



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

February 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. Why did AIG implement an economic capital model?
- III. What is the current status and plan for 2008?
- IV. What are the key challenges?
- V. What are the results to date?
- VI. What are the alternatives for utilizing excess capital?
- VII. How do the rating agencies view economic capital?

This update summarizes the progress made by AIG on its economic capital modeling initiative and applications during 2007 and its plans for 2008. AIG's major progress in 2007 included the following:

- We completed two firm-wide full valuation economic capital calculations using year-end 2006 financial data and mid-year 2007 financial data, respectively. The year-end 2006 results indicated that, on a conservative basis, AIG had excess capital (the difference between available economic capital and required economic capital) in the range of \$15 to \$20 Billion, as at year-end 2006, as was communicated previously;
- We have also completed two "roll-forward" quarter-end estimates of AIG's excess economic capital, determined in each case using available prior period firm-wide full valuation calculations that are updated for our estimates of the change in available economic capital (allowing for net income, share repurchases, dividend payments and hybrid issuances) and the change in required economic capital over the period. Based on these estimates, AIG had excess economic capital in the range of \$16 to \$21 billion as at September 30, 2007, as was communicated previously. At December 31, 2007¹, consequent to additional share repurchases and unrealized market valuation losses in the fourth quarter of 2007, this range declined to \$14.5 to \$19.5 billion;
- We assessed alternative risk retention and reinsurance strategies, within a strategic risk management framework, for exposures to U.S. natural catastrophes for our domestic general insurance businesses. The analysis provided useful inputs to the structuring of reinsurance treaties that are economically beneficial to AIG and provide good protection under extreme events;
- We considered the economic costs/benefits of purchasing index-based excess of loss credit protection for our aggregate portfolio of reinsurance recoverables;
- We evaluated alternative asset allocation strategies that leverage AIG's financial strength, taking account of regulatory constraints and economic considerations as well as long-term total return vis-à-vis short-term volatility for our life insurance businesses operating in low-yield environments;

¹ This estimate is based on a roll-forward of the September 30, 2007 disclosure and will be "refreshed" consequent to the full model valuation update at December 31, 2007. The full model valuation update uses as inputs the published financial statements of AIG as at December 31, 2007 and is therefore expected to be available in May 2008.

Economic Capital Modeling Initiative

- We began incorporating economic capital analyses into our various strategic and business decision processes, such as certain completed, ongoing and potential acquisitions and divestitures;
- We facilitated active capital management processes for the Life Insurance & Retirement Services segment by incorporating economic capital analysis for potential transactions;
- We continued to assess capital mobility throughout the organization, developing principles and strategies to improve capital efficiency;
- We continued to engage in substantive discussions with rating agencies concerning AIG's enterprise risk management practices and economic capital applications;
- We have discussed, recommended and implemented a number of significant methodological enhancements in the area of market consistent valuations, economic scenarios, risk aggregation, capital fungibility and stress testing.
- We have engaged the following external experts to perform independent reviews and certifications of the economic capital model, and have made good progress in the review process:
 - Towers Perrin;
 - Barrie & Hibbert Limited;
 - Rutter Associates; and
 - The Department of Risk Management and Insurance at Georgia State University's Robinson College of Business.
- We initiated the design and implementation of a robust control environment for the calculation and reporting of economic capital based on industry best practices.

I. WHAT IS ECONOMIC CAPITAL?

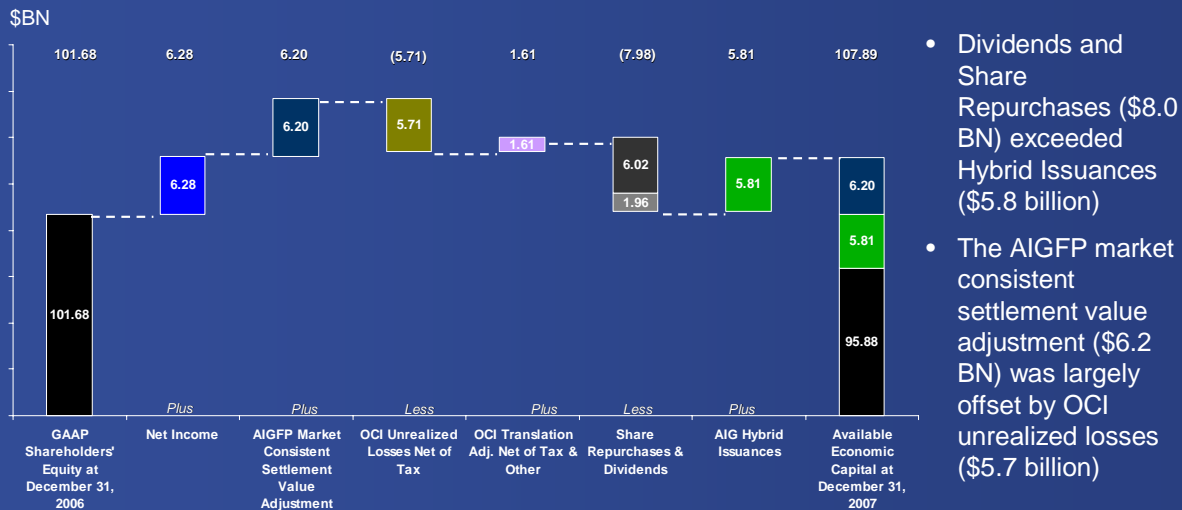
Economic capital is an assessment of the capital required to cover potential, unexpected losses within a target confidence level and timeframe. To be consistent with a strong and stable AA target rating, AIG's required economic capital estimates are calculated at a 99.95 percent confidence level and 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 with 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 hybrid capital issuances that receive substantial equity credit from rating agencies and reduced by share repurchases and dividend payments. During 2007, AIG's hybrid issuances totaled \$5.8 billion, while share repurchases, including payments advanced to purchase shares, and dividends paid totaled \$8.0 billion as illustrated in Exhibit 1 below.²

² As discussed in Section V, a "market consistent settlement value" adjustment has been made to GAAP Shareholders' Equity in the fourth quarter of 2007 for the purposes of determining AIG's available economic capital as at December 31, 2007.

Change in Available Economic Capital Year End 2006 to Year End 2007



During 2007, AIG's conservative estimate of Available Economic Capital increased by \$6.2 billion (i.e. \$107.9 less \$101.7 billion).

Exhibit 1

In the period to September 30, 2007, 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 intends to use "market consistent settlement value" as the basis.³

II. WHY DID AIG IMPLEMENT AN ECONOMIC CAPITAL MODEL?

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 For details of AIGFP's Market Consistent Settlement Value adjustment, please refer to the AIG, Inc. fourth quarter 2007 Conference Call Credit Presentation & Supplemental Materials dated February 28, 2008.

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 tool 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.

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.

III. WHAT IS THE CURRENT STATUS AND PLAN FOR 2008?

Commencing in 2005, AIG developed a firm-wide economic capital model that incorporates financial services industry best practices, reflects AIG's distinct global businesses and respects regulatory constraints. Utilizing stochastic simulation techniques, where appropriate, AIG has enhanced its existing models and developed new models working collaboratively with business executives, actuaries, accountants and risk professionals.

During 2006, AIG produced initial results for required economic capital at the consolidated, business segment and major profit center levels, using year-end 2005 financial data. AIG also carried out detailed analyses for selected businesses and products where economic capital results were applied for decision-making.

Throughout 2007, AIG's focus was on a wide range of business applications of the model together with the continued enhancement of the granularity of the model. For this purpose, AIG engaged a

panel of independent experts to provide further assurance to AIG's senior management, business segment executives and external stakeholders as to the validity of the model and its results for business segments and for AIG in the aggregate. The model has been developed by AIG's Enterprise Risk Management department in close collaboration with AIG's businesses. A comprehensive set of risk governance structures are in place supporting the model's inputs, assumptions and methodologies. During 2007, AIG completed two firm-wide full valuation updates of economic capital requirements, using year-end 2006 and mid-year 2007 financial data, respectively. AIG is in the process of calculating firm-wide full valuation economic capital requirements for December 31, 2007. The full model valuation update will use the published financial statements of AIG as at December 31, 2007, as inputs, and is therefore expected to be available in May 2008.

In 2008, AIG plans to extend the model's applications by building on the work performed in 2007 for a wider range of businesses, segments, geographies and product lines. 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. The capital planning and allocation process will continue to be enhanced by incorporating the regulatory, rating agency and economic capital requirements for business segments as well as the assessment of the mobility of excess economic capital.

IV. WHAT ARE THE KEY CHALLENGES?

Developing a consistent and comprehensive model for a global organization like AIG involves a number of challenges related to model consistency, data requirements and assumptions and organizational communication.

- *Model Consistency:* Substantial internal discussion, external assistance and model prototyping will continue to be required to ensure a consistent methodology for AIG's different lines of business which have very different risk profiles. Model consistency is a pre-requisite for aggregation across different lines of business.
- *Data Requirements and Assumptions:* Since economic capital modeling involves estimating unexpected losses at a very high confidence level, AIG has expended and will continue to expend significant effort in gathering available data and developing assumptions and parameters to support simulation-based modeling. Stress testing of model inputs and assumptions/methodologies supplements our efforts in this area. During 2007, AIG decided to split economic capital requirements into so-called Pillar I and Pillar II requirements. Pillar I economic capital requirements represent the requirements from simulation-based modeling at the chosen confidence level. In Pillar II, we apply a series of "severe" stress tests to determine capital "add-ons" to the Pillar I requirement 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 affecting AIG's various exposures to the sub-prime residential mortgage crisis in the US, etc. Pillar II requirements also reflect a "haircut" to the optimal diversification benefits captured under Pillar I for the regulated insurance businesses. This haircut allows for the impact of the applicable solvency capital requirements and reduced mobility of capital consequent to those requirements.
- *Organizational Communication:* A considerable amount of time and effort will continue to be spent communicating the terminology, purpose, approach, results and business applications at various levels of the organization around the world.

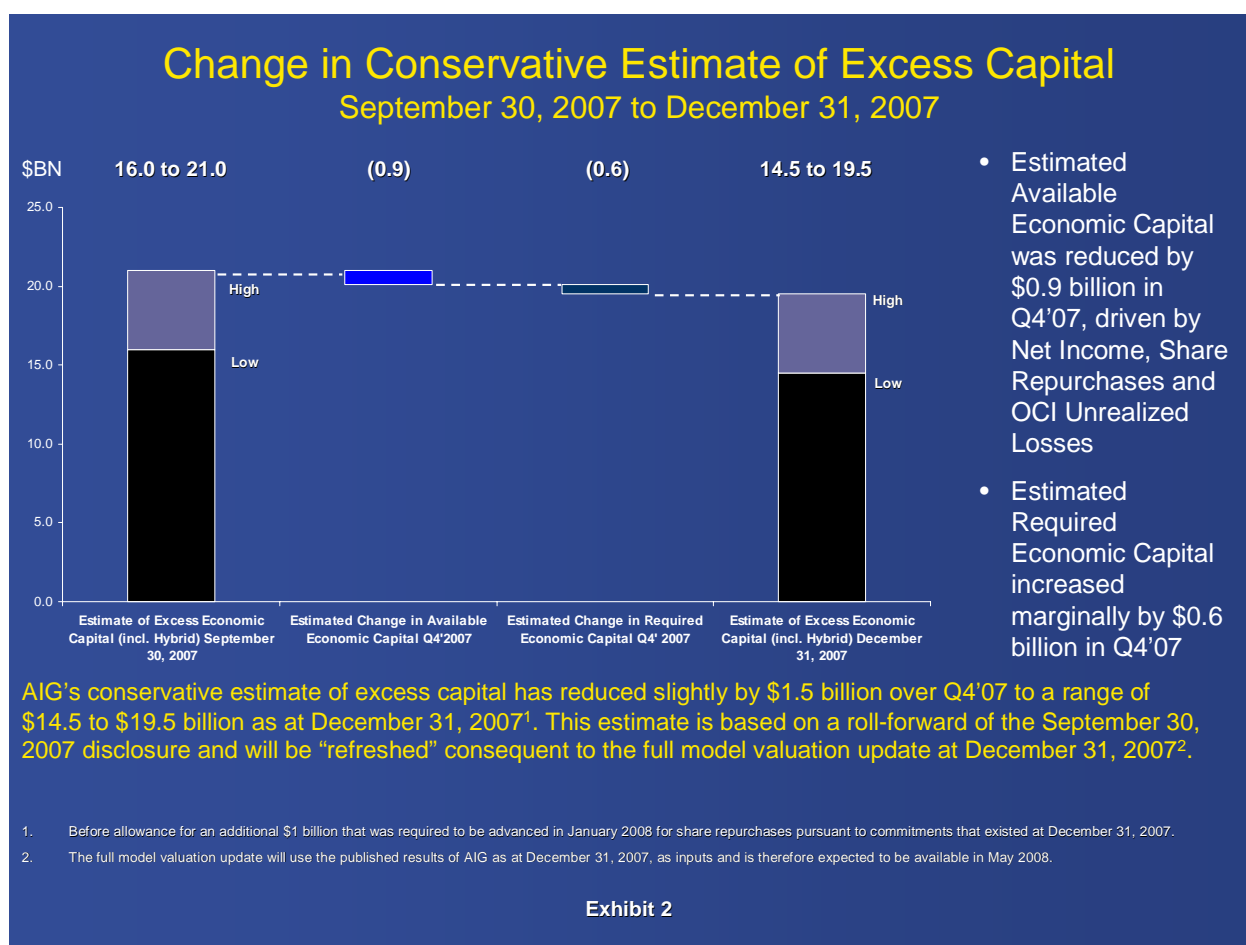
While each of these challenges has influenced the pace of work, AIG believes that the end product has been a far more robust and widely accepted framework for business decision making.

Economic Capital Modeling Initiative

V. WHAT ARE THE RESULTS TO DATE?

Excess capital is defined as the surplus of available economic capital over required economic capital. Analysis of AIG's firm-wide economic capital requirements using year-end 2006 financial data affirmed that at year-end 2006, on a conservative basis, AIG had excess capital in the range of \$15 billion to \$20 billion, as AIG has previously communicated.

We have also completed two "roll-forward" quarter end estimates of AIG's excess economic capital, determined in each case using available prior period firm wide full valuation calculations that are updated for our estimates of the change in available economic capital and the change in required economic capital over the period. Based on these estimates, AIG had excess economic capital in the range of \$16 to \$21 billion as at September 30, 2007, as was previously communicated. At December 31, 2007⁴, consequent to additional share repurchases and unrealized market valuation losses in the fourth quarter of 2007, this range declined to \$14.5 to \$19.5 billion as illustrated in Exhibit 2 below.

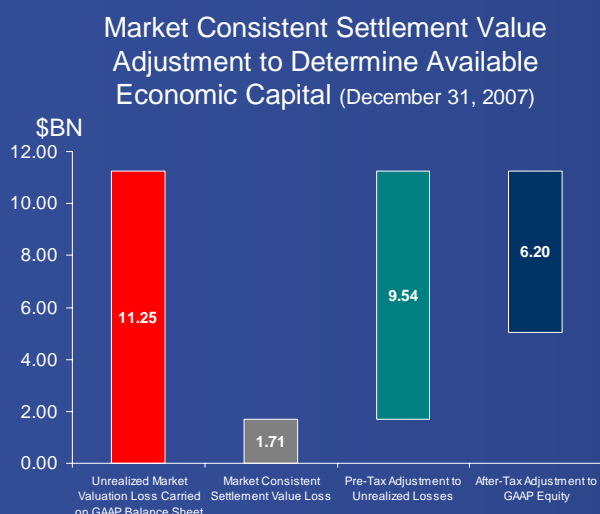


⁴ This estimate is based on a roll-forward of the September 30, 2007 disclosure and will be "refreshed" consequent to the full model valuation update at December 31, 2007. The full model valuation update will use as inputs the published financial statements of AIG as at December 31, 2007 and is therefore expected to be available in May 2008.

Economic Capital Modeling Initiative

AIG's estimate of excess capital as at December 31, 2007 incorporates an adjustment to the GAAP shareholders' equity as at that date based on the market consistent settlement value of AIGFP's Super Senior Credit Default Swap Portfolio on Multi-Sector CDOs as illustrated in Exhibit 3 below. 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 certify and review our estimate of market consistent embedded value for the Life Insurance & Retirement Services segment and to provide a consistent methodology for estimating available economic capital for the General Insurance segment⁵.

Adjustments Made to Unrealized GAAP Market Valuation Loss to Determine Available Economic Capital Under AIG's ECM



- At June 30, 2007 AIG used GAAP equity as a conservative proxy for Available Economic Capital
- For December 31, 2007:
 - AIG will use Market Consistent Embedded Value* as its estimate of Available Economic Capital for the Life & Retirement Services segment
 - For the General Insurance segment, a consistent approach will be used
 - These valuation approaches are consistent with the market consistent settlement value approach AIG has applied to FP's Super Senior credit derivative portfolio of Multi-Sector CDOs

* Currently being independently reviewed and certified by Towers Perrin.

For the purposes of determining Available Economic Capital, AIG believes it is reasonable to make a positive market consistent settlement value adjustment of \$6.2 billion in respect of the AIGFP Unrealized Loss to its GAAP Reported Total Shareholders' Equity as at December 31, 2007.

Exhibit 3

AIG intends to adopt "market consistent" settlement value as the principal measure of available economic capital. For tradeable assets and liabilities, this value reflects their market value without an adjustment for "own credit standing" for determining the value of liabilities. For non-tradeable assets and liabilities (e.g., those requiring use of "Level 3" inputs under FAS 157 under US GAAP), the market consistent settlement value represents the current estimated value of the asset or liability plus a risk margin for bearing risk out to settlement.⁶ No hypothetical "exit" from illiquid asset/liability positions is assumed at the valuation date under this methodology, which is generally

⁵ Towers Perrin expects to complete their review in the spring of 2008.

⁶ The risk margin has been calculated using the "Cost of Capital" methodology recommended by the CRO Forum for non-tradeable/non-hedgeable risks. (Refer www.croforum.org).

consistent with AIG's intentions or obligations under its policyholder and security holder contracts. AIG believes market consistent settlement value is a more appropriate measure for available economic capital, as it avoids imputing the characteristics of a hypothetical liquidation in times of market stress for illiquid assets/liabilities.

The key differences between current exit values (e.g. as defined under FAS157) and market consistent settlement 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 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 settlement or maturity;
- Current settlement value allows for the fundamental risk in AIG's illiquid asset or liability position by adding a risk margin for the fundamental risk to which AIG is exposed under its contracts, as an add-on to the best estimate discounted value of the relevant cash flows;
- The risk margin under a market consistent settlement value approach is determined using a "cost of capital" methodology in line with the recommendations of the CRO Forum for non-hedgeable/non-tradeable risks. 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 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.

VI. WHAT ARE THE ALTERNATIVES FOR UTILIZING EXCESS CAPITAL?

As a result of the need to meet rating agency and local regulatory requirements, not all of the estimated excess capital in the business units is readily available to be re-deployed or distributed. In addition, various frictional costs, such as taxes, may be incurred when moving excess capital from one jurisdiction or legal entity to another.

Efforts have been undertaken to analyze capital mobility throughout the organization. Over time, these analyses, combined with efforts to increase the awareness of both rating agencies and regulators of the merits and efficacy of AIG's economic capital model and the significant effect of portfolio diversification, may allow additional flexibility concerning the mobility of excess capital. These issues are considered within AIG's broader capital management strategy. Based upon the updated economic capital results and continuing analysis of the factors described above, AIG continues to consider a number of alternatives to utilize excess capital:

- *Growth Initiatives:* AIG continually evaluates the economic returns associated with utilizing its strong capital position to pursue business opportunities by providing new products, more capacity, higher risk retention and richer product features.
- *Dividends and Stock Repurchases:* In February 2007, AIG's Board of Directors adopted a new dividend policy, which took effect with the dividend declared in the second quarter of 2007, providing that under ordinary circumstances, AIG's plan will be to increase its common stock dividend by approximately 20 percent annually. The payment of any dividend, however, is at the discretion of AIG's Board of Directors, and the future payment of dividends will depend on various factors, including the performance of AIG's businesses, AIG's consolidated financial position, results of operations and liquidity and the existence of investment opportunities. In February 2007, AIG's Board of Directors also increased AIG's share repurchase program by authorizing the repurchase of shares with an aggregate purchase price of \$8 billion. In November 2007, AIG's Board of Directors authorized the repurchase of an additional \$8 billion in common stock. From March through December 31, 2007, AIG entered into structured share repurchase arrangements providing for the repurchase of shares over time with an aggregate purchase price of \$7 billion. At February 15, 2008, \$10.25 billion was available for share repurchase under the aggregate authorization approved by AIG's Board of Directors. AIG does not expect to repurchase additional shares for the foreseeable future, other than pursuant to commitments that existed at December 31, 2007.
- *Mergers, Acquisitions or New Business Opportunities:* AIG continually evaluates opportunities in mergers and acquisitions or new businesses that provide competitive advantages and generate risk-adjusted returns above AIG's cost of capital.

VII. HOW DO THE RATING AGENCIES VIEW ECONOMIC CAPITAL?

AIG's overall business is highly dependent on ratings from the major rating agencies. AIG began reviewing its economic capital modeling methodology with the agencies in the latter part of 2006. During the first quarter of 2007, AIG completed a first round of substantive conversations concerning its economic capital initiative with the four major rating agencies.

During the subsequent three quarters of 2007, various aspects and applications of AIG's economic capital model have been discussed and shared with rating agencies. AIG has also shared some of the enhancements implemented during 2007 (such as market consistent valuations, economic scenarios, risk aggregation, capital fungibility and stress testing) with the rating agencies.

As AIG continues to enhance its models and incorporate the results of the independent reviews currently under way, AIG will continue discussions with the rating agencies concerning its enterprise risk management processes, economic capital methodologies and its model results for their consideration in the rating process.

Each agency has its own method of evaluating capital which is in varying stages of development. The agencies are also developing frameworks for evaluating individual companies' economic capital modeling and the strength of their enterprise risk management practices. AIG is well placed to engage in these developments with the recent engagement of independent experts providing

external stakeholders with added assurance as to the robustness of the model and its results. AIG's estimate of excess capital incorporates diversification benefits across its many businesses, products and geographies, allowing for regulatory and other constraints on the mobility of capital. AIG intends to continue to highlight the importance and relevance of diversification in future discussions with the rating agencies given that their current models vary regarding the extent to which diversification benefits are incorporated. It is not clear when or to what extent the rating agencies will rely more significantly on AIG's economic capital model as a supplement to their own proprietary capital models.

CONCLUSION

AIG will need to balance (i) capital requirements to support the growth of existing and new businesses which meet AIG's risk-adjusted return expectations, (ii) market demands to actively manage shareholders' cost of capital, and (iii) regulatory and rating agency capital requirements. Balancing near-term and future opportunities will always require AIG to maintain capital in excess of that required to support its growth initiatives and target risk level.

Increasingly, 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.