Office Of Thrift Supervision
Department of the Treasury

Northeast Region

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October //, 2008

American International Group, Inc.
70 Pine Street
New York, NY 10270

Members of the Board or their Representative:

Pursuant to Section 10 of the Home Owners' Loan Act, we performed a risk-focused targeted review of American International Group's residential mortgage-related securities.

Information, comments and conclusions contained in this report are based on filings made with the Office of Thrift Supervision and the books and records of the holding company and its subsidiaries. OTS prepared this report for supervisory purposes, and you should not consider it an audit report. OTS prepared this report for supervisory purposes and furnishes this document to the holding company, subject to prohibition of disclosure or release, for its confidential use.

Please review the report in its entirety and advise us of what action you took, or will take, regarding each recommendation discussed in this report. Please reply within 45 days from the date of this letter.

TARGETED REVIEW

American International Group, Inc. (AIG)
70 Pine Street
New York, NY

Docket Number:	H2984
Subject of Review:	Residential Mortgage-Related Securities
Start Date:	February 11, 2008
End Date:	July 9, 2008

ABBREVIATIONS USED

AIG	American International Group, Inc.
AIGFP	AIG Financial Products, Inc.
BAIG	Banque AIG
CP	Counter Party
CRC	Credit Risk Committee
CCO	Chief Credit Officer
ERM	Enterprise Risk Management
IAD	Internal Audit Department
PwC	PriceWaterhouseCoopers
RMBS	Residential Mortgage-Backed Securities

SCOPE

A target examination of AIG Insurance Company, Inc. (AIG or the Company) commenced on September 2, 2008. The examination focused on a top down review of the Company's super senior credit default swaps written to facilitate regulatory capital relief for certain European Union financial institutions (regulatory capital CDS). AIG subsidiary AIG Financial Products Inc. (AIGFP) entered into these transactions through its French regulated subsidiary, Banque AIG (BAIG). The examination was conducted through discussions with AIG, AIGFP, and BAIG management and other personnel, the review of public records, internal financial records and other internal reports, and reports prepared for the examiners. The examination commenced and concluded with onsite work at AIG's offices in New York City, New York. Onsite work at BAIG's office in London, United Kingdom began on September 8, 2008, and was completed on September 12, 2008. Financial data and information in the report is as of June 30, 2008, unless otherwise noted.

The examination included an assessment of the potential for catastrophic market losses resulting from regulatory capital CDS exposure and the impact such losses would have on the Company's liquidity and consolidated capital position. The examination included a review of valuation methodologies. The review considered how the Company monitors and evaluates its counterparty termination

expectations. The review considered whether the Company conducted scenario analyses in preparation for the possibility that counterparties do not terminate the transactions as the Company expects, and whether the Company has in place a plan to value these transactions under such scenarios. The review considered how the Company monitors and assesses the performance of the underlying portfolios and the broader residential and corporate loan markets. The review focused on existing risk controls and governance matters. A small sample of transaction files was reviewed.

CONCLUSIONS

The regulatory capital CDS portfolio represents a significant concentration of risk to AIG. Despite declining by $72 billion since the beginning of 2008, the notional amount of this portfolio totaled $307 billion or 394 percent of capital as of June 30, 2008. The regulatory capital CDS transactions remain subject to the correlated risks such as a European and Worldwide recession, accounting volatility brought on by risk aversion, a rapid change in regulators views of Basel II Capital models, and long-dated legal maturities during which facts, circumstances, and conditions could change for the worse. In addition, the Company has not conducted a comprehensive, holistic analysis of the notional exposure subject to collateral calls, the conditions required for posting of collateral, and the impact collateral calls would have on the Company's liquidity.

The regulatory capital CDS portfolio is valued at zero as of June 30, 2008. Management conducted a comprehensive accounting analysis to support this valuation. Management concluded that the counterparties are motivated by economic capital relief and that the value of the credit risk transfer component of these transactions continues to be nominal. AIG believes that the most compelling data supporting this conclusion is the termination of $/// billion of net notional exposures in 2008 at no cost to AIG. However, facts, circumstances, and conditions supporting these conclusions could change rapidly. AIG does not have an alternative valuation methodology in place should these changes occur and the credit risk transfer component of these transaction increases in value.

The Company performs fundamental credit analysis and Worst Case Value-at-Risk (WVAR)[a] analysis of the portfolios of loans underlying each regulatory capital CDS transactions. The WVAR analysis may not be appropriate for a portfolio of this size because the analysis is designed to protect against the vast majority of statistically derived, expected outcomes, not stress. AIG should therefore focus on fundamental credit analysis and not place too much reliance on the WVAR analysis.

[a] Defined later in this document.

[redacted]

RISK MANAGEMENT PRACTICES

Risk Concentration

The regulatory capital CDS portfolio represents a significant concentration of risk to AIG due to the significant size of the notional exposure and the correlated risks. Despite declining by $72 billion since the beginning of 2008, the notional amount of this portfolio totaled $307 billion or 394 percent of shareholders equity capital as of June 30, 2008. The exposure increases to $313 billion when considering the $5.8 billion in credit derivatives written by the Company on tranches below super senior on certain of the regulatory capital CDS transactions. The regulatory capital CDS transactions remain subject to the following correlated risks:

1. A European and Worldwide recession would impact the quality of the underlying protected portfolios of mortgage and corporate loans;
2. A continuation or deterioration of the global credit markets disruption, brought on by risk aversion, would result in further volatility and flight to safety in Europe, as has occurred in the United Sates. These two risks may shift counterparties' motivations away from regulatory capital relief toward credit risk protection, reflecting increases in the value of the credit risk transfer component of these instruments;
3. The current economic malaise could lead European Regulators to suspend or change the capital reduction benefits afforded to these instruments by Basel II. This change could appear rapidly, before counterparties receive approval of their Basel II capital models from their local regulators and before the counterparties terminate the transactions at no cost to AIG.
4. The legal maturities of the regulatory capital CDS transactions are long dated. Most of the regulatory capital CDS transactions written on portfolios of residential loans mature in excess of 30 years, and some mature in excess of 50 years. Therefore, even if the value of the credit

risk transfer component is currently nominal and the risk of any payment obligation, or actual credit loss is currently remote, a long period of time exists during which facts, circumstances, and conditions could go very wrong. These changes could impact CDS valuations and result in credit losses.

These risks are mitigated in several respects. The regulatory capital CDS protected portfolios of loans are diversified by country and each CDS transaction is diversified by many obligors. AIGFP/BAIG underwrote each CDS transactions at attachment points designed to ensure, based on historical loss data, a remote risk of loss. The credit protection fee is typically fixed or tied to a slowly amortizing schedule. This makes the credit protection fee relatively more costly to the counterparty on declining portfolios of loans. There are fundamental differences between the U.S. and European loan origination models, at least with respect to the residential mortgage markets, However, the securitization motivated super senior CDS portfolio of multi-sector CDOs were mitigated by some of these same factors.

The Company expects the majority of regulatory capital CDS counterparties to terminate their contracts with the Company by the end of first quarter of 2009. Management contacts the counterparties each quarter now to determine if their intensions to terminate have changed. They use this information to estimate the expected call dates. At this point, the Company has not identified concerns that counterparties won't terminate as communicated to Company. However, as noted above, the facts, circumstances, and conditions providing motivation to the counterparties could change rapidly. *AIG should continue to monitor counterparty motivations regarding termination, establish concentration reduction targets, and prudentially reduce the size of this portfolio.*

Some of the regulatory capital CDS transactions are subject to collateral positing requirements. Management states that the collateral postings vary by counterparty. *The Company has not conducted a comprehensive, holistic analysis of the notional exposure subject to collateral calls, the conditions required for posting of collateral, and the impact collateral calls would have on the Company's liquidity. The Company should conduct this analysis promptly.*

[redacted]

Reporting

Our review found management reporting to be insufficiently comprehensive or robust. It reasonably reflects the level of AIGI's RMBS exposure and related risk management practices. However, AIG does not perform fundamental portfolio analysis and reporting of underlying mortgage characteristics to include, inter alia, sub-types, periods to next reset, loan-to-values (LTVs), credit scores, mortgage originators, geographic location, and credit surveillance results. Stratified risk measurement and reporting of these risk factors would provide a more complete representation of the Company's exposure to the residential mortgage market and further promote sound risk management.

Oversight and Risk Management

We note concerns with oversight of the risk management of RMBS. Prior to the recent U.S. housing market and credit markets downturn, AIG's corporate risk management did not provide active oversight other than annual portfolio reviews and delegations of credit authority. Managers responsible for acquiring RMBS currently conduct the portfolio performance reviews and underlying credit analysis with little independent confirmation.

We were unable to identify risk tolerance levels, risk adjusted return objectives, and performance metrics for the RMBS portfolio. The credit surveillance processes employed by the portfolio managers should be validated and strengthened with more rigorous screening and migration analysis. The improved processes could be used for internal risk rating, thereby reducing reliance placed on external ratings.

While we conclude that management has designed and executed reasonable risk management controls for RMBS portfolio pricing and determining OTTI, the independent oversight of the pricing processes was performed by the accounting group on an interim basis. Corporate management is currently transferring oversight of the pricing processes to Global and Regional Pricing Committees. Validation of the pricing processes will be performed by Enterprise Risk Management's (ERM's) Valuation Group.

Capital Adequacy

We are concerned with the size of the Company's exposure to the U.S. residential real estate and structured credit markets and its potential impact on capital. As of March 31, 2008, AIG reported cumulative realized and unrealized losses of $49 billion that are attributed to the continuing U.S. housing market deterioration and global credit markets disruption. The remaining potential exposure is significant and will be the subject of ongoing supervisory attention for the foreseeable future. We note management's recent capital augmentation and efforts to strengthen the Company's capital structure.