Testimony of Joseph J. Cassano
Before the Financial Crisis Inquiry Commission
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Chairman Angelides, Vice Chairman Thomas, and Members of the Commission:

Thank you for having me here to provide information. I hope my testimony is helpful in understanding fully the circumstances we faced at American International Group, Financial Products Division ("AIG-FP") in the period between August 2007 and February 2008.

As you may know, AIG-FP had a diverse portfolio. We were active in the capital markets, doing business in more than 25 countries. We had offices in the United States, the United Kingdom, Hong Kong, Japan, and France. AIG-FP was a dealer in derivatives and ran active portfolios in interest rates, commodities, currency, credit, and equity derivatives. At its peak, AIG-FP had more than 400 employees. When I became Chief Executive Officer in 2002, it was my distinct honor to manage such a diverse business with so many talented employees.

Understandably, you asked about one product in particular, the credit-default swaps ("CDSs") on super-senior tranches of multi-sector collateralized debt obligations ("CDOs"). As you know, a CDS is a contract that provides insurance-like protection against a risk of default. In the case of the multi-sector CDOs, the risk was on the super-senior layer of CDOs that contained a variety of debt — mostly residential-mortgage-backed securities (with both prime and subprime collateral), but also commercial-real-estate loans, corporate loans, consumer loans, and auto-loan receivables.

Often repeated are my words during an earnings call in August 2007 that I did not expect any realized, economic losses (as opposed to unrealized accounting losses) on this portfolio. I meant exactly what I said in August 2007. The underlying loans in the CDOs were diversified, and we insured only the super-senior tranche, which always had a AAA layer of loans below it. I did not expect actual, economic losses on the portfolio. That said, I was truthful at all times about the unrealized accounting losses and did my very best to estimate them accurately, in consultation with others at AIG-FP, as well as with my supervisors, AIG's senior accounting staff, and its internal and external auditors.

What is also true is this: we were "long" the housing market through the CDS contracts because we believed until late 2005 that banks and other mortgage originators were applying appropriate standards when writing mortgages. When we recognized — well before many others — that changes in the mortgage market likely presented increased risk for future deals, we decided to exit the subprime business. We thought the decision was appropriate, despite the lost profits at the time. With hindsight, the decision looks even more prudent.

You asked about the approval and monitoring system for the multi-sector CDS portfolio. The approval process had several stages, and the AIG parent organization reviewed every single transaction under its promulgated standards.

The first stage in the approval process was internal at AIG-FP. Every proposed CDS transaction first was reviewed by an experienced AIG-FP credit officer, who performed an independent analysis of the proposed deal. The credit officer analyzed the trade fundamentals, the proposed terms and conditions, and the asset classes.

After that initial review, University of Pennsylvania Professor Gary Gorton, who served as a consultant to AIG-FP, worked with our experienced analysts to refine the deal structure. To complete this review, Professor Gorton used a sophisticated actuarial model to make sure the proposed deal was fundamentally sound and to determine an appropriate attachment point. This process was designed to minimize risk to AIG-FP.

After AIG-FP reviewed a transaction, it could not be executed without AIG's specific review — and only upon its approval. AIG's credit risk officer, part of AIG's Credit Risk Committee ("CRC"), which was, in turn, part of AIG's Enterprise Risk Management group ("ERM"), first reviewed a detailed memorandum about the transaction. The CRC consisted of many of AIG's most senior and experienced employees, including its CFO, Head of Enterprise Risk, Chief Credit Officer, Vice President for Financial Services, and the Vice Chairman for Investments. Each memorandum provided an overview of the proposed transaction, including a description of the CDO structure, its assets and liabilities, and the terms of the proposed CDS. The memorandum also specifically identified risk factors and provided an analysis of those risks. Virtually every deal, including all CDS transactions above $250 million, required the CRC's approval, and the rare transaction with a net notional exposure of more than $5 billion also required approval from either AIG's Chief Executive Officer or AIG's Chief Risk Officer. AIG's Chief Credit Officer oversaw this review.

After AIG approved a transaction, AIG-FP continued its diligence throughout the deal's lifetime by conducting rigorous reviews to identify unanticipated risk. We reviewed the portfolio every month. We conducted a more in-depth analysis quarterly. AIG-FP ran stress tests using its model to determine whether each transaction continued to meet AIG's standards. We conducted this review with actual performance data. The ERM group reviewed the results of AIG-FP's quarterly analyses.

In addition, AIG's CRC conducted an annual review of AIG-FP's portfolio. The CRC included several of AIG's senior executives. The CRC's review was independent of AIG-FP's quarterly reviews. It was aimed at separately identifying any changes in the deals that led to undesired risk.

I do not believe this highly structured approval and review process changed over time in any significant way. At bottom, AIG and AIG-FP were in frequent communication, both formally and informally, about AIG-FP's super-senior CDS portfolio during the approval and monitoring processes.

You also asked about the growth of the CDS portfolio over time, and, in particular, in 2005. As you know, we made a decision at the end of 2005 to stop writing new deals that contained subprime collateral. Although we completed deals already in the pipeline, the portfolio grew comparatively little after 2006. Until about 2005, I suspect the pace of our growth was consistent with the growth of the CDO business generally. In dollar terms, our business grew every year because the CDS contracts were multi-year obligations: adding even one increased the notional size of the book. But, on a percentage basis, our biggest increases were prior to 2005. In fact, 2005 was a sizeable increase in dollars, but a far smaller percentage increase than the prior years. I suspect it was much smaller than the overall growth in the broader CDO market at the time. I recall in 2006, after we announced our exit from subprime transactions, some market participants were just announcing expansions of their CDO businesses. During the short period of growth and then decline in our multi-sector CDO business, we never compromised our standards to enter into a transaction. Every deal had to stand up to the rigorous evaluation process.

Let me explain more fully why AIG-FP stopped writing CDS protection on CDOs with subprime collateral. In mid-2005, AIG-FP's head trader was concerned that changes in the subprime mortgage market may have meant more risk in new deals compared to existing ones. We discussed taking a harder look at the market, and I asked for his recommendation. In the third quarter of 2005, the head trader expressed continued concern and asked to convene a group to gather additional information. I agreed his course was a prudent one, and we selected a team to assist in the fact-gathering and analysis.

After that detailed review and analysis, the head trader believed AIG-FP should stop writing CDS protection on CDOs with subprime exposure. With that analysis, and even though opinions varied within the group, we decided to stop writing deals with subprime exposure. We announced our decision to the marketplace in February 2006.

We made this decision, despite the immediate impact on our profits, for one reason: it was the right thing to do to protect the long-term health of our business. We hope that, with this decision, we helped limit risk.

When AIG-FP exited the business, we wondered whether there was a risk in our existing portfolio for which a hedge might be appropriate. After internal discussion, we believed that the existing vintages were not tainted by any slippage in underwriting standards. We remained confident in our risk analysis for the existing deals. The decision was based on our firm view that the portfolio would not experience realized losses (as opposed to short-term accounting losses). As I look at the performance of some of these same CDOs in Maiden Lane III, I think there would have been few, if any, realized losses on the CDS contracts had they not been unwound in the bailout.

But, as you know, a decision was taken after my departure from AIG-FP to unwind the CDS contracts due largely, so far as I can tell, to the proliferation of collateral calls under the CDS contracts. Generally under the credit support annexes to the CDS contracts, collateral calls were triggered by the reduction in fair value of the underlying CDOs and the reduction in the credit rating for AIG or the CDO. For example, if AIG was downgraded, a counterparty generally could call for the posting of collateral, but only if the diminution in fair market value was more than a stated percentage. If the parties disagreed about the fair market value of the bonds (which would likely happen in a period of illiquidity when bonds did not trade), the contracts generally had dispute-resolution processes, such as a so-called "dealer poll."

During my tenure, AIG-FP had disagreements with several counterparties relating to calls for collateral on AIG-FP's CDSs. I directed my team to conduct thorough diligence to determine both the basis for the numbers underlying the collateral calls and to reach the most reliable valuation of AIG-FP's book. As we dealt with collateral calls, which escalated as the market deteriorated, we used available contractual defenses, relied on fundamental analysis to challenge the values underlying the counterparties' demands, and were prepared to call for dealer polls as necessary. Through this strategy, we got steep reductions in the called-for amounts from all counterparties who made the largest calls. During my tenure, no counterparty declared us in breach or threatened litigation, which shows our strategy was effective. I believe this strategy was appropriate and in the best interests of the company and its shareholders.

You have asked about the way in which we calculated fair market value for our portfolio. This was, to be sure, a challenging, first-of-its-kind process at AIG-FP, but I believe we developed a reasonably strong analytic method for estimating fair value. We selected a model developed by Moody's (the Binomial Expansion Technique, or "BET") in September 2007. We customized it to provide the most accurate valuation estimate possible. We eventually developed two versions of the model, as a cross-check, using different sets of inputs. As is true with all models, our model had several assumptions and adjustments. We reviewed all the assumptions and adjustments with a large team from AIG and its outside auditors, which included executives with dozens of years of public-accounting experience (I am not a CPA).

You asked about one adjustment in particular, the so-called negative-basis adjustment, including our auditors' decision to disallow it. We believed then, and I still believe now, that it was a wholly appropriate adjustment.

At the time, in light of the great unrest in the market, we gathered the best data we could to evaluate the appropriateness of, and estimate the magnitude of, the negative-basis adjustment. Within days of developing the blueprint for the version of the model that required the adjustment, in late November 2007, we discussed the need for the adjustment specifically with AIG and its outside auditors. We continually made specific references to the adjustment in the weeks that followed.

No one raised concerns about the negative-basis adjustment until mid-January 2008. Ultimately, in February 2008, the auditors decided that we did not have sufficient audit-quality evidence for the adjustment. As a result, they disallowed it. I disagreed with that decision, as did several others at AIG. It was, however, the auditors' final decision and we had to abide it.

Regardless, the auditors' decision about the quantum of evidence supporting the adjustment had a huge impact on the company: it increased our unrealized accounting loss substantially. The auditors also made a material-weakness finding, which I first learned about in February 2008. In light of the auditors' heavy involvement in the fair-market-model evolution generally, and their prior knowledge of the existence and magnitude of the negative-basis adjustment in particular, I also found the material-weakness finding surprising, to say the least. I know AIG senior management argued strenuously against it.

After the material-weakness finding, I was called into a meeting with AIG's CEO in February 2008. Suggesting that "changes" would have to be made, he offered me an opportunity to retire, which I took. Management asked me to stay on in a consulting role without seeking other employment. I agreed to the arrangement.

I am glad you asked about the compensation structure at AIG-FP. We designed AIG-FP's compensation system to make sure that highly compensated employees had a large percentage of their compensation deferred and tied to the company's long-term performance. We adopted this plan approximately 15 years ago and changed it little after that. The plan generally required highly compensated employees to defer up to 45% of their compensation, through the purchase of AIG-FP subordinated debt, which was not guaranteed and was at risk to the business's performance. The deferred compensation was paid out annually during an average-life window (usually between four and six years). Although the money paid out over time, it vested immediately. Employees at some other financial institutions were essentially handcuffed to their jobs because leaving meant they would lose unvested, deferred compensation behind. Under AIG-FP's plan, any employee could leave without forfeiting any portion of their deferred compensation, which would continue to pay out over the average-life window even if an employee departed. In other words, if anyone did not like working with me, or did not like what we were doing, they could walk out the door without losing a penny in deferred compensation.

In November 2007, it became apparent that AIG-FP's accounting losses would be substantial and would require a change to our compensation structure to ensure that employees stayed with the company to help it address the issues surrounding the AIG-FP portfolio, but also would not be immune to AIG-FP's losses if they were actually realized. I had several discussions with my superiors at AIG about this change, emphasizing the need to recognize the accounting losses while also noting the importance of keeping our employees together during this critical time. For that reason, I suggested that AIG-FP adopt a special-incentive plan ("SIP"), which would place any compensation in excess of a set amount in a special deferred-compensation account. The funds in that account would remain subject to AIG-FP's business performance and the risk of realization of the accounting losses. Unlike the standard deferred compensation, one-third of the SIP funds would vest at the end of 2008 and the remaining two-thirds would vest at the end of 2009, and the funds would have been paid in 2012. My goal in proposing the SIP was to recognize the unrealized accounting losses and to put highly compensated employees' pay at risk to those losses becoming realized, while also providing an incentive for them to remain with the company through the end of 2009.

Although I was pleased with the SIP and believed it was a fair and appropriate plan given the magnitude of the accounting losses, I went one step further and volunteered to take no bonus whatsoever for 2007. Instead, I proposed to AIG that we simply have a handshake agreement that AIG would compensate me in the future if AIG-FP's accounting losses reversed, as I was confident they would. I did not make this offer because anyone asked me to — I did it because it was the right thing to do, even though AIG management ultimately rejected my proposal.

In closing, I understand that identifying the root causes of the financial crisis is an extraordinarily important, yet dauntingly complex, mission. I greatly appreciate the professional and objective manner in which the Commission's staff has dealt with me and my counsel, and I am available for any questions.