more hideous and the bigger problem. But as Superintendent Dinallo eluded to, and I absolutely agree with him, the fundamental product is the same. I am seeking credit protection. For what reason, I don't care, but I'm seeking credit protection from you. And that, to me, is asking you for an insurance policy. And under the laws of the State of New York, that's a, you know, 6900, that's a financial guaranty policy and it should be run as a financial guaranty policy with this proviso: if you have no insurable interest, it's void as a matter of public policy and the insurance industry has been through that road so many times over the years. And yes, it's fine that, you know, other companies and other jurisdictions may allow for insurance without an insurable interest, but I think we should draw the line. The swap market, we have heard, has grown from its beginnings in the 1980s, from 10 members, all inter-banks, dealing amongst themselves, and that was fine. If we're netting out positions, you know, it can serve as a very useful tool. But when we have notional amounts of swaps, and just as General Motors, as an example, where there were $65 billion worth of credit swaps against a company that had only $38 billion of total debt, people are making active bets in this industry. And like the scientists will tell you, there comes a point and time where you cannot observe an event without becoming part of that event. And whether it was making the Giants lose or whatever, but if you've got $68 billion dollars worth of bets in the market against GM, there's something that's going to happen. You've affected people's decisions in the market place. This credit default swap multiplier is seen in the industry as a hole with $62 trillion dollars. Even if it's $36 trillion dollars, it's bigger than everything else around. There's something wrong here. The… if we were to permit credit default swaps in their current unregulated form, and I think we can permit that two ways… one, wait for the fed, I think we're doing ourselves and our public a disservice. They have become just about as addicting as heroin. And the regulatory aid… aspect of ISDA to date has failed to reign in this problem. And I don't see, as a member based organization, ISDA (International Swaps & Derivatives Association) having the capacity to do anything else. We need a non-member based organization, and the non-member based organization is really the insurance commissioners in the various states. To the extent that we wait for the fed to act, and perhaps that, you know, in a larger sense, you could make a case for that, I think you possibly open the

door or this body would possibly open the door to federal regulation of insurance. Insurance is regulated by the states, should be regulated by the states, and if this product had been regulated by the states, we probably wouldn't be here right now. But I don't think the time is now to allow the nose of the camel under the tent, and permit or encourage federal regulation in this market. It is an insurance product; it is a financial guaranty product. The insurable interest, to me, is the biggest part of this, and is the defining characteristic of… you know, some people would say a naked credit default swap is slightly different. I say it's the same instrument, just without insurable interest, and should be void. With the reserve and solvency standards, I agree with Mr. Schozer that posting of the collateral, when you're always on one side of the trade, is a problem, and I agree that that should not be permitted for the insurance companies. You know, the more I think about these things and netting positions off against one another, you come back to, you know, the guy standing at the horse track betting on the ponies, he's taking the bets. And as long as his book is covered, he's fine, he's happy. He can settle his trades. It's everybody else in the room that gets hurt. And that's where the insurance companies come in. The insurance companies are ultimately the ones being asked to take the risk. A lot of what I had in the written testimony, Mr. Chairman, is on the record. You also have fairly much of my agreement, you know, and I realize the time that has been taken so far with what you've heard to date from Superintendent Dinallo. I would like to see the states reassert their control of this industry. And this is a product that is well within the sweet spot of their industry. Secondarily, and not necessarily one of the questions that have come up today, but there is a relationship between the insurance departments of the various states and the rating agencies with respect to the financial guaranty industry. It is very possible to comply with every single rule and every single regulation within the insurance department. And yet, you will not be a financial guaranty company. We need to recognize that in a very real sense the financial guaranty companies have a relationship to the rating agencies much like a Coca-Cola bottler has to Coca-Cola. They have one and only one product to sell. They cannot sell you any other. They can only sell you a AAA, and let's just use S&P (Standard & Poor's) for… but it's true with Moody's… they cannot… AMBAC in the old days could not sell you a AA policy; they

couldn't sell you a single A policy. They can only sell you one policy. Over time, the rating agencies have become the defacto regulator of this industry. And so I do believe that we need to reassess the relationship between the insurance department and the rating agencies as to how are we going to regulate this industry. We have seen the entire industry hit the wall, and it's time to go look at it and say, "have the rating agencies failed this industry," and should we be reasserting our… we, the regulators of insurance, be reasserting our control over financial guaranty. Those are my remarks, and I appreciate the opportunity to add those other comments.

MORELLE: Great. Thank you very much for your testimony, for being here today. Much of what you said, it seems to me, is not… well certainly I think when the Superintendent gave testimony, he suggested near the end of it that the notion of essentially declaring illegal the naked swaps in terms of being outside… illegal insurance, would probably have a chilling effect. Yet that's essentially what you're suggesting. You… have you given any thought to what the consequences, unintended or otherwise, would be for the… in terms of the world markets if we were to invoke that position?

HOENS: It would probably have a chilling effect on those 80 percent of the people that would like to be in a hedge fund and buy protection and engage in bets. That's not a bad thing.

MORELLE: But… well it does remind me, I remember as a kid, I'm sure this is entirely inappropriate but I'll say it anyway. When I was very young, my father did this occasionally, George, not often. He'd bring home a slip that would have football teams and a plus or a minus. And I remember saying to him, "well if everybody bet the same way because they thought so-and-so was going to win, somebody is going to owe an awful lot of money." And he said, "Well the plus and minus doesn't really have anything to do with what they think the outcome of the game will be." And I thought about that, and I thought, "Oh, that's interesting, I don't understand that, but that's interesting." And he said, "The number will change so that make sure whoever is taking the basic offering, the deal, has people on both sides of it so that it basically nets out, and they'll get basically a percentage of it and they're going to…." Which is essentially… I hate to boil it all down, but that's

effectively… if you're not… if you're not totally the seller…

HOENS: My dad used to call those people bookies.

MORELLE: I'm sorry?

HOENS: My dad used to call those people bookies.

MORELLE: Yeah, well… yeah. But that's essentially… in some respects, that's sort of where we are with… at least with the nakeds… in that… and it goes to pricing, it goes to a whole lot of issues, but it does allow for a lot of movement in the market place. But it's an interesting point. If you're only the seller, which is, I think, what Mr. Schozer's point was, as opposed to someone who's buying and selling and a market maker, then there are issues that we would insist on in terms of reserving, etc. because you are the seller of protection. So it's effectively… and I think what you're saying is that we ought to treat everyone who is selling to be bound by the rules as though they were only a seller. Even if they may be buying in other places, the person on the other end of that contract would have to be treated as if they were only the seller of protection. And so you don't get to… is that right, I mean, you have to treat those…

HOENS: The seller of protection should be a financial guaranty company.

MORELLE: Exclusively?

HOENS: It's a… well unless you want to change and allow other multi-lines to do it, but it is essentially a financial guaranty product. It is credit risk insurance on a corporate municipal whatever basis.

MORELLE: The insurable interest question, which has been obviously talked about a lot here, and is a critical lynch pin of the insurance law, there are questions about particularly for those companies that would buy a position or sell a position that they may be hedging another position they have. And some people might not argue that is strictly insurable interest because you may not have exposure, for instance, to Ford directly, but you may be downstream. Would you argue for a slight loosening of the insurable interest concept or theory so that it could be more

expansive and allow more hedging of risk, but where you have real exposure somewhere along that stream of commerce as opposed to purely speculative where you really don't have any exposure to any kind of loss directly or indirectly.

HOENS: I think you can create, you know, all sorts of rationales for, "Please let me play in this pond," and you know, in the life insurance area we could probably make a case to say, "Please let me take an insurance policy out on President Obama, or Governor Patterson." And we as a matter of law and well-standing, you know, fact, we don't permit those. It is too tenuous. And I would rather see, "You had better have an insurable interest, vis-à-vis, Ford, if you want protection against Ford."

MORELLE: Okay.

HOENS: And with all due respect, at some point and time, if you hold a Ford bond, sell it. If you think Ford is going bankrupt in five years, why are you long Ford bonds?

MORELLE: That's an interesting point.

HOENS: Well I mean one part in the mathematics of it is, if I own a Ford bond that pays 9 percent, and I can buy credit protection from somebody who theoretically is AAA for 3 percent, I'm making 6 percent on what is now theoretically a AAA policy. That ain't bad. Sell the Ford bond.

MORELLE: Representative Keiser.

KEISER: Mr. Chairman, thank you, and Mr. Hoens, and I apologize for bringing this question up to you. I should have asked it two speakers ago, but I was…

HOENS: I do a pretty good impression of Superintendent Dinallo.

KEISER: No, no, not him, but… I… so I apologize, but you made the statement so I'm going to hold you to it. You said we should require reserve rather than collateral. And they made a big point to do that. And I'm not certain, I'm a simple guy, and I'm not certain I understand reserve and collateral real well, so I'm going to try and phrase my question in a way that you can explain it so I can understand it. You said it, two speakers ago they said, don't require collateral, make it a reserve. In the

insurance side, which we do regulate, we have pretty strict guidelines on the reserving… what can qualify to be reserved as an asset to pay by insurance companies. We limit the types of securities, cash, other things that can be in there, but we do it. Now that's for insurance companies. Now we're dealing with credit default swaps, and we were told early on these are very sophisticated transactions between very sophisticated parties. And their business model is… can be whatever it… they want it to be, I assume. So "don't have collateral" seems to me that we're saying that we want to try and dictate a specific business model in a very sophisticated world, number one. So then I say to myself, and this is where I get confused, collateral and reserves, to me, don't have the difference it seems to have to you folks. If my collateral and reserve were $1 million dollars, and I entered into a transaction with Representative Morelle, and… not Representative but whatever his title is… Assemblyman Morelle, it really doesn't matter what I call it. If I have to pay him off for $100,000, it's $100,000. It doesn't matter.

HOENS: Yeah… if the default happens.

KEISER: Okay, if the default happens.

HOENS: If the default happens.

KEISER: So what's this… why do I want it to be the reserve versus collateral?

HOENS: Because during the period… when I was at Fitch, I rated IBM. And when I got involved in rating IBM, everybody thought the company was going to break up into five different pieces, and it was just a terrible company, and nobody could stand it. And you know, at that point and time, the mark to market accounting on a credit default swap against IBM would have you funding collateral. And you know what, smart management in the form of Lou Gerstner turned that company around. There was some pain involved, but it turned that company around. So why are we sending cash back and forth? It is mechanism that works with the banks where they are in the center, they are the market maker, they are netting a zero book position. It doesn't work when it's all one-sided. I have no way of getting that cash back from somebody.

KEISER: Again, and I understand that, but then we can control the quality of the element that is in the collateral or the reserve…

HOENS: Definitely…

KEISER: … but it's the same thing. I have to make a payment ultimately. And whether I call it collateral or reserve, I still have to make the payment. And if it's a quality product that's in there, in cash maybe, where is the distinction between reserving… you reserve the entire book of business versus a specific account, but there is no reserve for the entire book of business that doesn't incorporate the reserve or collateral for the… and risk for the specific accounts. I don't understand that distinction, and I'm trying to figure out why this is so important.

MORELLE: Well if I might, I think… again, this is I'm sure far beyond my area of competence, but reserving allows you to have assets in hand as an insurance company or financial guaranty. They might not be liquid, but you have to have on your balance sheet so much in reserve and surplus in the eventuality that there's actually a claim.

HOENS: And we're not part of the State Guaranty Fund. There's a… called Contingency Reserve Build Up, and is part of the rating agency part that… almost all of that is U.S. Treasuries.

MORELLE: But collateral, on the other hand, is not having assets necessarily. You don't have to set aside assets liquid or otherwise. What you have to actually do is, if there's a collateral call because the eventuality default, not default, but the spread has started to increase, it may actually trigger a collateral call, you actually have to liquidate assets and post that in terms of cash or municipal bonds or something…

HOENS: And write a check.

MORELLE: … which is what happened with AIG, as I recall. It wasn't that they didn't have the assets, it was that they had to basically have a fire sale to create liquidity so they could post either treasuries or something, so it actually weakened the company, although there was no… I'm using their example, but it could be anybody, even without having

a credit event where you had any loss or payment, you still had to change your business model to now make liquid and post collateral as opposed to reserves which would be done in insurance policies.

HOENS: But I think partly to Representative Keiser's point, is there… if I'm on the hook because I wrote a credit default swap of $1 million dollars, alright, and I've gotten a premium of $20,000 for this thing, and thank you very much, to the extent it looks more and more likely that I'm actually going to have to write a million dollar check, is there really any difference between having a million dollars in my bank book that I'm going to have to write you… maybe a 60 percent chance I'm going to have to write you that check, or handing off the collateral right now?

KEISER: And Mr. Chairman, that is just the point. I cannot see the distinction here between the two when there is a payment to be made. I just don't get that relationship.

HOENS: And that comes back to what should the reserving requirement be for credit default swaps. It is a fundamentally different instrument than anything contemplated under Article 69, which is municipal bond insurance. Municipal bond defaults, to the extent that they have happened, have typically been a failure to pay, burned through the Debt Service Reserve Fund, and then probably a three-year default period, at which point the municipality starts becoming current and repays the financial guarantor. Now that's a different level of, you know, how much reserves you have to take for a muni bond policy than a credit default swap, which is all of sudden, boom, game over, write the check.

MORELLE: Right, because you… as I understand it, the bond insurance, if there's a default, you pay back the bond holders on the schedule which they would have been paid under the bond. It may be a 20 year pay-out depending on when the default occurs.

HOENS: Correct.

MORELLE: A credit default swap is, you pay it then.

HOENS: Fundamentally correct, absolutely. So it's a very big liquidity issue and there's a question in my mind as to the adequacy of reserves that you should keep if the contract

is going to call for 100 percent payment due today and very little, if any, chance of recovery in the future. That is fundamentally different than what the financial guaranty companies started off as.

MORELLE: Senator, do you have questions? Senator Crisco, no? Senator Breslin? Ms. Calhoun?

CALHOUN: No.

MORELLE: Mr. Damron? Mr. Seward?

SEWARD: No.

MORELLE: Thank you. I think we will… we'd like to obviously continue this conversation further and particularly as it relates to with the state's responsibilities and obligations. Obviously of all the witnesses, you've probably been the strongest in terms of the assertion that the states ought to step in here and not allow, to the extent that we'd stop a federal regulator, but create a regulatory environment where the states have primacy here. And obviously we'll want to talk further with you about your thoughts on the subject.

HOENS: Absolutely, Mr. Chairman. Thank you very much for your time, I appreciate it.

MORELLE: Thank you very much for your testimony. The next witness is Nat Shapo, Partner of Katten Muchin Rosenman, on behalf of the National Association of Mutual Insurance Companies, and he will be followed by David Ingram, Senior Vice President, Willis Re on behalf of the American Academy of Actuaries. And maybe we can get Representative Keiser's questions answered when we hear from the Actuaries, on the difference between collateral and reserves. Thank you, sir.

SHAPO: Good afternoon, Mr. Chairman. President Seward, thanks for having me in. I am speaking on a paper which I think you've been distributed that I wrote for NAMIC, National Association of Municipal Insurance Companies.

MORELLE: Yes.

SHAPO: You know, I think that would serve as my written testimony. And obviously I won't read it verbatim, I'll just skim

through it and point out some high points. I know you're on a schedule and I'll try to moderate. The… I think NAMIC's thinking in asking me to write the paper was to think about what they believe were some misperceptions in the market place recently. Most important one, American International Group, commonly being called short hand, an insurance company, over and over again. The rescued… with respect to the financial bailout, the rescued entity is a diverse financial services holding company. AIG's non-insurance operations were settled, sound, solvent. The insurance operations were… it's non-insurance operations were the ones that caused the parent company the need to seek the bailout. The parent company is not a regulated insurance company, it's a large holding company. Credit default swaps, I mean there's… it's very… it's not a… as has been… as we've seen from the witnesses today, there's different ways to view them and I think there's different opinions about them. In our view, they're not insurance. Just because they're risk transfer mechanisms or just because they're used to hedge risk, that doesn't mean they're insurance. There's lots of mechanisms for transferring risk that are not insurance. We believe this is true under established law, they haven't been regulated as insurance, they haven't been managed as insurance. It's important to us to make that point because we think that the state insurance solvency regulatory system has served us very well. We think that they've been an oasis of stability in a very troubled seat right now. Derivatives and credit default swaps failures are not caused by or related to insurance regulation. State insurance regulation solvency neither caused nor contributed to the current crisis, in fact, it has excelled during the crisis. States' insurance solvency regulation, I think it's very interesting if you look, you know, with the benefit of hindsight, the very time when… credit… the problems with derivatives were first noticed in early to mid-90's… you know, and it continued unabated, and of course, it turned into a full-fledged crisis. If you look at the… it's interesting to look at the calendar that it's during those very years when the state solvency regulatory system really matured and excelled, thanks to, in a large part, to NCOIL's support, and NCOIL's commitment and its members commitment to backing the leading solvency initiatives. The issue has been discussed a lot today, are any credit default swaps insurance or are all of them insurance. There seems to be a large consensus that the so-called naked swaps aren't. And I think the issue is on the

covered swaps. In my view, it's not insurance. The product is… has two sophisticated parties entering a contract. Just the fact that they're sophisticated is not necessarily dispositive here. The bigger issue is the way that the contract is formed. It's two parties coming in to negotiate, to hedge or transfer risk, between two parties. It's not really spreading risk amongst a group of… in the insurance context what we call them insureds. Insure… I mean I got a quote from Mr. Bernstein's book, "Against the Gods, The Incredible Story of Risk," which I commend highly when you're thinking about risk holistically. We buy insurance because we cannot afford to take the risk of losing our home to fire. That is we prefer to gamble it as 100 percent odds on a small loss, the premium we must pay. But a small chance of a large gain if catastrophe strikes. To a gamble with a certain small gain, saving the cost of the insurance premium, but with uncertain and potentially ruinous consequences for us or a family. In the absence of insurance, just about any outcome seems to be a matter of luck. And the idea there is that if I want to be able to buy a house with a mortgage on it, which I have no way of being able to afford right now, I don't have liquidity, I'm not worth that much. I have to get fire insurance to be able to do that and to, you know, support… and to try to build a middle class life. Well you're all… many of you anyway, be in the same position. So what we all do is we all come together, pay the more certain payment which is the premium, which is a much smaller premium, knowing we can all do it together, into a common fund. And the insurance companies which are the gatekeeper of the fund underwrites rates, and then we have our protection that way. But that… to me, that's not two parties coming together in this kind of hedging mechanism. That's really all of us coming together, an insurance company essentially playing a gatekeeper role as a supervisor of the common fund. The U.S. Supreme Court says the primary elements of an insurance contract are the spreading and underwriting of a policyholder's risk. It's a characteristic of insurance that a number of risks are accepted, some of which involve losses. And as such losses are spread over all the risk so as to enable the insured to accept each risk at a slight fraction of the possible liability upon it. References to the meaning of the business of insurance in the legislative history of the McCarran-Ferguson Act strongly suggest that Congress understood the business of insurance to be the underwriting spreading of risk. Thus, one early House report stated the theory of insurance is the distribution

of risk according to hazard experience and the laws of averages. These factors are not within the control of the insuring companies in the sense that the producer or manufacturer may control cost factors. You know, law of large numbers, law of averages, distribution of risk, I mean to me that's the essence of the insurance enterprise and you know, I can't claim to be an ultimate expert on credit default swaps, but I haven't heard anything that makes me think it falls within that common law definition anyway. Page Six of the paper in constructing is another quote from a scholarly piece. In constructing risk classes, the insurer's goal is to determine the expected loss of each insured to place expected similar losses into the same class so that each may be charged the same rate. By creating classes of insureds that correspond to individual risk profiles, the insurance market is able to efficiently spread catastrophic risk across the full spectrum of policyholders. In contrast, derivatives reduce risk through trading, matching counter-parties with complimentary and offsetting risk profiles. I mean again, you know, the nature of that to me is significantly different. Individuals, potential policy owners coming together, trying to join up in a common fund versus two parties coming and negotiating a transaction. Again, derivatives… according to Mr. Bernstein again, insurance, by combining the risk of many people, enables each individual to enjoy the advantages provided by the law of large numbers. Insurance is available only when the law of large numbers is observed. Again, I see credit default swaps and derivatives as a form of risk management, but not necessarily insurance, which is itself another but not the only method of managing risk. As I mentioned before, I think it's very interesting to see on Page Seven of my paper now that you know, at the very time… I love this book, the… Against Gods book by Mr. Bernstein, because it's published in 1996. And in fact, somebody gave it to me when I started as an insurance commissioner, and they said, you know, you'll find this very interesting. One of the most interesting things to me about it was flipping through it, Incredible Story of Risk, is it… most of it wasn't about insurance. Most of it was about securities markets and other forms of risk management, and he talked about derivatives. Actually it's very pressing, he wrote this in 1996, and there were a few early signs of this, and he talked about, you know, how it happened. Big name companies adding to their exposure to volatility rather than limiting it, as we've heard earlier; treating low

probability events as being impossible; ignoring the most fundamental principle of investment theory, you cannot expect to make large profits without taking the risk of large losses. The financial solvency of these institutions supports the financial solvency of the world economic system itself. Every single day they are involved in millions of transactions involving trillions of dollars, complex set of arrangements, margin for error miniscule, poor controls are intolerable. So much is at stake beyond the fortunes of any single institution. This was in 1996, and it, you know, it's very pressing about what ended up happening. But again, I found very interesting that book, he wasn't talking about insurance here, he was talking about derivatives. A small part of that book actually talked about insurance. Anyway, as I said before, if you look at that timeline starting in the early 90's, Mr. Bernstein wrote about, you know, there are all these… the issues there were noted and available, very little was done about it. The same time, NAIC and NCOIL were working together for a solvency agenda that's been very successful in the states. And those are the main points that I have to make, and I do know you're on a schedule, and I know you've all been asking a lot of questions, so I'll… I'll just wrap up by saying that the paper focuses mainly on the common law. You know, if it becomes a point of issue, I could take a look at the New York Statutes. I was able to do some on my Blackberry, which is always a challenge to try to do, you know, legal research on your Blackberry. It's not clear to me that that provision… that provision necessarily distinguishes between covered swaps and naked swaps. It's not clear to me that it necessarily applies to either. It's not clear to me… it certainly doesn't obviate the discussion of the common law I've given here today, so in general, I feel comfortable with the conclusions we've reached. I guess I'd also just offer that if they had been… I mean that provision has been there for awhile. If it had been insurance, I think that it seems unlikely with that market, if that was truly an insurance product, that everybody involved in that product in all these years would not have thought it was insurance. But I do want to let you ask your questions.

MORELLE: Okay, thank you so much for being here, and I have also read Mr. Bernstein's book, and it is terrific as you say, and it's fascinating in its… information about statistics and the history of insurance, and the history of looking at numbers in this way. And we, in fact, invited Mr.

Bernstein here to testify. Maybe one of these days we'll get him to a hearing, but fascinating volume. But it does occur to me that, and I think it's interesting that you raised the issue of pooling and whether or not for you to have insurance it necessitates large numbers and pooling. Clearly, when you self-insure, it doesn't… we still call it insurance, and it has certain principles. You're looking for what's the likelihood of an occurrence of an event, whatever it is that you're insuring against, so frequency is an issue and you're also looking at severity, what your expectation about severity is, and then you make premiums accordingly. When you have large groups, you can actually further, you know, take that formula further out and then you can look at the likelihood of it happening among the large group and what the severity is, and that regulates your premiums. But the fact that you offer in effect a guarantee in itself so that I wonder whether or not the pooling isn't a mechanism by which insurers do their business, but the actual insurance and the contract of insurance doesn't occur when you enter into the agreement, that when X happens, I get paid Y. And then pooling is just a mechanism to make sure that if that event happens, that there's sufficient resources to fulfill the promise. But it's an interesting point you make. So your argument would be that you have to have the pooling in order for insurance to happen at all?

SHAPO: Yeah… I think that… I mean I quoted from one Supreme Court case, there are several other cases, I think some of which are in the end notes, but not all, that has classified insurance as a risk pooling enterprise. And so I think that in terms of the common law, I think that's the rule that's stated in the common law. I also think in terms of public policy that… I think the interest in the insurance enterprise as a matter of public policy, and in fact I quote the German Alliance v. Lewis case in 1914 in the end notes… if I can find it quickly I will discuss, if I can't, I won't. The companies have been said to be the mere machinery by which the inevitable losses by fire are distributed, so it's to fall as lightly as possible on the public at large. Their efficiency, therefore, and solvency are of great concern. Indeed, it may be enough to say without stating other effects of insurance that a large portion of the country's wealth is protected by insurance. Again, that… they tie that in to the risk pooling function. It's also about risk transfer, it certainly is, but every time you see that discussed, it's about the pooling, and I

think that's, from a public policy perspective, that's a large part of why insurance is such a heavily regulated enterprise under the code. I mean it's one of the more heavily regulated industries, and I think it's because of the, you know, the notion that we're all putting in to the… it's the common fund notion, and I think he's key. You know, for instance, the Unfair Discrimination Provision. The Unfair Discrimination Provision is an essential part of insurance underwriting. Like risks must be treated alike. The state actually steps in and puts that rule in place, recognizing that if there's going to be a common fund, the underwriting needs to be fair in that way. And again, I don't think that the public policy rationale on the credit default swaps, although they are important and we're not saying they shouldn't be regulated, we just don't think that the insurance… that the common law definition of insurance and the public policy rationale behind that common law don't… I don't think are as on point for the credit default swaps.

MORELLE: And so when it comes to writing bond insurance, the pooling is by whom?

SHAPO: The keeper of the common funds, the company.

MORELLE: And in the case… so you would argue that bilateral contracts, just by the nature that they're bilateral, are mutually exclusive… cannot be, by definition, cannot be insurance.

SHAPO: Yeah, you know, I'd hate to say… I'd hate to give an answer that's, you know, all black and all white. I mean… because there's public policy issues here as well as common law issues. But I think under the common law, that that's a key part of the discussion whenever the Supreme Court and other leading courts address these kind of issues. I mean several of the cases I've cited… specifically involved the question of whether something was insurance. So whenever the courts discuss that, they discuss it as the pooling of risk. And I think from a public policy perspective that the particular types of protection we're trying to give to consumers are more apt an insurance situation and what's been called insurance than in these products because… the law recognizes that we're all throwing money into this common fund so that it all doesn't go back out if the horrible event happens.

MORELLE: But isn't that… I don't mean to interrupt you, but I note that there are certain specialty insurance products, surplus lines, where you may have a major league pitcher's right arm is insured for X number of dollars. Obviously not a broad pool, someone has taken on the risk. It's still considered insurance, we still… I mean there's still regulatory schemes in place, but I would hardly say that's the pooling of risk. And it seems to me that what happens then is, you're willing to take on low probability event and you're going to then go on the back end and distribute that risk because I assume they go back and use reinsurers, you know, clearly laying off the risk. There's not a pool there in that sense anymore than there would be, I would think, in credit default swaps where you're clearly going to lay off the risk. No one's just selling and hanging onto the risk. They're clearly managing it, and so I suppose in that sense there's a pool somewhere, which is not a like or a common pool in that sense.

SHAPO: I mean I think that the… again, my analysis is essentially common law since it… it's not meant to be a 50 state survey of statutes.

MORELLE: Right.

SHAPO: And certainly, many state statutes have to create different kinds of coverage, and… you know, surplus lines which usually doesn't have guarantee fund protection. You know, the state makes a public…

MORELLE: That doesn't make it non-insurance.

SHAPO: … no, but the states made a public policy decision though to treat it differently than the fully regulated lines of insurance. And that's… you know, that's why I'm trying to say, I don't want to give a straight black and white answer to these questions because it's ultimately a question of public policy.

MORELLE: Well that's a great point, I mean you're raising a very important point to this, so that's why I'm just trying to probe to understand.

SHAPO: And all I'm saying is, you know, I think that, you know, like surplus lines, it's… the states made a public policy decision, yeah, we think it should be regulated, and we think it should be regulated by the Department of

Insurance. And that's… you know, I mean that's what this… that's what you're there for.

MORELLE: Right.

SHAPO: And that's what the Insurance Department is there for to do what you tell them to do. And, you know, you may decide in this case that you just don't have enough confidence in the pace or the quality of these federal discussions that Superintendent Dinallo talked about, and you may at that time just figure you have… this is such an important consumer protection issue, it has to be addressed and it's not being addressed anywhere else. You may choose to do that. You know, just as like with surplus lines, they've made a specific set of rules that govern that, and no one could quarrel with that. I would start with the premise that this is not, you know, this is not normally what you would think of as insurance. If you're going to address it in a state, I would suggest doing so by new regulation, not by existing common law, and in most states, existing statutes. And you know, hopefully… and it seems to me that it is interstate commerce, it's international commerce. I think it's most appropriate for this to be handled at the federal level, but you know, again if the progress isn't there and the consumer protection needs are there, you know, I think it's appropriate for you to step in.

MORELLE: Mr. Keiser.

KEISER: Thank you. I was going to bring up the same point. The surplus lines clearly are insurance products, considered to be insurance products by the states. In fact, if it's a Lloyd's product, and think about a Lloyd's product. They offset the risk in a small pool, and no different than in the CDS market with their investors offsetting the risk. I guess… this is probably more of a comment, yeah, we haven't called it insurance up 'til now. It's a brand new product. I don't know when they started, but I never heard of a CDS 20 years ago. And as new products come on line, we as policy makers do have to find a place to put them. They're not working real well in the unregulated market. I think we can all accept that fact. We've got a problem that has to be addressed, so where do you place them and most appropriately place them. And I would argue, directly with you, that anytime you're offsetting risk with a new product that comes into the market place, it's a lot closer to the insurance than the security, and as such, fits better. And

I do agree that maybe we do need a new category of insurance to address this, like surplus lines, but it doesn't… it's not a solid argument to me that we just don't call it that because it's different. It is new, but I think the similarities are there.

MORELLE: Does anyone else have a question… Representative… let's go with Senator Leavell.

LEAVELL: Very quickly, I read your analysis yesterday afternoon, and in depth, as I was flying here and it was well-written and well-done. But I came out of it with certainly the distinct impression that number one, it needs regulated, but number two, state insurance departments are probably not the ones to do that. And maybe I'm reading something in there that you didn't intend. But I certainly respect your thought on it and I assume that this is the Association of Mutual Insurance Company's position also.

SHAPO: Yeah, I mean I was acting as their agent essentially.

LEAVELL: Yes, thank you very much. I appreciated the comment you made on insurance regulation, you were very complimentary of it, and I appreciate that. I do have some concern about the OII, because your… you and your organization apparently are pushing for a federal office and I think our organization has some very strong concerns about that, and I think you're very well aware of those. But I do appreciate your paper and do appreciate your position. Thank you.

SHAPO: And if I might, regarding the OII, I think we tried to use careful language such as, you know, as a properly established and properly focused organization. I mean I think that, you know, NAMIC can speak for itself, but you know, they certainly… I think NAMIC's got a very strong track record about being concerned about mission creep and any federal endeavor on this. I think that they take a very practical view of this, which is that clearly there is a lot of holistic analysis going on right now, federally, of the financial services markets. And I think that they look… they look at it at the crisis, and they see everybody saying AIG is this insurance company in the insurance regulatory system, and there was a flurry of bed pieces and statements by the Treasury Secretary, etc., basically trying to blame… really, trying to blame the crisis back in September/October on AIG and on insurance regulation. And

it's, you know, we just feel that that… insurance regulation has been, you know, relative to the rest of the market on solvency, very strong. I think that, you know, NAMIC is definitely concerned about mission creep, they're definitely concerned about what would happen, however, they feel that there is a lot of pressure to do something at the federal level. This is… this would not, if it's… the way NAMIC would support an OII if it would not take regulatory authority away from the states. And I think very specifically with respect to the ideas talked about in this paper, the hope would be, since there is no institutional presence in the federal government with respect to insurance, that if there were, hopefully it was properly constituted and they were doing their job correctly. They would have had a voice here to say, hey wait a minute, AIG wasn't an insurance regulatory failure. That's just not right, you know, and giving that broad perspective in the market, you know, hopefully that's not too optimistic in terms of the way it would play out. But I think that's their intent when they say that they support that concept.

LEAVELL: Let me say this about that, is that if this does come to be, does come to happen, I hope that their… I hope they have the same limit on the authority that they have that you're outlining in here.

THESING: Mr. Chairman, members of the Committee, Joe Thesing from NAMIC. If I could just for a moment augment Nat's comments about NAMIC's position. Senator Leavell, a couple of initial points. As NCOIL well knows, NAMIC's official position is that we are in favor of a reform system of state insurance regulation, and we've been working hand-in-hand with NCOIL and state legislators across the country over the years to pass regulatory and modernization laws, and that is our number one priority in… that is our members' official position. So I think that that's one thing that needs to be pointed out. And that we've worked hand-in-hand with NCOIL to craft and to support the NCOIL regulatory… or rate modernization laws. Related to the OII, Senator Leavell, obviously that was a very vigorous debate internally and the reasons for us taking a position of… we are obviously supporting the OII, but it is conditional support and I do want to emphasize the word conditional, and we've made it very clear to Representative (Paul) Kanjorski (D-PA) and to the Congress that if the focus of that bill starts to slip, that we're going to pull our support. We're supporting the bill, as Nat mentioned,

because it addresses two very specific points or concerns that have been made by the Congress that we think are valid concerns. So I just wanted to address that and we'll be happy to answer any questions.

LEAVELL: I appreciate your comments very much. Thank you.

THESING: Thank you, Senator.

SEWARD: Okay, Representative Damron.

DAMRON: Yeah, I just want to make sure that I'm clear on where NAMIC is. Do you share the same… do you… do or do not, do you share the same concerns about collateral versus the reserves that were raised by the previous speakers?

THESING: Mr. Chairman, Representative Damron, I'll just be honest with you. I don't know if I know enough about those specific issues to give you an informed comment, but we'd be happy to take your concerns back and to provide you with a written response if that would be…

DAMRON: Alright, Nat, do you have any… I mean as a former insurance commissioner from Illinois, I think you were…

SHAPO: Yes, sir. I thought that the distinction made sense when people were discussing it, and I think that the… I'm sorry, there was a lot of witnesses, I can't remember who said what, but that the… the concern over the collateral and the ratings trigger I thought, you know, I'm not as expert in this as he is, but I thought it was well… it made a lot of sense when he expressed the danger in that. And, you know, and I think when you're talking about insurance solvency regulation and concerns about whether it's an official insurance product or not, regulate the Department of Insurance, that reserves are always a healthy way to approach it.

DAMRON: Well… I haven't seen NAMIC at the table, at the NAIC table or at the trough, like ACLI has on asking for changes in reserves in this point and time when things are so critical. Is NAMIC over there at the trough trying to do that, too?

THESING: No, Representative Damron.

DAMRON: Well I think that's good to hear. I think it's really… it

questions in my mind the ACLI, and it would certainly question in my mind you all, and your positions in the future of asking for us to lower our reserves at a point and time when the economy is in such dire shape and we've got insurance companies… and we talked about your position on OII, so I wanted to find out where you all were on that provision. I am strongly opposed, by the way, of what the NAIC is potentially considering doing with the ACLI's request. And so I just wanted to know where NAMIC was, and Nat, if you could comment?

SHAPO: Yeah, I mean Joe just said NAMIC has not been advocating that, and I guess… I'd speak for myself and I think for NAMIC, too, and that, you know, I've testified… I mean this paper is a very strong support of state insurance solvency regulation, and I think it's conservative bent has been a big part of that. We've, you know, we've been very… we tried to be unsparing in our praise of the state insurance solvency regulation. You know, at the same time, I've testified in front of Congress several times about market regulation, and you know, and we feel that… and I felt, I'm speaking for myself in this testimony, I've been a strong advocate that, you know… my praise has not been as effusive of market regulation as it's been of solvency regulation, and I think that… we have… there's a footnote in here that addresses that as well. I think that, speaking for myself, I would… I think reform efforts are our best target toward the market side than the solvency side. The solvency side has been well… well vindicated… by, you know, it's current status.

DAMRON: Thank you, Mr. Chairman.

KEISER: Joe, I gotta give you a little bit of grief now. It's now NAMIC's position, relative to health, a little bit pregnant is okay. Because that's really what an OII support with limited conditions is. You show me a program where the federal government has become engaged that, with over time, they haven't taken over. So this is a little bit pregnant, and no matter what NAMIC wants to say or do, you guys, we hope… I encourage you to take back the message, at least for me, you know, fish or cut bait on this one. Because there isn't a little bit pregnant.

THESING: Mr. Chairman, members of the Committee, if I could respond to my good friend from North Dakota. I certainly understand your reaction, Representative Keiser, and it

certainly is a vigorous debate internally. And we basically have decided to take a calculated risk. But at the same time, I think that our track record in support of state regulatory modernization is pretty clear. So I understand your comments and your point, and we know that there is risk associated with taking this position, but we took this risk, we took this position for, you know, solid and well-thought out reasons.

MORELLE: Gentlemen, ladies? Great. Gentlemen, thank you so much for your testimony and for your participation. Our next witness is David Ingram, Senior Vice President, Willis Re… … American Academy of Actuaries. He'll be followed by Professor Michael Greenberger, Professor of Law at the University of Maryland School of Law. How are you, sir?

INGRAM: Thank you. I'm going to… I'd like to go through our remarks extremely quickly and offer to spend most of the time answering your questions, because my real purpose in being here is to offer technical assistance from the actuarial profession in resolving these matters. And our comments were just meant to really introduce that idea. So, as I said, let me do that. Clearly, the CDS market situation, as everybody realizes, is excessive accumulation of risk by individual counterparties who are providing protection. The issues relating to the mark to market participant security are very similar, in our opinion, to the issues that are dealt with in the… in regulating the insurance industry. The Academy of Actuaries has no position, no opinion on who should be regulating this… CDS business, but we think that the nature of those regulations should be very similar to the nature of insurance regulations… because there are the same considerations. When we look at the CDS versus insurance, you'll see that both are… provide individual transactions that are generally unique and that are over-the-counter. The contracts are heterogeneous, every single contract is different from every other contract because what exactly has been covered in every contract is different than every other contract. And the insurance contracts are all illiquid, there's no resale market. And the main differences in the area of insurable interest, and there's been a lot of discussion of that, and we see… you look at that difference for a minute, and you realize that, well the lack of insurable interest in the CDS market screams out that there's more danger here, so there should probably be more care and concern in regulation, not less as has

been the case. And the… we think that there need to be solvency standards, we think that there need to be standards for tracking risk exposures, standards for risk management, standards for risk margins that are laid down for this business, very similarly to how they're laid down for the insurance industry. The actuarial profession has been valuing contingent liabilities, not CDS', but a lot many other liabilities, for 100 years. In the past 25 years or so, the actuarial profession has evolved from having a very strong set of customs about how we do our work to having strict professional standards. And we want to offer our assistance in this, within those professional standards, as a profession, giving you advice on this. And I'll stop there. I should have started by introducing myself very briefly, because I don't think anybody here knows me. I've been very active in the actuarial profession in the risk management area, that's my specialty, and I've been the leader of the North American Actuarial Profession's risk management efforts for several years. And I'm also involved as the Vice Chair of the International Actuarial Association's Enterprise and Financial Risk Committee. And I've been a qualified Actuary for going on 29 years when I joined the American Academy of Actuaries. So, at this point, I'll take questions and be glad to talk about reserves, because that is one of the things we do.

MORELLE: Good. Well thank you very much for being here and for your willingness to lend your expertise. And I appreciate your and the American Academy's desire to remain neutral on the question of who does the regulation, etc. But I can't help believe that the CDS, and to some degree, all the things that have happened over the last year, year and a half, are like a dream come true for an Actuary who gets to look at this. It's like, you know, I mean there's a lot of things you must think about when you're reading about this and what's happening.

INGRAM: Well when you said you couldn't think of anything better to do on a Saturday afternoon, I figured you were all Actuaries. (laughter)

MORELLE: And we don't even play them on TV. So answer me this, from your perspective, looking at what's happened, or as you sort of understand how the CDS market works, are you comfortable from an actuarial point of view that the risk is managed well enough?

INGRAM: I think it's pretty obvious that it isn't.

MORELLE: It doesn't seem to… that wasn't necessarily the consensus we heard today, although I wouldn't necessarily disagree with you. So from your… and that would… was that… does that logically mean that we have to employ better methods and the people who are selling the protection have to employ better methods, or is it a statutory or regulatory problem? What would you say… if you were to… if someone said, "What are the five things, or two things, or three things that you would recommend that a body who's going to look at this and provide perhaps a framework for regulation, what are the things that you would want to insist on from an actuarial point of view?

INGRAM: Well I think there's a fairly short list that, from an actuarial point of view, we'd want to insist on. One of them has to do with the reserves, you know, as we talked about reserves… that… that I don't hear from the market that they've looked at risk the same way we look at risk in insurance. And I think there's some problems with that. So I think the reserving requirements need to be there. The…

MORELLE: Can I just stop you, because it's an interesting point I think that you just said, which is, they don't look at it the same way we would look at it in the insurance world. Are you pretty well convinced that it ought to be looked at, whether you conclude that it's insurance or not, as insurable interest or not, all those other issues that have been talked about. But purely from insuring that you have adequate capacity to pay off a claim if there's a credit event, do you think that ought to be treated sort of more purely as an insurance… in the framework of an insurance…

INGRAM: Well a lot of the commentary has raised some of these points, but I'll just mention them again. If one entity enters into a contract with another entity, and writes one CDS contract, that's the same thing as if you had one insurance policy written by one entity to another. We don't allow that. Why, because the fundamental idea behind insurance is pooling; the fundamental idea behind this is similar to insurance because of the fact that you're buying protection for something that is a remote event that is out of the control of the individuals, and if you want it to be financially sound, you need to figure out some way of

pooling those events. Otherwise, the appropriate reserve requirements for one contract are huge. They approach the amount of the notional. If you have a thousand contracts, they shrink down. The law of… somebody mentioned the law of large numbers. People sometimes forget these underlying ideas of insurance that makes it work, and it doesn't work for one contract.

MORELLE: So the… to say this in layperson's terms or at least I may not even be up to the level of a layperson, if you and I enter into a contract on an event happening, essentially by the nature of the fact that it's bilateral and that there's no pooling, it's almost as though I've transferred self-insurance from me to you, and that you have to essentially put all the money aside or somehow have the capacity to insure that you assume 100 percent, and you should… you have to weigh, I guess, the likelihood of the event is, and that's… people measure what's the likelihood of fault… of Ford defaulting or someone else defaulting, but if that event hit, if that happens, you're on the hook for the whole thing.

INGRAM: For the whole thing.

MORELLE: And there is no pooling, so…

INGRAM: There's no spreading… all you've done is moved the risk from here to there. And so we ignore those concepts… some of the discussion relating to the difference between, you know, collateral and reserves, I'd have to admit, I don't agree with much of it. That's… there's a lot of places in the insurance industry where we allow the reserves to be held somewhere else other than in the insurance entity. You know, there are reinsurance treaties where the funds are held in the other party. And so I don't think where the funds are held, you know, that argument that was being made about the cash collateral… it is an important argument. What's important is, is that the amount of money that they're worried about, the amount that should have been reserved, was set up; that if you have the right amount of reserves, if you have to give that in cash to somebody, well if you have the money, then what's the problem.

MORELLE: To Representative Keiser's argument.

INGRAM: Yes.

MORELLE: Although there is a difference in how the policyholders are treated if it's collateral versus reserves, isn't that true? And that may not be an actuarial question.

INGRAM: It's not, and I think it really has to do with the legal arrangements, is that… if there is a default that they get to keep 100 percent of… it's like the questions with the Madoff situation where they might go back to people and say you have to give back some of that money. So it really depends on the legal standing of different people.

MORELLE: Yep, yep. I'm sorry, I think I interrupted you. Were you in the middle of a further point, though?

INGRAM: Yeah, I was in the middle… there are risk management practices that should be required of people providing this protection because there is a public interest in having these contracts pay off, and so there should be the standards that we have the kind of outward look of having that… the reserves and capital requirements, but we also have a process that will keep that good, because when the regulators look at whether there's enough money in the insurance company, they're always looking backwards. The risk management system looks forward… so that you can have some assurance if there's a risk management system in place that the good standing you had at the end of last year may be still there at the end of next year.

MORELLE: Yes, Representative Keiser.

KEISER: Thank you very much, and again, I'm going to admit my ignorance up front and then ask my question regardless. When… Dinallo was here this morning, the Commissioner, he talked about the two types of credit default swaps. The original type, which was truly a kind of a Lloyd product where you had the coverage, you entered into the contract, and then he talked about the naked, the transition into the naked form. Wasn't… that is part of the problem, from my perspective, but that was an attempt to use the pooling and create a lot of large numbers. In other words, get 10 contracts, have enough reserved or collateral, whatever you want to call it, to cover each one if it failed individually, but if more than one failed, you would have had inadequate reserves, just as not all the houses covered on a P&C program are going to burn on the same day; not everybody's going to have a car wreck on the same day.

We're pooling the risk, we're able to reduce the premiums as a result of that. Wasn't this national transition into the naked format an attempt to do that amongst the better operators. In some cases, it created a tool where I could collect premium without having any coverage, really. It was a heck of deal, I just wish I would have thought about it about 10 years ago before it became a problem because a lot of people leveraged a very small amount of money into a tremendous return.

INGRAM: The leverage needs to be recognized, though, in the way that you set the reserves and… but particularly in the way that you set the solvency margins. And so that the kinds of… and I'd have to admit, I don't know exactly what banks were required to do on solvency margins on this. I find it hard to believe the way events have played out that they were reasonable, but maybe they were. And… but… if… when you have these very highly leveraged contracts, the solvency margins should be appropriately adjusted for that. The other thing that I think was not taken into account appropriately is that the market, when it was only people who were buying covered… coverage for things… risks that they had was a different market than the market that includes all of these people that were buying coverage for risks that they didn't have. And it's… the way that you look at that market, the way that you manage your risks in that market, the way that you set your reserves and your solvency margins may be significantly different. And it's quite possible, as Superintendent Dinallo says, that if you put these things in there in a reasonable way, that part of the market will… I'm not sure it will disappear completely, but it would shrink drastically. And… but I think that that's one of the things that did go wrong, was that people did not recognize the fact that the market had changed in its very nature, and kept treating this as if it was the market that was just the covered business.

MORELLE: You know, I'm struck by something you said when you first started speaking relative to a bilateral contract. If you assume all the risk, essentially the premium almost ought to be essentially the notional value of the risk.

INGRAM: Or at least the reserve.

MORELLE: Right.

INGRAM: And if you have to set up that much reserve, you would want

that much premium, you're right.

MORELLE: If you have an event that from an actuarial point of view happens once every 10 years, and it's a million dollar loss, I suppose you'd argue that the premium would be $100,000 to cover the loss and some amount for administrative, etc., but you'd sort of…

INGRAM: Expenses and profits, yeah.

MORELLE: … right, and actually that works really well if it doesn't happen for the 10 years. But if it happens twice in the first 10 years, you know, you've got some real problems. So you obviously factor in what the likelihood is, and that's all the, you know, these mathematical models that are created about it. But it doesn't really shift, because there's no pooling, it doesn't shift the burden for the exposure anywhere. That's what's done on the back end. There's no pooling so you have to go back and use other risk management tools to do that. And I guess the question is whether or not we can all be comforted by the notion that there's all these other risk management tools when there's not reserving and collateral requirements, and I think at least in the short term, the evidence is that there has not been adequate… maybe there couldn't be. Maybe there's no such thing where you can actually figure out or have a strategy of risk management that helps, you know, helps you contain entirely the risk, but… so I keep coming back to this thought that even on the naked swaps, sartorial swaps, all of them, that some kind of reserving or collateral requirement ought to be a part of it. And I'm trying to figure out how you get around that notion.

INGRAM: Well you wouldn't, but I think the point I was trying to make before was that you'd want to limit who could write those kind… I mean if your next door neighbor offered to insure your house against fire, how much money would you like them to have available to pay you? Would you like them to have a reserve that was one percent? Would that work?

MORELLE: No.

INGRAM: And I think, you know, so because of that, if you want these contracts to be paid off, you'd want to try and limit the kind of businesses people can have that puts them on the other side of that. The risk management ideas work

similar to, you know, there was a discussion a little bit earlier about specialty coverages where you have totally… and conceptually the risk management ideas work like that where yes, you cover a pitcher's arm, and the legs of an actress, and you have a conceptually large pool of these diverse risks which aren't all going to hit at the same time. So that risk management argument can be used to say, "Well I only wrote one CDS contract, but I have 10,000 other risks that aren't like that," but you still ought to make sure. And I think one of the other dangerous things in this, and we heard it earlier today is, is paying attention to those notional amounts because that really is the amount you're on the hook for. And instead of what the industry likes to talk about is… is the collateral amounts is how much risk that they have. And what happens when things go bad is, you need the whole notional amount, not just the next step in the collateral. There… what… the issue is with this business is the same thing with the house fire. It's a jump risk. It's, the company looks, you know, whoever you're writing the CDS on, they look good; they look good; they look good; oh my God, they're now out of business.

MORELLE: Well that's… good to your point that if your next door neighbor was insuring your house, you'd want a lot more security. It's not that the risk that your house suffers a loss has changed at all, it's the same. What you're worried about is the capacity of the person that's made the guarantee to fulfill that obligation. And I guess as it relates to the credit default swap market because it's not very transparent and because there's no requirements on reserving, and outside of whatever contractual obligations there is for collateral, you really don't know. If someone's position changes… let's say even when they entered into the contract, they were fully capable of being able to meet the obligation. Over time, as their position deteriorates, you still have the same contract, there's no reserving requirements, so there's really… becomes less and less of a commitment, and I think, you know, as it relates to AIG, I think the federal government, i.e., the taxpayers of the United States, have put $150 billion dollars as a backstop on AIG's losses. So, I mean, and there's… I mean that's a company that does reserving on all of its other businesses, just not that one.

SANDBERG: (*away from mic*) Dave Sandberg, also representing with the Academy. Just to build a little bit on some of your

comments, the… we've talked a lot about what kind of money should there be and what… we can define it however you want, but there's two elements that actuaries have seen. Besides… I mean besides the money part, you also need the sense of the design of the risk. So a simple concept, like if you think about in the Middle Ages, we invented double entry accounting. Huge insight… was really the, in may ways, the foundation of the Renaissance, because all of a sudden money had to be accounted for, it couldn't just disappear. One of the things that we've kind of been missing is what I might call a double entry risk system. Risk can't disappear out of the system. And so by writing a contract and you could get some clarity about defining, "well, is this an insurance, am I providing a guarantee, am I speculating," you know, Dinallo did a nice job of saying, well here's the options, here's what you're doing. If you regulate some rigor around that up front and say, "What are you doing," account for… and state, "I've taken on this risk. Okay, what have I done with it." Now if I send it someplace else, they've got to pick it up and there's a way for it to kind of follow through and track. So whether you're leveraging or whether you're doing some other kind of spreading, I mean that's going to get, you know, follow through. But the ability for regulators to respond has been short-changed because it's like, "Oh, we don't know where it went." So when we mention, you know, we've spent a lot of time over the years thinking through, "are there refinements to quantitative methods." So we mention the CTE method, for example, in our paper. This is one we developed over a dozen years ago because we saw some shortcomings in VAR models that, you know, everyone is going, "Oh wait a minute, gee, it doesn't tell us much about the tale." And… but even CTE is not a perfect method, it's just a better method, and so what we're just saying is, you need to have someone who has kind of thought through, how do you handle both the money that's needed and how do you think about the product design issues so when "Oh my gosh, the disaster occurs," is there something that we could either be doing ahead of time so that we can reduce or minimize or allow us to get through in a successful manner. So that's kind of what we're saying. Those things should be part and parcel of whatever regulatory answer is decided, not only on this issue, but any kind of issue that's dealing with public policy or safety issues.

MORELLE: Well one of the things that I think I could get concerned

with is, with liquidity and speed in the marketplace, it's a pretty active market obviously. The ability to take on risk with the notion that basically you're looking for the spread to be able to… and sell that protection, or you sell it and then buy it, however you end up shedding the risk, and you're really looking to do it at a time when you can make money off the transaction. But you really don't have a whole lot of interest in providing, you know, the… you don't intend to be the backstop. You don't intend to be the pass-through to someone else, and it keeps multiplying, and if we forget the importance of when, in a sense, the music stops -- that's how I think of this -- you know, the chair is missing, when the music stops, somebody's going to be without a chair. And that's how I fear, and maybe in my mind I look at this, is that there's so much liquidity, so much speed in the marketplace, such a vibrant market, but unfortunately if people aren't really thinking that while I have this, or however long I have it, I'm holding the… you know, what's that game they used to have with the thing… the device would go off… that if it goes off while I'm holding, I better be able to make good on it. And I'm afraid that we haven't invested enough energy and time thinking of that from a public policy point of view, to make sure that whoever it is, sophisticated or unsophisticated person who sought the protection and paid for the protection, that they're ultimately protected. And I guess I haven't heard anything in the last four, five, six months, seven months, that convinces me that anyone from a public policy point of view has thought that through enough, and that there's so much speed that everyone ultimately thinks, "Well I can just sort of spread it out enough that it doesn't end up residing at my doorstep." And I don't know how the actuarial world looks at that, but I gotta believe that there's certain standards that haven't really been adhered to that ought to be.

SANDBERG: Well I think the disclosure of the risk, I mean you talk about the speed, what you're really saying is, people are buying something they really didn't understand. If I bought it and I say… you know, like a cigarette warning, "May be hazardous to your health." You know, but if you want to buy it, fine. There's reasons why you should, or you know, that maybe… I don't mean to make that in a dramatic, you know, kind of statement, but if you had the required risk awareness, you just bought and you're exposed now to these kinds of risks. Okay, that at least causes a reality check and puts some discipline on it. If you want

to take it, that's fine. If you're a corporation and you understand, and you've got someone that realizes we're accountable for the risk exposures we've taken, there's a regulator who's asking you. One of the other ideas that we would… I would encourage you to think about is, you know, from a corporate standpoint, a lot of corporations felt like we've got value added by having a cheap risk officer function to kind of step back and say, "Let's look at the big picture." Now we can criticize and look back and say, "Well why did they miss some of the things that may have happened within their industry," but I don't think that anybody doubts that having someone step back and say what's going on in a larger sense is a value added situation. From a regulator standpoint, we haven't quite moved to that awareness as well. Is there someone in the regulatory arena who says, I'm responsible for systemic risk, has the ability to go ask companies and say, "Are you clearing your risks?" What is it that we're working on? One of the projects the Academy is working on is, within the NAIC there's a requirement to have risk focus examinations for all insurance companies. The examiners come in and they prioritize the risk, and they apply this same kind of insight. And what we've been working with in proposals with the NAIC and NCOIL is, well what kind of risk-focused reporting would most fit with the idea that we want to look at risk from a standpoint. It's such a new paradigm 'cause we're used to looking at the numbers, just prepare a financial statement and tell me a number. And there's so much more about the dynamics of the risk that we think is important to be coming out.

MORELLE: That's a very good point… and it'd be interesting to continue talking about that because that is an interesting point. One last thing I think about is, and this probably is not an actuarial question per se, but Superintendent Dinallo sort of talked about his view that there's sort of these four ways they can invest money, you know, you can wager it, you can deposit it in a bank, you can take out insurance, or you can invest it, in his mind, and securities investing was the one where you don't really have a guarantee of something, you know, you don't have a guaranteed path. When you buy stock in something, you're actually taking part ownership of that company, that company goes out of business, you know the inherent risk is, you may end up having… holding on to a share that's worth nothing. I wonder if, sometimes it concerns me that the CDS are seen as securities, so that people sort of say,

"Well I can manage the risk, I've got tolerance for risk here," and you know, I treat it the same way I treat equities, but this is different. There's a commitment… at the end of the line, someone is supposed to be the backstop and be able to fulfill that commitment. And so it may not be insurance, and people may not talk about it that way, it may not ultimately be regulated that way, but it's more… it seems to me we ought to think of it more in that environment than we should look at it as securities because someone has made a commitment, there's going to be a payment in a credit event or restructuring, or bankruptcy, whatever it is.

INGRAM: I think that the collateral confuses that issue a little bit, and in people's minds, they feel they're secure because they have the collateral, but they're not realizing that there is that jump risk that, you know, the house could burn down tomorrow. You know, if your collateral was the premium you received last week, that really doesn't help you a lot. And also the issue was that some market participants, many of them weren't posting collateral a lot of the time, you know. The situation with AIG was not uncommon. The people didn't post collateral, but only would have to post them under some conditions. So the idea of reserve requirements and collateral requirements or, you know, some combination of them that apply uniformly to all the market participants. The idea that's been suggested that insurers don't have to do collateral, you don't have to bother, you can just prohibit them from being in the business… because if you said insurers don't have to post collateral but everybody else is going to do it, nobody would do business with the insurers. It's a waste of time talking about it.

KEISER: Thank you. You sort of addressed my point and that… this is a different paradigm, and Assemblyman Morelle was really talking about that as well. Traditionally in the insurance market, we've gone from homogeneity of line. If we want to be in the auto business, the life business, whatever, or p & c generally. This is different. Solvency here isn't from the homogeneity, it's from the diversity. And we need to change the way we look at reserving. What's the problem? We had too much homogeneity in the CDS market in terms of the mortgage industry. Concentrated… they became very specialized in it; their reserving should have gone sky high at the moment they started to become so concentrated in a single industry, because when that

industry goes south, everybody in the pool goes south. Just comment on… from your… American Academy of Actuaries that it… we don't have to develop a different paradigm of reserving that looks at it differently and maybe I haven't described it well, but it seems to me… I believe it's an insurance product and we have to look at it in a new way.

SANDBERG: Just as an observation, I've worked on several projects over the last few years, and it's clear to me that within our market structure we don't have very clear definitions of the difference between insurance and securities. And what we have is kind of like an ad hoc… I'll call a bond… you know, like the Congress when they define the securities law just listed a bunch of things. There's no set of principles that underlies it and says, "Well here's how you would tell what is a security versus insurance." And so I think the question is, you really end up with two poles. I have a guarantee, and I have complete investment risk exposure. And what the last 15 years has shown is that people want something that has some elements of both, and from a regulatory standpoint, we haven't really kept up with, "Well how do I sort out, have a little check list or identifier, that helps me understand what am I on the risk for, what's a guarantee, who's the person on the risk." And that's why this idea of kind of a risk balance sheet, you know, or double entry risk kind of helps clarify, "Wait a minute, here's what's really going on." And so that's kind of… I would… the answer to your question is yeah, that's exactly the problem, is that we need some better clarity and we need some insight because people are wanting to combine elements and when are they putting society at risk, when are they putting themselves at risk, and do they understand the difference.

INGRAM: Just to speak to another part of your question there, I did do a little bit of work with mortgage insurers in the last two years. And the way I heard it from them was that they had… they have an immense amount of data. You know, they know what's happened with everybody's house, and whether you've made your payments or not. And so they… and they mined this data tremendously and they've look back over 15… 20 years, and they came up with their plan and their risk management based on that. And during that time, there was never a national housing decline, there were regional housing declines. And using that kind of information, they decided… and also every housing value decline was followed a rise in unemployment. So their strategy was to look for

rises in unemployment and to try and stop writing business, or at least slow down writing business in the region where that was a problem. When people put together CDOs, they looked at that same kind of data and said, "Okay, well this is diversified, because we have people from California, people from Florida, people from New York, and so we're diversified here." And so what do we have? We have a depression in house prices that was driven by over-valuation, not by unemployment. The unemployment has followed the housing slump, not the other way around. So everything was different than what was in their data. And that's kinda… so that it isn't the principles are any different, it's that this time things worked out differently and that's because the models that we used didn't anticipate the kind of situation we actually had.

SANDBERG: And one of the things that intrigued me on this issue when it first came across our kind of radar screen a few weeks ago was realizing that this CDS market is really… combines elements that traditionally are separate in insurance. You've got P&C insurance, has its principles focused on catastrophe risk and some of those items. It's also a long duration contract, so you've got both elements. It would take some, you know, thinking through, but from a standpoint of saying, "Do we understand what the risks are," and you have to have ways to address it, think about how the thing could break down and how can it fall apart. That's kind of what we kind of bring to the table.

MORELLE: Senator? Any questions? Good. Thank you both very much for your testimony. We'll look forward to talking with you further. Our next witness is Michael Greenberger, Law School Professor, University of Maryland School of Law. Good afternoon, Professor, good to see you again, and thank you for being here.

GREENBERGER: Good afternoon. It's a pleasure to be here, and I want to congratulate you all for holding this hearing. I would say if a hearing of the similar depth were held prior to the passage of the CFMA, it never would have passed. And you are to be congratulated and your constituents, and others who rely on your public service have been greatly helped by these few hours you've spent here. The reason I'm involved in this is from 1997 to 1999, I was the Director of the Division of Trading and Markets at the Commodity Futures Trading Commission. And that was a landmark period because my boss, the Chair, Brooksley Born, saw that this swaps

market was growing and that the swaps dealers refused to comply with the law that was existent at that time. These were risk shifting instruments, and they were covered by the Commodity Exchange Act. And before the CFMA, the Commodity Exchange Act required risk shifting standardized instruments of this kind to be traded on a regulated exchange. The industry kept saying, “Oh, it’s not risk shifting, it’s swaps.” Sort of a technical, magical thing. And of course, in ’98, ’99, and 2000, the economy was booming and no one really wanted to hear about regulating. And the overwhelming view was that government only gets in the way; that this kind of trading is limited to sophisticated investors; they can watch out for their own interests; who are you as a government regulator to second guess the wisdom, ingenuity and innovation of these markets. At that point, the entire over-the-counter derivative swaps market was $28 trillion dollars. It’s now estimated to be $800 trillion dollars. We’ve had a debate today about how much of that is credit default swaps, it’s 30, it’s 60… no one really knows. We keep saying these are private bilateral contracts. And as Mr. Dinallo said, the former Secretary of the Treasury, the present Chairman of the Fed, the next Secretary of the Treasury would give their right arm to know how many of these contracts are out there, who holds them, and whether they’re going to explode and make a AAA company one day a bankrupt or a potential bankrupt the next. Now when these products were subject to regulation, and if the regulatory scheme had been followed, the contract itself, it was going to be traded on an exchange, would have been examined by economists at the Commodity Futures Trading Commission to determine whether systemic risk would have been created by these contracts. There would have been transparency in the transactions, at least to the point that the federal government would know what’s out there. There would have been collateral, and I know we’ve talked a lot about that today. There would not have been reserves. It would have been a market-driven thing, margin requirement would have prevailed. As I see margin, that’s a form of collateral so that anybody who purchased these contracts on exchange would have had to put up good faith money. By the way, in the futures industry, good faith money can be anywhere from 4 to 7 percent of the contract. It’s not like the stock market where you have to put up 50 percent. There would have been self-regulation, there would have been anti-fraud, anti-manipulation, private enforcement, and day-to-day monitoring of these transactions by the federal government. What we ended up

with, because the banks didn't want to have any regulation, was not only that the CFTC was not allowed to treat these as traditional futures contracts, but that these instruments were, by-and-large, completely deregulated from the federal government. So when you hear that 89 percent of this is handled by regulated institutions, the question is, are the instruments within those institutions regulated. And the answer… by the way, I have prepared a statement which I will… I have only a few copies of, but I will try to circulate it on the overarching issue. Chairman Cox, who is not noted… has not been noted as an aggressive regulator of the SEC, pleaded with the Senate Banking Committee, when they created the bailout TARP funding, that there is a regulatory black hole here and it requires immediate legislative attention, and the regulatory black hole was the credit default swaps market. Unfortunately Secretary Paulson quickly said, "Oh, it's too complicated to do now. We need this money so fast, we'll worry about that later on." There is worrying about this at the federal level. The Chairman of that Senate Agriculture Committee and the Chairman of the House Agriculture Committee, which arguably are the Committees of jurisdiction over the Commodity Futures Trading Commission, have both proposed either exchange trading of these instruments or some kind of super clearing that's on steroids, which would require margin requirements and transparency, and things of this sort. By the way, when you hear today that the financial services industry is in favor of clearing, they're only in favor of voluntary clearing, and they're not in favor of clearing on steroids. Now, I come to you today, and I know Assemblyman Morelle knows this because he's held an excellent hearing on this before, urging you to take action. Do not wait for the federal government. I know that I've just said that there are people that are saying we should do something, but God only knows what they're going to do and it's not a clear thing. And by the way, even if Senator Harkin prevails and has this traded on exchange, one of the things the Commodity Futures Modernization Act did was deregulate the exchanges. For example, you're hearing an awful lot about ICE or Chicago Mercantile group coming in to get permission to be a clearing facility. Last night I looked at the statute, the CFMA, and the regulations they're under. By the way, the regulations to clear these products are seven and half pages long. The requirement, now what are we doing when we're having somebody clear? We're essentially having a kind of credit default swap. Some "strong AAA

company" is going to stand between both counterparties and guarantee the transaction. Three years ago, if AIG had said, "Gee, we're AAA, we're the biggest insurance company in the world, this is a good business for us," people would have said, "Hey, that would be a great clearer." Today we've got other AAA rated companies saying they want to clear. The standard in the regs and in the statutes are, that the federal government should insure that the clear is "financially sound." That's it. Now that's not the way you guys regulate insurance companies. You just don't say we want to make sure they're financially sound. So when you hear about this panacea, all you're hearing is another today AAA rated company is going to undertake guaranteeing all these credit default swap trades. If counterparties start failing, they're going to have to take the money out of their pocket to make the transactions good, and it's just going to be AIG all over again. Now everybody… there was discussion about what the common law says about insurance. Everybody is… who's… has common sense within their human body says this is insurance, it may be something else, but it's definitely insurance. Dinallo, who is charged with enforcing the New York State laws and is a smart guy says it's insurance. The people who are criticizing the states for not getting a handle on this stuff say you've failed in your insurance obligations. There's no doubt this is insurance, I agree completely with the people who say it's insurance. Where I disagree to some extent with Mr. Dinallo, who I have the highest respect for, and he has had his hands filled; even before AIG failed, he had MBIA on his hands. And by the way, the federal government is sitting on his back because when MBIA fails or AIG fails, all the banks were running around saying, "We're hedged because we're insured." Suddenly the hedge is gone and billions of dollars of new losses have to go on their sheets. And I would also say when you're told, "Don't worry, this is all working out. We have auctions and people come to the table and have paid off their commitments." Well one of the people who comes to the table and pays off their commitments is AIG. Where are they getting that money? Where are they getting that money? So when you're told, "Don't worry, we're working all this out 'cause the banks are coming to the table with money," that's TARP funds. And if it's not TARP funds, the federal reserve under Section 13-3 of the Federal Reserve Act, passed in 1938, is handing money to the banks. It's quite ironic that we sweated bullets over whether the TARP legislation would pass for $700 billion dollars, but in one

night, Citigroup walked away with almost $350 billion dollars in capital infusion and guarantees of their troubled assets completely outside of TARP. The Fed just decided, “Here’s $350 billion dollars.” And you know, whatever is done here, I’ve talked to policymakers here, and what they’re worried about, if it is $30 trillion dollars as the prior speaker said, that’s $30 trillion dollars in real risk. If you have widespread failures, there’s a limit to how much the United States can keep giving institutions to make these payments. And the idea that these banks are dealers and they’re like bookies and have an even book, no, no, no, no, no! Why did Bank of America need another capital infusion? Because Merrill Lynch thought that the way to make money here is to sell CDS. Why did they think that? Well they thought housing prices would always go up, so they were not insuring a real risk. They thought they had learned how to print money. Every quarter they got premiums for no risk. Suddenly housing prices went down, and the risk started triggering. They were wrong. And we’re paying, ourselves, you and me, billions and billions of dollars… I mean the estimate is that we’re up to $6… $7 trillion dollars when you look at all the guarantees and the payouts here. There are limits to what can be done. Now, my message to you is, I come from Washington, DC, and the conventional wisdom there is that the states have failed, and we need a federal insurance regulator. We’ll give the states some role just like they have in regulating equities, but we need the SEC equivalent for federal insurance. If you pass on this, which is the crisis of… the financial crisis of our lifetime, you are inviting those who will say the states just are not up to dealing with this issue. And as you’ve said among yourselves, to the extent that you’ve regulated entities, there haven’t been these systemic failures. You could deal with this. And my one disagreement with Mr. Dinallo, and I think frankly with time I have some hope he will come to this conclusion, too, is that don’t just worry about the 20 percent of this market. The other part of this market is unlawful insurance. You don’t want to allow unlawful insurance. Don’t be intimidated by the fact that it’s many trillions of dollars, and don’t… you can’t do anything about the horse that’s out of the barn, but going forward, if you’re not insuring an insurable risk, you have illegal insurance. And if you step back and say we’re going to wait, I’m telling you as sure as I’m sitting here, you’re going to lose all power, not only over credit default swaps, but the ability to ensure regulation.

You're going to hand it away. You have the power to do it; you shouldn't feel guilty about the fact that you're coming to the table now because frankly I think you guys know more than half the CEOs that are writing the CDS right now after sitting here for four hours, if not, your prior preparation. And I believe that you should aggressively take this under your arms, and you can't deal with the back, but in the front, just like Mr. Dinallo decided on December 20th… 22nd, prospectively, this is what's going to be done. And look, if AIG had had to put capital reserves aside, or if they even had to post collateral… 'cause they didn't have to post collateral because they were AAA rated, the collateral was their AAA rating. What happened was, when they lost their AAA rating, well then people started to say, "Well housing prices are going down, now we don't know if we can trust you to make the payment. Now you've got to start ponying up money so we feel better about this." And the witness who said the problem wasn't credit default swaps, the problem was the collateral, is like saying the problem with John Wilkes Booth is he had a bullet in his gun. The collateral is the part of the credit default swaps issue, and it has been explained, it's very simple. I got insurance from you, you got a AAA rating, now housing prices are going down all over the place. My bet, if I have something real to insured, I now have to collect my insurance. If I'm betting that housing prices are going to go down, now I want to collect on my bet, I gotta see AIG that now that you're going from AAA to whatever that you've got something there. Pony up. That was part of the credit… nobody would enter into a credit default swap without a AAA rating or collateral for something other than a AAA rating. Now the debate over whether it's collateral or whether it's adequate capital reserves, I… my own personal view is adequate capital reserves are the trick. Why is that, because when you go to buy one of these contracts, if you have capital reserve, it's there in the bank. If you're going to have to… if AIG, when it had to pay collateral, that was a big surprise to AIG. They never thought they'd lose their AAA rating. They didn't have the money set aside. So you're… that happens in the stock market and the futures market every day. Somebody has a margin call and can't make the margin call. When they bought the stock or the futures contract, they never dreamed it would go down. I mean that's the whole deal, in the middle of the night, you see these ads for people to buy heating oil in the winter time. And the way they get taken to the cleaners is, they buy a contract,

the margin hits, it's collected and they're wiped out before anything happens. So would it be better to have adequate capital reserves, I think the answer is probably yes. But right now, we have nothing. We have no collateral, no adequate capital reserves. What we do have is you and me making up for money that was never there. And there's a limit to our ability to do that, and we may never be able to correct that problem. But the mission here today is going forward. If we are blessed in working our way out of this problem, are we ever going to let it happen again? And my view is, you should move on this until you're told, "stand down because we're preempting state law." And my feeling is, because I've worked in these many different areas where the states are involved, if the states uniformly believe they have a role on this, their delegations will hear them out and I would be shocked, if you take an aggressive stance on this, if you were preempted. It may be that to the extent states don't have laws that deem this as insurance, you can trade this on an exchange, but I think there's a very strong argument here that this is insurance, it should be treated like insurance. And the argument, finally, and I'll just end with this, that somehow the bucket shop laws have tied our hands. The bucket shop laws were essentially somebody going into a store and saying, "I want to bet on a stock. If it goes up, I win; if it goes down, I lose." That wasn't insurance… that wasn't insurance. They weren't insuring anything or receiving insurance, it was a bet on who would win on the stock. So the idea that the bucket laws somehow prevents you from dealing with naked insurance and calling it unlawful is a bafflement to me. And if there's any doubt about it, my view is the American public, somewhere, somehow, needs aggressive government standing up for them. And my view is the states should move aggressively on this until they're told to stop. I think the public deserves that much. Thank you.

MORELLE: Thank you, Professor. To your point about the bucket shop laws, I thought the point… and I… correct me or give me your impression, I thought the argument was that bucket shop laws were instituted to prohibit the speculation on stock or securities that you didn't have an interest in, because they viewed it as a form of gambling. And that without the Modernization Act of 2001, that states might actually look at credit default swaps and say effectively the naked ones are again speculative gaming activities for which someone doesn't own the… doesn't have real exposure.

REENBERGER: My memory is the bucket shop thing went in there even before the CFMA, that it predates the CFMA and it's…

MORELLE: But it all goes back to the early 1900s…

REENBERGER: Yeah, the point was if you're going in and buying a contract to hedge your wheat growth, you're buying a derivative that you may be betting on the price wheat. In fact there are speculators in the exchanges who do that. So when they created regulated commodities laws, they wanted to eliminate bucket shops. But the idea that bucket shops somehow ties your hand is mystifying to me. What did… what they did want…

MORELLE: No, I think it wasn't that the bucket shops ties our hands, I think it's that federal government's preemption of the bucket shop laws ties our hands.

REENBERGER: I think that's… I would be…

MORELLE: But that's only as it related to gaming and not to the regular insurance.

REENBERGER: Yeah. I just think that's… I would be shocked if anybody would say to you, you've decided, you've followed Mr. Dinallo's advice but you're going to extend it to naked credit default swaps that they would say, "Oops, the bucket shop law doesn't let you do that." The bucket shop law had nothing to do with that.

MORELLE: You mentioned earlier, we've heard a lot today about numbers that would be notional numbers, net numbers, the netting and frankly how much exposure there really is. Could you just talk about this because it makes it sound, if I might, that if I were to measure the gross value of the contracts, they may be $100 million dollars. But when I net out and actually look at my exposure, 'cause a lot of it is offsetting, it might be $10 million dollars.

GREENBERGER: Well there are two different things, but the question is very good. The netting is just that you have exposure here, you have exposure there, you put it together and you balance it out.

MORELLE: So if I have a long and short position and they… something happens…

GREENBERGER: Yeah, yeah… and what the bill of goods you're trying to be sold is, that Citigroup, for example, who just had its troubled assets guaranteed to the tune of $306 billion dollars, has a perfect book, perfectly hedged book. If they had a perfectly hedged book, they wouldn't need a guarantee of $306 billion because what that $306 billion is for is when they get called on, among other things, their credit default swaps, they may not have the capital to make the payment and it's been guaranteed and the federal government will stand in for them. But the other point I wanted to make, in traditional derivatives things, there is an importance between notional and money that's at risk. In the insurance credit default swap thing, notional and risk come together. In other words, you have guaranteed the full value of the insurance. The difference is, for example, if somebody has a loan and they have an adjustable interest rate, they can go to a bank and get a swap, and they swap their adjustable rate for the fixed rate. So the exposure there for either side isn't on whether the loan gets paid or not, it's the difference between adjustable and fixed. Well when they calculate how much notional value, they calculate the loan in two. So when you get $800 trillion, let's put credit defaults aside, I can comfort you by telling you maybe it's only $20 trillion, that it's not a whole $800 trillion. But for credit default swaps, you are going on the line for the full payment. So when we talk about the notional value being $30 trillion, that's real risk. And I tell you something, I see people, I talked to some guy the other night that's working on legislation on this, and he said to me, "Michael, there is only so much money in the world."

MORELLE: But let me understand this, if I had a position that I was going to pay someone $100 if a stock gets over $35 dollars, and someone else was going to pay me $100 if it was under $35 dollars… I don't know if I said that right, but…

REENBERGER: No, I understand what you're…

MORELLE: … essentially it zeroes out. There's $200 worth of guarantees out there, but they zero out. Is that not what they're suggesting?

REENBERGER: That is true, but one thing is, is the party who's guaranteeing the downside going to have the money when the debt comes through? In other words, in a bucket shop…

MORELLE: Well that's true.

REENBERGER: … the bucket shop, the people walked away. They closed the doors and went to another spot.

MORELLE: So it relies on my example. If somebody's paying me $100 and I'm paying someone $100 if the price reaches a certain number so they zero out, I guess that's true as long as the person who is paying me can actually pay me, 'cause I'm on the hook for…

REENBERGER: And here, people were under the impression that they had zeroed out, they had a risky bet that was insured. So when the CEO said, "Hey, you're not getting us in too deep," the risk manager said, "Oh no, we're hedged. AIG has us… we have insurance with a AAA company. If we lose here, we pay here." That was the supposed zero out. Well AIG, the only reason it's being zeroed out now…

MORELLE: Because we're paying for it.

GREENBERGER: … we're paying. But Lehman Brothers… and that's another thing. When you hear, "Oh, the Lehman Brothers thing worked out fine," that was CDS written on Lehman Brothers worked out fine. In other words, some people were insuring the financial stability of Lehman Brothers, some people were getting the insurance.

MORELLE: On Lehman's credit, in other words, the credit default on Lehman itself.

GREENBERGER: Yes, not on Lehman's CDO guarantees. You see, Lehman guaranteed a lot of CDOs. That wasn't in, but even if it's true that it evened out, it evened out because of the TARP funds or the Fed's injection of hundreds and billions of dollars into the economy. And understand this -- this financial infrastructure is not just residential housing, it's commercial real estate, it's student loans, it's credit cards, it's auto loans. And that's why you see… the Fed very quietly said, "We're setting aside $200 billion dollars to start buying the paper on student loans, credit card companies, commercial…," because that's the next wave. So this is like, you know, the money was just never there. It's like the Bernie Madoff case. People were walking around thinking they were rich, and then somebody said, "Hey, the money isn't there." We're not… the money isn't

there on this issue to the tune of trillions and trillions of dollars. Now, that's why we talk about adequate capital reserves. If AIG had had to put aside capital, or even if it had to pony up collateral to begin with, that would have been such an intensive burden on them that they wouldn't have issued the insurance. I have every confidence.

KEISER: Thank you, and Michael, nice job today. And you may not be able to answer this, and I apologize I can't give the person credit, but I was recently watching a show and the economist who forecast the demise of the real estate market and did so about three years ago, and said that this was coming, said that wave 2 and wave 3 are coming. The commercial is coming, and then he referred to them as day loans in the housing mortgage as big as the current crisis. Do you know about those, are you making a prediction?

REENBERGER: I mean… look, my prediction, if I really was a… had a lot of confidence in my predictions I wouldn't be here today, I'd be at a beach in Rio de Janeiro because my predictions had been so good. But no, seriously speaking, I am very, very worried that we have only seen the tip of the iceberg here. And really what this gets to is confidence. If somehow confidence can be restored, we may not… it may sort of put a floor on this. And frankly, I think our president is going to play… he potentially will play a very big role. I mean if you read the history of the New Deal after Roosevelt took office, everybody wanted to get their money out of the banks, 'cause they thought there wasn't enough money and they wanted to get there first and get theirs out. And he made his first Fireside Chat. And some economist was said to say, President Roosevelt restored confidence in a make-believe system. And what we're having here is the make-believe of our financial system has been exposed to everybody. We thought Lehman was a rock. We thought Bear Stearns was a rock. I thought Citigroup was a rock. Personally, I was shocked about Citigroup. But now they're talking about nationalizing Citigroup. And so our make-believe in the system has gone away, and I think it's going to be critical that it be restored. Because if it's not restored, it's a self-fulfilling prophecy; it's just playing on one another. It starts with subprime, then it's prime. It starts in residential, it goes to commercial. And the reason we can't get credit is these things are hidden land mines all over the economy. If I look at your financial statement, and by the way, these CDS are not clearly on financial statements, they're on something

called structured investment vehicles. But I can't tell from your financial statement whether you have a guarantee you've made on a credit default swap. And I know that Lehman's gone down, Bear Stearns has gone down, Merrill has gone down, and you may go down, so I'm not going to lend you money. And that's what the credit crisis is all about. Nobody trusts anybody else because they may have these private bilateral land mines in their inventory. Which, by the way, they're telling you, "Don't worry about our investment in subprime because we're insured." So they haven't brought that onto their books yet as a loss. If for some reason AIG fails, hundreds of millions of dollars are going to come out of the books, and they're not going to be a good credit risk.

MORELLE: Well it's an interesting issue that you hear economists, you hear folks talking, and you hear people just complaining that the banks aren't lending, but it does occur to me that it's not irrational, if you're a bank right now, not to lend money or not to be involved in the credit markets for that very reason.

GREENBERGER: Absolutely. They don't know who to trust.

MORELLE: It's really hard to measure what your exposure is.

GREENBERGER: They don't know who to trust.

MORELLE: Senator Seward?

SEWARD: Yes, thank you. Professor Greenberger, listening to your presentation makes me want to go back to school… except for that part where you said you were worried. No, seriously, you said to us, as state legislators, take action, take action. Could you recommend to us two or three action items that you would…

GREENBERGER: I recommend one action item to you. I would take Eric Dinallo and Governor Paterson's September 22nd memo and apply it both to covered and uncovered credit default swaps. And say, on a date certain, we're going to require this be treated as insurance with all the capital reserve requirements of insurance. Now you may have to fiddle with some… I know there's some statute that sort of raises confusion on this issue in New York law and I don't remember it right now, but you know, I don't think Eric Dinallo let that little thing… because it would have

interfered with what he did on September 22nd. My view is, the cleanest, clearest way, is for the states to say, if they can by virtue of their statutes, credit default swaps is insurance whether it's covered or uncovered. If it's uncovered, it's like insuring somebody else's life. And quite frankly, the people who took the insurance felt they were getting insurance on someone that was 115 years old, life insurance. That was how strongly they felt that that insurance was going to be paid off. Or, they were… had their automobile ready to run over a 115 year old. And that's not a joke because it was expressed earlier. If you have a naked credit default swap that pays off, for example, if people can't pay their mortgages, you are not in favor of mortgage work-outs. And a lot of those people have brought law suits against financial institutions who want to do the work-outs, saying oh no, that's not permitted, but what's their motivation? You're interfering with my big day of payoff. And that's why it should be outlawed, the same way we outlawed insuring ship cargo that you didn't own… 'caused you'd call the enemy navy and have that ship sunk.

SEWARD: Thank you.

MORELLE: Any questions? Senator Breslin? Professor, thank you, we'll continue our dialog, I'm sure, in the weeks to come.

REENBERGER: Thank you.

SEWARD: Do you have copies, Mike?

MORELLE: We'll… if you give us one, we'll reproduce it. Yeah, we'll give them to Mike. Michael, could you or someone make sure that all the members get that subsequent to today? Yeah, we don't need… I think there's four. At some point make sure they get entered into the record. We did have one additional individual who had asked for an opportunity to speak, and if there are others, please, make yourself known to us. Let me call Michael Erlanger, Chairman and Chief Executive of Marketcore, Inc.

. ERLANGER: (barely audible) The Chairman and Chief Executive of Marketcore is my wife, Connie.

. ERLANGER: How do you do?

MORELLE: How are you?

M. ERLANGER: I am the former Chairman.

MORELLE: Very good, okay. I'm just going by what your card says. And is it Connie Erlanger?

C. ERLANGER: Yes.

MORELLE: Welcome.

C. ERLANGER: Thank you. Thank you very much for giving us the opportunity to speak. As a preface, I just want to say that there's been a great deal of discussion about collateral and reserves, and these are things we can't comment on because we are not actually insurance people. But we note that there's been no discussion about information. And we are here as… representing our company, Marketcore, which is a company dedicated to creating solutions to enhance financial markets, and our solutions are centered on information. Risks are defined by the underwriting standards, terms and conditions that are contained in every financial contract. Those underwriting standards and statistics define the specific elements of any risk transfer. Understanding the underwriting standards and statistics is essential to understanding the risks the counterparties to any contract are willing to assume, whether it be in loans, lines of credit, insurance, or credit default swaps. Transparency in a market is key to restoring confidence in the meaning of financial contracts; transparency is essential to empowering regulators to do their jobs correctly and completely; and it is key to restoring confidence in the financial markets, not just the contracts, but the markets as well. Marketcore has designed a patented data processing system intended to support a single or multiple linked transaction platforms and clearinghouse facilities. The data processing system collects all of the data points on the underwriting standards and statistics of each transaction. It displays the data electronically and in real-time, and is available to all market participants including regulators. Each transaction has a fix to it what we call a transaction credit, and a transaction credit has two purposes. One is that it has real economic and strategic value to the principles to a transaction, and it also functions as a tracking mechanism for all the elements of a transaction, providing the ability to track its performance in all of details through to the maturity of the financial

instrument. Our system is designed to generate a real-time data stream, or electronic ticker so to speak, on a market. One of our trademarks is the statement, “Information is to financial markets as oxygen is to life.” It’s because we believe that the flow of information and the tracking mechanism that our system design provides is absolutely critical to creating full transparency. It is critical to enabling real-time price discovery and to resolving matters of counterparty risk. Such a tool empowers regulators to do their jobs without encumbrance. Others have observed that our system provides a means by which we may, as a nation, actually grow our way out of economic crisis. In November 2008, the Congressional Research Service, which is the public policy research arm of the Library of Congress, released a report to Congress in which Marketcore’s work is mentioned as offering a solution to the opacity and illiquidity in capital markets. We are very honored to be named in this report, and copies of excerpts of it was provided to each of you. The report is focused on financing recovery from large-scale natural disaster. A portion of that report addresses the need for properly functioning capital markets to facilitate the proper functioning of insurance markets. Marketcore’s solution is cited in the context of restoring liquidity, operating efficiency and creating transparency in capital markets. To the extent that a credit default swap is a financial contract, we believe that our approach can be used to create transparency and restore confidence in the market. We are here to assist you in creating and implementing a solution to the issues at hand. It is our hope that you will read the report as we provided it to you, and that we have the opportunity to speak with you further and to work with you if you see it as being appropriate. There’s general agreement that transparency is needed, and that’s precisely what our system creates in a way that is compatible with exchanges and clearinghouses, and virtually all approaches because underwriting standards and statistics are the building blocks of all financial products. No matter how you end up defining credit default swaps, if the true intention is to fully identify and understand the risks, you must know the inherent risks of the instruments underlying the CDS, and that requires disclosure of the underwriting statistics. Confidence is restored to any market with access to this information, and that’s what our system is designed to provide. Thank you very much for your time.

MORELLE: Thank you. I think there's no question that greater transparency and more information exchange of clearinghouses is going to be critical. I think, you know, from our point of view, and I'd certainly entertain if there's any questions, that you're probably… the work that you're doing and the questions that you're looking to solve are probably a little further down the road than where we are right now, because obviously we're looking at the bigger question of whether or not we have a role to play, and how will we regulate it. But there's no question that products like yours and others in the marketplace will go a long way towards providing both sophisticated and unsophisticated investors more information about what's going on in the marketplace. Any further questions? Senator? Thank you both very much for being here and participating, and we look forward to continuing the conversation as per your invitation.

C. ERLANGER: Thank you very much.

MORELLE: Do we have any other individuals who would like to speak before the hearing? Seeing none, I want to thank everyone for their participation and for all of my colleagues' participation today, and look forward to further deliberations. The hearing is closed. Thank you.

(END OF TRANSCRIPT)