Testimony of Elias Habayeb
Before the Financial Crisis Inquiry Commission

July 1, 2010

Chairman Angelides, Vice Chairman Thomas, and members of the Commission, thank you for the invitation to appear before you today.

By way of background, I am a licensed CPA and I practiced with Deloitte & Touche LLP, becoming a partner in 2003, before I was recruited to AIG in 2005. From September 2005 until May of last year, I was Senior Vice President and Chief Financial Officer of the Financial Services Division of AIG. AIG's subsidiaries within the Financial Services Division engage in a diverse range of activities including aircraft and equipment leasing, capital markets, consumer finance and insurance premium finance. These subsidiaries include AIG Financial Products Corp., or FP. As you know, FP is the unit that wrote credit default swaps protecting multi-sector collateralized debt obligations that had exposure to the U.S. subprime mortgage market.

In May 2009, I left AIG on excellent terms and continued to provide advisory services to the company. I returned to AIG just this week, as Senior Vice President of Investments and Financial Services Division.

I understand that today's panel has been assembled to address Goldman Sachs' calls for the posting of collateral under its credit default swap contracts with FP during 2007 and 2008. My position as CFO of the Financial Services Division of AIG gave me some insight into the collateral calls that FP received after the subprime mortgage market crisis began in late 2007. Beginning in 2008, I also participated in discussions with certain counterparties, including Goldman Sachs, about the collateral call disputes.

First, it may be helpful for me to discuss my understanding of FP's swap book and how the swaps worked.

Since 2002, FP wrote swaps that provided credit protection on multi-sector collateralized debt obligations (referred to here as the bonds). As of September 30, 2008, the total notional value of the bonds was approximately $72 billion.

FP's counterparties to these swaps were mostly large US and international financial institutions. The counterparties purchasing the swaps paid FP periodic premiums in exchange for FP assuming the risk that the counterparties had of non-payment or loss resulting from certain "credit events" (e.g., the failure to pay, bankruptcy, acceleration, restructuring) with respect to the underlying bonds.

FP was also required under certain circumstances to post collateral to the counterparties to secure FP's ability to perform in the event of a default or other credit event triggering a payment obligation on the swap.

Generally, the amount of collateral required to be posted by FP under the swaps was determined by formulas that took into account AIG's credit rating, the underlying bond's credit ratings, and the market value of the underlying bond.

During the subprime mortgage crisis, the bonds underlying FP's swaps began to decrease in value. As a result, beginning in late 2007 through 2008, FP reported billions of dollars of unrealized mark-to-market losses on the swaps under the fair value accounting rules. These valuation losses could (and initially were expected to) reverse if the fair value of the swaps recovered and FP still held the swaps.

FP also received billions of dollars in collateral calls from its counterparties to the swaps as a result of the declining market value of the bonds and declines in AIG's and the bonds' credit ratings. Because the bonds were not trading, it was difficult to determine the appropriate "value" of the bonds and thus, the amount of collateral required to be posted under the swap agreements. FP and its counterparties, including Goldman Sachs, engaged in ongoing discussions in an effort to come to some agreement as to the amount of collateral to be posted under the swap.

Beginning in the summer of 2008, I was also involved along with others at AIG and its advisors in exploring possibilities to reduce the liquidity and mark-to-market risks posed by FP's swaps and the ongoing collateral calls.

However, at that time AIG lacked the financial resources to come up with a large scale solution involving a $72 billion book of swaps. Even though AIG had many assets, most were assets held by its insurance company subsidiaries, and state insurance regulations limited AIG's ability to access them. Because AIG is not a bank, it did not have access to funding through the Federal Reserve in the normal course. Instead, AIG had to rely on the capital markets. But AIG was unable to obtain additional liquidity from the capital markets.

Additionally, AIG's efforts to stem the tide of collateral calls and reduce FP's risk exposure by negotiating with counterparties, including Goldman Sachs, during this period were largely unsuccessful. Unfortunately, AIG had little negotiating leverage with FP's counterparties to extract discounts. Even the threat of and FP or AIG bankruptcy did not give AIG any leverage because as I understand it, counterparties would get special protections under the bankruptcy laws and in certain circumstances, could end up keeping the collateral FP had posted to date as well as the underlying bonds (and any future upside).

By August 31, 2008, FP had posted $19 billion in collateral to FP's swap counterparties, including $6.8 billion to Goldman Sachs. And by the beginning of September 2008, FP's collateral payment obligations, and cash requirements in certain of AIG's other business segments, were placing increasing stress on AIG's liquidity. On September 15, 2008, the rating agencies downgraded AIG's credit rating, triggering an onslaught of new collateral calls. Unable to access the capital markets or meet its liquidity demands, it was at this point that AIG received emergency government assistance.

I am happy to answer any questions the members of the Commission may have. Thank you.