AJIT JAIN

Chairman Frank, Ranking Member Bachus, and members of the Committee:

It is my privilege to appear before you today. Recognizing the value of your time; I will get right to the three issues you have asked me to address, which are:

1. The circumstances which prompted us to form Berkshire Hathaway Assurance Corporation, a bond insurer, and our offer to reinsure the portfolio of several existing financial guarantors;
2. The value of bond insurance to the issuers and investors; and
3. How will the bond insurance industry develop going forward?

Berkshire Hathaway's Initiatives:

Our decision to enter the bond insurance business was initiated by a simple phone call from New York Superintendent of Insurance, Eric Dinallo. When I was told Superintendent Dinallo wanted to speak to me, my initial reaction was to be ready to receive some sort of bureaucratic complaint. Instead, the Superintendent was calling to work on a very businesslike approach to solving a problem, and invited us to create a bond insurer in his state of New York. Clearly flattered by the phone call, we felt the need to reciprocate and be associated with an effort to help address a problem of national importance. At about the time Superintendent Dinallo called us, we felt there was a real possibility that the bond insurance industry would undergo a structural and permanent shift. For almost 20 years, we had considered entry into this business. With our AAA rating and our excess capital position, this segment was always a natural extension of our existing insurance operations. These attractive macro features notwithstanding, when we analyzed the risk/reward characteristics of a typical transaction we concluded that pricing did not adequately compensate the capital provider for the risk- especially for the tail risk- i.e. what is now commonly referred to as the “Black Swan” event, defined as a random, difficult to predict event--an event that may have never happened before (and is therefore very unlikely to happen), but when it does happen, it has a huge impact.

Our assessment of the business in this regard began to change radically in October 2007 with the advent of the subprime crisis and the increased awareness of the financial losses it could bring. We hypothesized that risk in general, and financial credit risk in particular, would no longer be underappreciated and underpriced. Pricing going forward would reflect expectancy of losses plus a reasonable return to the risk bearer. In addition, it was our hypothesis that the existing industry leaders could have their franchises mortally wounded by the subprime and structured finance exposures that they had taken on. Whether or not these companies were able to raise additional capital, we believed there was a good chance that, given their prior history of mismanaging this business, they could no longer maintain their all-important AAA ratings. If that happened, there would be a need for a new AAA rated bond insurer--a role we could play.

As for our offer to reinsure the municipal bond business of the existing monoline insurers, here again Superintendent Dinallo gets the credit. He forced us to consider how our capital could be deployed to help alleviate the pressures on the existing bond insurers, and in particular the municipal bond policyholders that they had insured. A comprehensive solution, including both the structured finance and municipal obligations, was everybody’s first prize. However, we were unable to analyze the numerous complex financial transactions that made up the structured finance portfolios. On their municipal bond side of the house, while we continued to feel that the historical pricing was inadequate, we could nevertheless take on *that* risk with a price adjustment, which we made in the terms of our offer to reinsure that portfolio.

We believe that our offer to protect the municipal bond side of the guarantors' business had merit on several levels. First from the muni bond issuers' perspective, having a solid AAA insurer backing the bonds that they had issued would almost certainly avoid the steep increases in interest costs they have seen in variable and auction rate securities. Similarly for muni bond investors, our protection may well have avoided the steep price decreases in the value of their bonds that we witnessed two weeks ago. Furthermore, by releasing capital from the muni side of the business, the structured finance policyholders could well have had more capital available to pay for their losses. Finally, for the shareholders of these companies, by shedding their thirty year muni obligations, these companies could then negotiate to terminate their structured finance obligations with their counterparties. They could then return capital to their shareholders. This may well have been the best possible outcome for the shareholders-especially given where the shares of these companies are currently trading. However, our offer was clearly not in the best interest of the management of these companies, although we were hoping that the combined interests of the investors, issuers, policyholders, and shareholders would trump management's interests.

Value of Bond Insurance:

The second issue I have been asked to address is the benefit of bond insurance to issuers and investors. On this point, I can add almost nothing to what has been spelled out by so many others. To briefly rehash the point: from the perspective of a municipality, and speaking historically, the cost of purchasing a financial guaranty insurance policy was more than justified by the reduction in the interest rate that municipalities paid the credit markets for the funds being borrowed. From the investor's perspective, of course, the ratings enhancement lent by the insurance maintained a stable and liquid market for the bonds. Thus, the insurance provided lower interest rates to municipalities and greater price stability and liquidity to investors.

Outlook of the Bond Insurance Industry:

Given all this, I can well understand the Committee's interest in the last issue it has asked me to address, which is "Where are we going with all of this?" What my answer lacks in helpfulness it makes up for in honesty: I don't know. There remains a great deal of uncertainty. For our part, we are tip-toeing into the water and, while we are writing business at pricing levels that are economically attractive to us, I remain very concerned about the long-term viability of this business in general and for us in particular. There are several very good reasons for my concern.

First, and this applies just as much to all insurance as it does to financial guaranty insurance, the product that is being sold is nothing more than a future promise to pay. Its value relies heavily on the credibility of the promisor. With recent headlines of issuers having to pay as much as 20% on auction rate securities and with insured muni bonds selling at higher yields than corresponding uninsured bonds, buyers have every right to question the value of the bond insurers' promise to pay. Efforts to create a "good bank/bad bank" situation will further reinforce buyers' concerns about the integrity of the insurance product. It is one thing for regulators to prioritize among policyholder obligations for the greater public good in a potential insurer insolvency situation, but for the management of a AAA rated going concern to use the concept of a good bank/bad bank as a tool to enrich their stockholders at the expense of certain categories of policyholders is something that can cause permanent damage to the insurance business.

Put yourself in the shoes of a chief financial officer of a health care facility. Your initial, superficial reaction to this “split” of insurer obligations may be one of relief, since in the first instance you are within the “good bank” bucket, and the value of the insurance on your bonds will not be eroded by structured finance claims. But tomorrow, when a few of your fellow health care facilities default, what assurance do you have that all health care bonds won’t be put into a “bad bank,” leaving the health care facilities to fend for themselves?

Second, if the rating agencies level the playing field in terms of how they rate municipal versus corporate obligations, there will be little need for a financial guaranty insurance marketplace as we know it, because much municipal debt on a stand alone basis may not require the enhancement of the insurance to manage the costs of that debt, depending on whether investors accept the altered rating approach.

Finally, if the rating agencies permit some of the more compromised monolines to maintain their historical AAA ratings, the ongoing efforts of those companies to underwrite their way back to strength will lead to pricing wars; that will be unavoidable. Unless you continue to believe that this is zero-loss business, that conduct assures a bleak future for this business. On that point, I am actually amazed that experts in the business continue to consider municipal bond insurance as almost a zero-loss business. There is hardly a sufficient history to conclude that there is a zero chance of loss in this business, although that is the assessment that gets reflected in the pricing. While there have been few municipal defaults in the past fifty years, Jefferson County, Alabama and Vajello, California, both having received publicity lately about possible defaults on their debt obligations, could just be the tip of the iceberg as municipalities are coming under increasingly unfavorable economic conditions, including reduced real estate and sales-generated tax revenues and underfunded future pension and healthcare costs, that by anyone's measure increases the risk of insuring long-term municipal obligations. Yet I am assured that this remains a zero loss business.

Given that gloomy sentiment, I feel confident in saying that it has been more my pleasure to appear before you then your pleasure in having me. I would be pleased to try and answer any questions you may have, and I thank you once again for inviting me to address you on this important issue.