



**AMERICAN INTERNATIONAL GROUP, INC.
ECONOMIC CAPITAL MODELING RESULTS &
APPLICATIONS**

May 2008 Update

INTRODUCTION

AIG has made significant progress to date on its economic capital modeling initiative that commenced in 2005 with today's focus being firmly on the applications across a wide range of AIG's decision-making processes. This summary describes AIG's economic capital model and addresses the following questions:

- I. What is economic capital?
- II. How do the rating agencies view economic capital?
- III. What are the results to date?
- IV. How is AIG using economic capital to help manage its businesses?

I. WHAT IS ECONOMIC CAPITAL?*Definitions*

Economic capital is an assessment of the capital required to cover potential, unexpected losses within a target confidence level and timeframe. To be consistent with a strong and stable AA target rating, AIG's required economic capital estimates are calculated at a 99.95 percent confidence level and a one-year time horizon. AIG has modeled five major risk categories that are consistent with financial services industry best practices -- property & casualty insurance risk, life insurance risk, market risk, credit risk and operational risk.

Required economic capital is compared to available economic capital, defined as the difference between the economic value of AIG's assets and the economic value of AIG's liabilities, in each case across all of AIG's segments.

Period to period, available economic capital is increased by earnings and capital issuances (e.g. hybrid capital issuances that receive substantial equity credit from rating agencies) and reduced by share repurchases and dividend payments.

Required Economic Capital – Pillar I and Pillar II Approach

AIG derives significant benefits from its diversification across its lines of business, risk categories and geographies. Diversification benefits significantly reduce required economic capital and, thus, increase AIG's estimate of excess capital. AIG measures its diversification benefits across its different business segments (General Insurance, Life Insurance & Retirement Services, Financial Services, and Asset Management) and across risk categories (property & casualty insurance, life insurance, credit, market, and operational risks).

- *Inter-segment diversification* is the difference between the required economic capital for AIG on a consolidated basis and the sum of the respective required economic capital amounts for the business segments if they were standalone entities. This diversification derives from different business segments having different risk profiles suggesting that their extreme-case losses will not occur simultaneously.
- *Inter-risk diversification* arises due to the fact that correlations are imperfect among different risk categories, such as insurance, credit and market risks. Inter-risk diversification exists within a business segment and for AIG as a whole.

Both inter-risk diversification and inter-segment diversification are significant for AIG and AIG continues to explore mechanisms for leveraging these benefits, taking account of the mobility of capital due to regulatory and rating agency requirements.

AIG determines required economic capital in two steps: Pillar I and Pillar II requirements. Pillar I required economic capital represents the results from simulation-based modeling at the chosen confidence level and incorporating a reasonable allowance for diversification. In Pillar II, we apply a series of stress tests to determine capital “add-ons” to the Pillar I economic capital requirements to cover “unmodelable” or “difficult to model” events such as the risk of a coordinated terrorist attack in the US, Europe and Asia, a severe global pandemic outbreak, a persistent multi-decadal low interest rate environment in Asia, severe credit defaults and risk aversion affecting AIG’s various exposures to the sub-prime residential mortgage crisis in the US, latent risk in casualty lines of business (“next asbestos”) etc.

Pillar II economic capital requirements also reflect a “haircut” to the diversification benefits captured under Pillar I for AIG’s regulated insurance businesses. This haircut allows for the effect of the applicable solvency capital requirements and reduced mobility of capital consequent to those requirements under an optimized portfolio of capital and risk transfer instruments.

In the latter half of 2007, AIG engaged third party experts to provide independent reviews of various aspects of AIG’s economic capital model. AIG’s independent advisors have confirmed that AIG’s approach to the determination of economic capital requirements under Pillar I is in line with industry best practices. Our independent advisor reviewing the overall economic capital methodology has concluded that the methodology employed is generally theoretically sound and has also advised that our Pillar II approach to the determination of economic capital requirements is prudent as it sets aside additional capital for stress scenarios beyond that contemplated within the Pillar I framework.

Available Economic Capital – Market Consistent Valuation

In AIG’s 2007 disclosures on economic capital, AIG had used GAAP shareholders’ equity plus hybrid capital as a conservative proxy for available economic capital. For the December 31, 2007, and future firm-wide full valuation calculations of economic capital, AIG uses the excess of the “market value” of assets over the “market consistent value” of the liabilities as the basis for measuring available economic capital to ensure greater consistency between the measurement of required and available economic capital.

For assets and hedgeable/tradeable liabilities, this value reflects their fair or market value. For non-hedgeable/ non-tradeable liabilities, the market consistent value represents the current estimated value of the asset or liability – generally without an adjustment for “own credit spread”¹ - plus a risk margin for bearing risk out to contract fulfillment. No hypothetical “exit” from illiquid asset/liability positions is assumed at the valuation date under this methodology, which is generally consistent with AIG’s intentions or obligations under its policyholder and security holder contracts.

The key differences between current exit values (e.g. as defined under FAS157) and market consistent values are as follows:

- Current exit value, which uses as inputs, current exit prices in the principal market (as those terms are defined under FAS157), may in fact converge with the value applicable to a

¹ The key exception is that business units that elect the fair value option under U.S. GAAP to more closely align earnings with the economics of their transactions by recognizing changes in asset values concurrently with changes in liability values (e.g., AIGFP) may include “own credit spread” in their liability valuations for the purposes of AIG’s economic capital model, to the extent that these spreads are representative of market-based credit spreads for similarly rated entities. (For example, during the quarter ended March 31, 2008, the total increase to pre-tax earnings attributable to changes in AIG’s own credit spreads for AIGFP was substantially offset by the effect of changes in counterparty credit spreads for assets measured at fair value at AIGFP.)

liquidation or transfer of an asset or liability in times of market disruption, even though AIG may have every intention of, or may be obligated to hold its position through contract fulfillment or maturity;

- Market consistent value allows for the risk to which AIG is exposed under its illiquid liability positions by adding a risk margin for this fundamental risk to the best estimate discounted value of the relevant cash flows;
- The risk margin under a market consistent valuation approach is determined using a “cost of capital” methodology in line with the recommendations of the CRO Forum for non-hedgeable/non-tradeable risks.² Importantly, such a risk margin allows for the fundamental risk underpinning AIG’s contractual obligations and does not use market implied risk margins which at times of market disruption, may include a significant premium for liquidity risk, market-driven risk aversion, opportunity costs, return on franchise value, the desire of the third party to recover sunk costs unrelated to the transaction and general exploitation of a temporal or persistent supply/demand imbalance in the market.

AIG’s estimate of available economic capital also incorporates an adjustment to GAAP shareholders’ equity based on the market consistent value of AIGFP’s obligations under its Super Senior Credit Default Swap Portfolio on Multi-Sector CDOs.

This adjustment is consistent with the economic capital model enhancements AIG initiated during 2007 to measure available economic capital on a market consistent basis. In October 2007, the firm of Towers Perrin was engaged to independently review our estimate of market consistent embedded value (MCEV) for the Life Insurance & Retirement Services segment and to provide a consistent methodology for estimating required economic capital for the General Insurance segment that facilitated AIG’s determination of available economic capital for its insurance business segments. This review process has been substantially completed.

AIG’s estimate of excess economic capital thus includes a market consistent valuation adjustment for the insurance liabilities in both the General Insurance and Life & Retirement Services segments and for AIGFP’s obligations under its Super Senior Credit Default Swap Portfolio on Multi-Sector CDOs.

II. HOW DO THE RATING AGENCIES VIEW ECONOMIC CAPITAL?

Each rating agency has its own method of evaluating capital adequacy which is in varying stages of development. Some of the agencies are also developing frameworks for evaluating individual companies’ economic capital modeling and the strength of their enterprise risk management practices. However, the precise mechanics for incorporating the results of a firm’s economic capital model into the rating agency’s assessment of capital adequacy have not yet been finalized by any of the four major rating agencies. Key considerations that have not yet been resolved include:

- How rating agencies will adjust for valuation differences between the economic, statutory and accounting balance sheets;
- The extent to which rating agencies will perform their own analysis of company internal models and the extent to which they will rely on independent third party opinions;
- Whether rating agencies will adopt an evolutionary (e.g., phasing in over 5 years) approach to weighting a firm’s internally calculated economic capital requirements with requirements determined using the rating agencies’ proprietary capital models.

² Refer www.croforum.org

Likewise some insurance regulators have begun using the results of internal capital models to augment their views of capital requirements for some of AIG's businesses. Wholesale changes to some regulatory capital regimes towards a more economic capital oriented view are also planned - for example, Solvency II in Europe which is expected to become operational in 2012/2013.

AIG is well placed to engage in these developments with AIG's independent third party reviews nearing completion in May 2008. Based on the preliminary results presented to AIG, overall, the reviews confirm that "AIG's approach to the determination of excess economic capital (under Pillar I) is generally consistent with accepted theory, in line with industry best practices, and that AIG's Pillar II approach to the determination of economic capital requirements is prudent in the way that it contemplates additional stress scenarios beyond what is modeled in Pillar I."

However, in the short to medium term, AIG must continue to meet existing regulatory and rating agency capital requirements that in some cases are substantially different than AIG's economic capital requirements.

III. WHAT ARE THE RESULTS TO DATE?

In February 2008, AIG provided a "roll-forward" estimate of AIG's excess economic capital, as of December 31, 2007, determined using available, prior period, firm wide, "full model valuation" calculations that were updated for our estimates of the change in available economic capital and the change in required economic capital over that prior period. Our "roll-forward" estimate of AIG's excess economic capital as of December 31, 2007, was in the range of \$14.5 to \$19.5 billion.

Since February 2008, we have completed our "full model valuation" update as of December 31, 2007, using the published financial statements of AIG as of that date, as inputs. The full model valuation update as of December 31, 2007, confirms that our "roll forward" estimate provided in February 2008 was appropriate (difference in conservative range of excess economic capital being less than \$0.5 billion at that date).

Using the results of our full valuation model as of December 31, 2007, and AIG's published financial statements as of March 31, 2008, our conservative "roll forward" estimate of excess economic capital as of March 31, 2008, has reduced to a range of \$2.5 to \$7.5 billion. The largest drivers of the reduction to AIG's excess economic capital over the quarter ended March 31, 2008, were the unrealized depreciation of investments (\$6.8 billion, net of tax); other-than-temporary impairments (\$3.6 billion, tax affected³) and dividends and share repurchases⁴ (\$1.5 billion).

IV. HOW IS AIG USING ECONOMIC CAPITAL TO HELP MANAGE ITS BUSINESSES?

AIG's economic capital model is an important decision-making tool used for a wide variety of applications throughout the organization. It provides a more refined view of AIG's capital adequacy at multiple levels of the business, e.g., consolidated, business segment and major profit center level. It also provides a consistent and comprehensive framework to discuss capital and performance on a risk-adjusted basis internally within AIG and externally with the investment community, credit providers, rating agencies and regulators.

Management is able to apply the economic capital model and its results to a number of areas. This process enables AIG to better assess the relative economic value added by a business, product or transaction to AIG as a whole by comparing risk-adjusted returns to the related cost of capital.

³ Other-than-temporary impairments (OTTI) for the quarter ended March 31, 2008 were \$5.6 billion. The tax affected (at 35%) contribution to consolidated net realized losses from OTTI charges for the quarter was thus \$3.6 billion.

⁴ Including payments advanced to purchase shares.

Economic Capital Modeling Results & Applications

Capital efficiency is assessed more robustly with risk-adjusted returns for existing and new businesses taking account of regulatory, rating agency and economic requirements. The benefits of portfolio diversification are quantified and assessed across businesses, risk categories, and geographies. Following are some of AIG's applications of the economic capital model.

- *Business Performance*: Analysis of operating performance on a risk-adjusted basis using consistent measures across segments.
- *Capital and Asset Allocation*: Quantitative framework to optimize asset allocation within AIG's global investment portfolio and allocate capital to businesses providing the most attractive risk-adjusted returns.
- *Capital Management*: Methodology for optimizing AIG's capital structure and lowering the cost of capital, in part through utilization of capital markets to leverage AIG's capital base more efficiently.
- *Mergers and Acquisitions*: Quantitative inputs into decision-making related to mergers, acquisitions, divestitures and strategic investments.
- *Risk Management*: Approach to analyze economic risks and benefits of investment strategies and risk mitigation through reinsurance and hedging programs.
- *Cost of Regulation and Ratings*: Framework for analyzing the cost of maintaining capital to meet rating agency and regulatory standards for capital required to be held in excess of the economic capital required to support AIG's risk profile.
- *Product Development*: Detailed approach to develop and price products to meet market demand and to maximize economic value added.
- *Management Compensation*: Framework to incorporate the importance of maximizing economic value added into management compensation programs. Commencing in 2008, the economic value added for each of AIG's business segments will be considered as an element, alongside other existing measures, in the evaluation of senior management performance.

AIG's economic capital model has augmented a review of certain segment specific business issues and assisted in the development of new business strategies. For example, economic capital analysis is now routinely incorporated into the assessment phase for certain mergers, acquisitions and divestitures, and in the assessment of specific capital markets solutions. In the reinsurance area, economic capital considerations are fundamental to the development of optimal risk retention and reinsurance strategies. In the Life Insurance & Retirement Services segment, the economic capital model has been used for product development, pricing and hedging strategies for living benefits in the variable annuity business. For life insurance products in Asian markets, enhanced asset-liability management strategies have been formulated for long duration liability structures and low interest rate environments in certain markets.

CONCLUSION

AIG will continue to use its economic capital model to help manage

- (i) capital requirements to support the growth of existing and new businesses that meet AIG's risk-adjusted return expectations,
- (ii) market demands to actively optimize AIG's weighted average cost of capital; and
- (iii) regulatory and rating agency capital requirements.

Economic Capital Modeling Results & Applications

AIG will use the results of the economic capital model as an effective tool in managing the competing demands for capital, optimizing risk-adjusted returns for AIG's investors and maintaining the capital strength required to support AIG's businesses and future growth opportunities. However, since the majority of AIG's regulators and rating agencies do not yet quantitatively recognize the results of AIG's internal model, AIG must continue to meet existing regulatory and rating agency requirements that in some cases are substantially different than AIG's economic capital requirements.