From: Tagar Olson <olsot@kkr.com>
Sent: Tuesday, September 16, 2008 9:04 PM
To: Deryck Maughan <Deryck.Maughan@kkr.com>; George Roberts <george.roberts@kkr.com>
Cc: Henry Kravis <KRAVH@KKR.com>; Investment Committee <InvestmentCommittee@kkr.com>; Global FIG Team <GlobalFIGTeam@KKR.com>
Subject: AIG

George,

The AIG transaction has not yet been officially announced, so it is difficult to know the exact structure. However, based on what I have heard, the loan will be secured against all of AIG's assets and therefore be senior to AIG's other unsecured debt. As a result, I believe it will be money good.

If what I have heard is correct, they are using a structure very similar to what we had proposed (except that they are providing the entire loan - rather than finding third party providers - and are getting a contingent call on 80% of the equity - rather than our proposed 60%). If you assume that the economic losses against the CDS book (estimated by Blackrock at $11-$18bn) and other under-reserved amounts / questionable assets (the great unknown) are less than the value of their core insurance and other businesses (~$100bn of book value), this could be a very profitable trade for taxpayers.

Also, I think it's unlikely that the entire loan will be funded, particularly since government backing will likely relax the need to post additional collateral due to the ratings downgrade.

We will let you know more about the structure as we learn more details. Let us know of any questions. Thanks.

- The AIG Team

From: Deryck Maughan
To: George Roberts
Cc: Henry Kravis; NY FIG PE Team
Sent: Tue Sep 16 20:44:36 2008
Subject: AIG

Nothing yet on Treasury or AIG websites but here is the WSJ story. Tagar will comment further.

Wall Street Journal

The U.S government moved toward an emergency rescue of American International Group Inc. -- one of the world's biggest insurers -- signaling the intensity of its concerns about the danger a collapse could pose to the financial system.

The board of AIG approved a government-led rescue plan late Tuesday, according to people familiar with the matter.

The decision to provide a federal backstop for AIG came Tuesday as the federal government concluded it would be "catastrophic" to allow AIG to fail, according to a person familiar with the matter. Federal officials had tried to get the private sector to pony up funds during a three-day meeting in New York over the weekend.

But those efforts failed and with no private sector support forthcoming, Federal Reserve Chairman Ben Bernanke, Federal Reserve Bank of New York President Timothy Geithner and Treasury Secretary Henry Paulson concluded that federal assistance would be necessary to avert an AIG bankruptcy, which they feared would have disastrous repercussions throughout the financial markets.

Staff from the Federal Reserve and Treasury worked on the plan through Monday night. President Bush was briefed on the rescue Tuesday afternoon during a meeting of the President's Working Groups on Financial Markets.

The move is a dramatic turnabout for the federal government, which has strongly resisted overtures from AIG for an emergency loan or some intervention that would prevent the insurer from falling into bankruptcy. Just last weekend, the government effectively pulled the plug on Lehman Brothers Holdings Inc., allowing the big investment bank to fail instead of giving it financial support.

The precise details of the government's plans were still being formulated. The primary option being hammered out involved the Fed providing AIG with a short-term loan of $85 billion, according to people familiar with the situation. In exchange, the government would receive warrants in AIG representing the right to buy its as much as 80% of its stock under certain conditions, according to one person familiar with the matter.

That could put the government in a position to potentially control of a private insurer, a historic move, especially considering that AIG isn't directly regulated by the federal government.

The moves capped day of high drama in Washington, which was peppered with canceled meetings and speeches from top officials. Messrs. Paulson and Bernanke convened in the early evening an unexpected meeting of top Congressional leaders, including Sen. Harry Reid of Nevada, the majority leader, top members of the Senate banking committee and leaders, too, from the House.

Sen. Richard Shelby of Alabama said he didn't receive a "satisfactory" answer from Mr. Paulson in an early conversation about the ultimate scope of government intervention. "I laid out -- where do you stop? Where do you draw the line?"

The Federal Reserve appeared to be motivated in part by worries that Wall Street's financial crisis could begin to spill over into seemingly safe investments held by small investors, such as money-market funds that invest in AIG debt.

Indeed, on Tuesday the $62 billion Reserve Primary Fund, a New York cash-management fund, said it "broke the buck" -- that is, its net asset value fell below $1-a-share level that funds like this must maintain. Breaking the buck is an extremely rare occurrence. The fund was pinched by investments in bonds issued by now collapsing Lehman Brothers.

Money-market funds are supposed to be among the safest investments available. No fund in the $3.5 trillion mutual-fund industry has lost money since 1994, when Orange County, Calif., went bankrupt. A number of money-market funds own securities issued by AIG.

AIG's financial crisis intensified Monday night when its credit rating was downgraded, forcing it to post $14.5 billion in collateral. The insurer has far more than that in assets that it could sell, but it could not get the cash quickly enough to satisfy the collateral demands. Thus the interest in obtaining a bridge loan to carry it through.

That the government would prop up AIG financially offers a stark indication of the breadth of the insurer's role in the global economy. If AIG were to have trouble meeting its obligations, the potential domino effect could reach around the world.

For one thing, banks and mutual funds are major holders off AIG's debt and could take a hit if the insurer were to default. In addition, AIG was a major seller of "credit-default swaps," essentially, insurance against default on assets tied to corporate debt and mortgage securities. Weakness at AIG could force financial institutions in the U.S., Europe and Asia that bought these swaps to take write-downs or losses.

AIG's millions of insurance policyholders appear to be considerably less at risk. That's because of how the company is structured and regulated. Its insurance policies are issued by separate subsidiaries of AIG, highly regulated units that have assets available to pay claims. In the U.S., those assets can't be shifted out of the subsidiaries without regulatory approval, and insurance is also regulated strictly abroad.

Tuesday afternoon, after the market closed, AIG put out a statement saying its basic insurance and retirement services businesses are "fully capable of meeting their obligations to policyholders." AIG said it was trying to "increase short-term liquidity in the parent company," but said that didn't "include any effort to reduce the capital of any of its subsidiaries or to tap into Asian operations for liquidity." Asia is one AIG's largest markets.

Where the company is feeling financial pain is at the corporate level, even while its insurance operations are healthy. If a bankruptcy filing did ensue, the insurance subsidiaries could continue to operate while in Chapter 11, or could also be sold.

Still, a collapse of the parent company would have huge ripple effects. The urgency of federal aid came into stark relief Tuesday as other options fell off the table and pressures continued to built. On Tuesday, AIG's attempt to raise as much as $75 billion from private-sector banks failed. The banks advising the firm concluded it would be all but impossible to organize a loan of that size, making the government AIG's chief hope.

As a result of the credit downgrades, AIG has to post $14.5 billion in collateral to bolster its credit rating. In the debt markets, AIG also has to post additional collateral to investment banks and others it trades with.

Crisis on Wall Street

Concerns about AIG's future are prompting some of its clients to close out their accounts, further exacerbating the situation, according to a person familiar with the matter.

Adding to AIG's woes, investors continued to pummel the company's stock on Tuesday, pushing the share price down another 21%, to $3.75. It was the third double-digit percentage decline in the last three trading days.

Federal officials worked throughout the day to help the company forestall a possible bankruptcy filing. Insurance regulators in New York, where AIG is based, are also working on a plan to let AIG move some assets into and out of its subsidiaries in order to be able to borrow up to $20 billion against some of them. But a spokesman says the department is confident it is protecting policyholders.

"Our deal is contingent on a broader solution to AIG's problems," says the department spokesman, David Neustadt.

AIG's cash squeeze is driven in large part by losses in a unit separate from its traditional insurance businesses. That financial-products unit, which has been a part of AIG for years, sold the credit-default swap contracts designed to protect investors against default in an array of assets, including subprime mortgages.

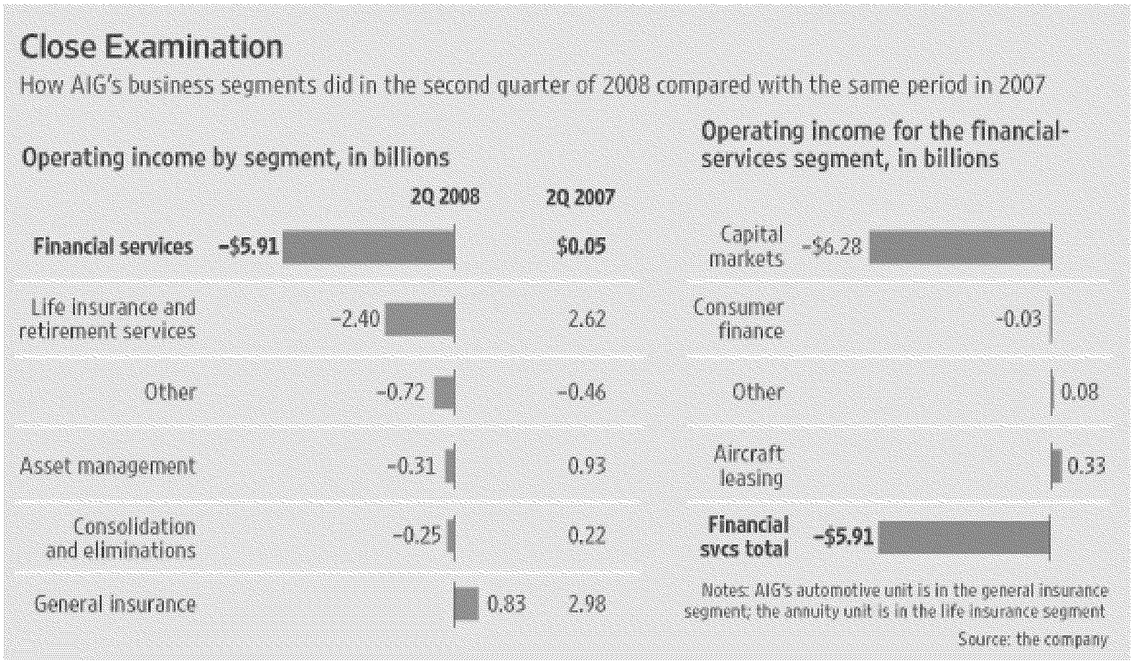
But as the housing market has crumbled, the value of those contracts has dropped sharply, driving $18 billion in losses over the past three quarters and forcing AIG to put up billions of dollars in collateral. AIG raised $20 billion earlier this year. But the ongoing demands are straining the holding company's resources. Further losses in the third quarter are increasing the tension.

That strain contributed to the ratings downgrades on Monday. Those downgrades, in turn, ratcheted up the pressure on the company to come up with more cash, quickly.

As confidence in the company's fate has plummeted, the amount it feels compelled to raise to calm its many constituents continues to rise. Though $40 billion was the figure over the weekend, it climbed to 75 billion on Monday and, according to a person close to the company, to $100 billion on Tuesday.

The rapid escalation in its potential needs has raised the spectre of bankruptcy. In preparation for a possible bankruptcy filing, AIG has hired New York law firm Weil Gotshal & Manges to advise it. Weil is also working for Lehman Brothers Holdings Inc., which filed for Chapter 11 bankruptcy protection earlier this week.

Experts say insurance bankruptcies are somewhat rare, partly because the insurance industry is largely governed by state law and therefore largely barred from using the federal-bankruptcy system.



The ratings downgrades also triggered a provision in some of AIG's large commercial insurance policies that allow holders to cancel the policies and recoup some of the premiums they paid, according to people familiar with the matter. It's not clear whether policyholders are exercising that right.

But insurance brokers are contending with worried clients who have policies issued by AIG. Daniel Glaser, the head of the brokerage unit at Marsh & McLennan Cos. (and a former AIG executive) posted a letter to customers on the company's Web site saying that AIG is "facing a liquidity crisis." Nonetheless, Mr. Glaser wrote that AIG meets the broker's "financial guidelines," despite recent rating downgrades. "Therefore, we have no restrictions on the use of AIG insurance company subsidiaries for client placements," Mr. Glaser wrote.

In Asia, where AIG operates a wide network of businesses, its affiliates sought to reassure clients that they had sufficient capital to meet all policy claims. Regulators in India, Hong Kong, Singapore and Thailand said local AIG units have enough capital to cover their obligations. Regulators in China said they were monitoring the situation.

Customers outside the U.S. accounted for 79% of AIG's insurance premiums last year, with Japan and Taiwan among its largest markets.

Despite reassurances from regulators that their policies were covered and warnings that cancellations could lead to losses, dozens of people lined up outside AIG-affiliated offices in Singapore. Some waited for three hours to be attended by staffers. Others said that they wanted to make sure that their policies are safe, while others said they would cancel their policies.

—Jon Hilsenrath, Diya Gullapalli, Serena Ng, Damian Paletta and Ashby Jones contributed to this article.

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