AMERICAN INTERNATIONAL GROUP, INC.

MEMORANDUM – CONFIDENTIAL

DATE: FEBRUARY, 2008
TO: FILES
FROM: E. HABAYEB
CC:
SUBJECT: REGULATORY CAPITAL TRANSACTIONS

Objective

The objective of this memorandum is to describe the valuation of the European residential mortgages and mapped corporate loan deals (the transactions) entered into by Banque AIG, a subsidiary of AIGFP, with third-party banks for regulatory capital purposes.

Main Characteristics and Business Driver

AIGFP writes Credit Default Swaps ("CDS") on the super senior risk layers of designated pools of prime European residential mortgages or corporate loans through its European banking subsidiary, Banque AIG, to financial institutions, principally in Europe. The primary purpose of these transactions is to allow the counterparty financial institutions to help meet relevant regulatory capital requirements for the referenced assets in the CDS.

At December 31st, 2007, AIGFP was party to such transactions with a notional exposure of $379 billion ($230 billion on the corporate loans-mapped transaction portfolio and $149 billion on the residential mortgage portfolio), of which approximately $77 billion were placed in the fourth quarter of 2007 and $54 billion have been terminated in 2008, of which $44 billion are corporate loans portfolios and $10 billion are residential mortgages portfolios (approximately $5 billion of the terminated transactions represents a transaction entered into in late 2007). Therefore this analysis focused on the remaining portfolio, which amounts to $262 billion.

The regulatory benefit was particularly useful under the pre-Basel II Accord ("Basel II") regulatory capital framework that existed through the end of 2007. Prior to the adoption of the Basel II approach to measuring minimum capital requirements, no distinction was made for regulatory capital purposes between riskier layers of pooled mortgage securities and a super senior risk layer. Hence, a bank was required to hold capital against the entire portfolio and no reduction in the requirement was afforded when the risk of loss was remote. One of the means for a bank to reduce its required regulatory capital was to purchase credit protection from a regulated financial institution, such as Banque AIG, in order to benefit from such regulated financial institution's lower risk weighting.

With the full implementation of Basel II by EU member states on January 1, 2008 (and subject to individual country transition rules), European banks will no longer need to enter into CDS transactions with Banque AIG in order to reduce their regulatory capital requirements with respect to super senior tranches of pooled mortgages securities. The new regulatory framework recognizes and gives credit to the super senior risk layer, which means less capital is required to be held against this tranche. The value proposition for the CDS transactions disappears, once a bank has implemented a model that is compliant with Basel II and has obtained an approval from their respective regulators to put the model in use. In most cases, depending on the application and interpretation of Basel II by the national regulator, there is a parallel run period (usually three years) during which the banks must calculate their capital requirements under both Basel I and Basel II. This three-year phase-in of Basel II is a safeguard to ensure that no bank would be permitted to operate under Basel II until it has proved ready to do so. Accordingly, a bank will be able to move from the parallel run to live Basel II capital calculations with typically a 95 percent floor during the first year after it has received approval to do so from its primary supervisor, based on a thorough evaluation of its model and its ability to calculate risk-based capital requirements using the Basel II framework. A similar approach would be taken for the 90 percent and 85 percent floors applicable in the second and third transition years. After the third year of floors, a bank will be able to move to the full Basel II risk-based capital calculation without floors. Therefore, the pace at which the CDS transactions will terminate will vary across the counterparties based on a number of factors notably their progress in having their internal models approved by their national regulator and the parallel run period requirements. In any case, AIGFP expects that the counterparties in the CDS transactions will gradually terminate the trades with AIGFP during this transition period and typically within the next 12 to 18 months as their models get approved and the capital requirements become more favorable under the phasing-in of Basel II

Each of the CDS transaction is bespoke in nature. The terms of the transactions (including premium/fees, reference obligations, attachment points, detachment points, triggers, termination rights, amortization, and credit support arrangements) are negotiated to meet the counterparty's specific needs and at the same time afford Banque AIG the maximum level of protection. These terms vary from transaction to transaction. Therefore, the key business driver for these transactions is essentially based on a specific regulatory need and cannot be uniformly determined, since different counterparties will be motivated to varying degrees by different factors.

The counterparties enter these transactions for regulatory purposes not for credit risk management purposes. This is notably illustrated by a conversation between AIG and BNP on February 25th, 2008. Representatives from Banque AIG (Andrew Forster & Amos Benaroch) along with Elias Habayeb from AIG Inc. had a call with Emmanuel Deboaisne at BNP who was the person responsible for structuring two of the Super Senior trades that we have transacted with BNP (Global Liberté IV and V).

AIG asked BNP what their intent in entering these transactions with AIGFP is was of today. Emmanuel Deboaisne confirmed that BNP still viewed both trades as an important part of the bank's regulatory capital management. He indicated that BNP's intent was and remains the need for capital relief. He also indicated that their internal ratings based model had been approved by their national regulator (Commission Bancaire). However they are now in a transition period and will continue to monitor their need to maintain the Super Senior CDS for capital relief until the requirements they are subject to under Basel I phase out and move to Basel II and the CDS then become unnecessary. He made reference to the fact that they had already reduced these two trades by 20% of their original notional amounts (in accordance with the documentation) because BNP's overall loan origination volumes had declined and hence BNP had less need for regulatory capital relief.

The regulatory-based motivation of these transactions is also evidenced by the fact that a significant number of trades have been terminated during the first two months of 2008 ($50 billion, excluding the transactions entered into during the fourth quarter of 2007). If the motivation of the counterparties were to obtain credit protection through the CDS with AIGFP instead of capital relief, they would have maintained their positions with AIGFP instead of terminating them as what happened in early 2008. Indeed, as indicated by the level of the CDX or ITRAXX indices at year-end, it would have probably been more costly for the counterparties to go and buy credit protection on their portfolios in comparison to the premiums they were paying to AIGFP as of Dec 31st, 2007. Therefore it would have made no economic sense for the counterparties to terminate theses transactions, if their motivation and intent were to enter the transactions for credit protection purposes, since the CDS were typically in-the-money for the counterparties, depending on the benchmark, and would have represented an inexpensive form of credit protection.

Recent Increase in the CDX/ITRAXX Indices

The spreads of credit indices such as the CDX, ITRAXX or ABX have widened significantly over the past few months, notably since July 2007 and the turmoil in the US credit markets. This has notably been illustrated in an analysis performed by representatives of Banque AIG where ABS Spreads with RMBS underlying from different countries are shown to have widened. This trend raises the question whether the counterparties in the CDS transactions might change their motivation from capital management to credit risk management.

AIG does not believe that the recent increase in the indices will prompt the counterparties to undergo such a change in motivation. First and foremost the motivation of the counterparties to enter these transactions was and remains regulatory-driven as epitomized by the BNP call on February 25th 2008. The best evidence of the counterparties' regulatory intent lies in the $54 billion that have been terminated in early 2008. Although these indices have been widening since July 2007, more than 17% of the transactions have been terminated in the first two months of 2008. The fact is that terminations are actually taking place in accordance with the progressive implementation of Basel II and in spite of the current widening of the spreads. This further demonstrates that credit risk management is not an incentive to enter or extend these transactions beyond their useful life i.e. so long as they provide any capital relief to the counterparty.

Referenced Assets / Markets and Credit Monitoring

As previously mentioned, there are two types of portfolios: (1) the mapped corporate loan portfolios comprised of bilateral and syndicated loans, most of which are not rated by the major rating agencies, secured and unsecured, from small and medium-sized entities in different regions of the world; and (2) the residential mortgage portfolios, which include prime mortgages mainly issued to borrowers in the Nordic European countries, France, Germany, the Netherlands and the U.K and Spain to a lesser extent. These markets have not experienced, even remotely, the degree of credit deterioration that has affected the US market. They have much smaller sub-prime residential markets, have not had as much high loan-to-value lending, are better regulated, and continue to report positive, albeit declining home price appreciation. For these very reasons the regulatory capital transactions book must be apprehended differently from the multi-sector CDO book. Although both benefit from high subordination, the underlying pools are very different in nature. One is exposed to the US market and suffers from current market issues such as increasing defaults and foreclosures while the other is exposed to a completely different environment with fewer defaults, better LTV ratios, and markets with stronger underwriting credit policies.

The underlying portfolios in these transactions continue to perform well. The current corporate loan portfolios notional have an average attachment point of 24.7% against a historical loss rate of just 1 basis point. The worst Value-at-Risk (W-VaR) analysis demonstrates that all deals remain super senior, with none showing W-VaRs above the attachment point. Default rates have not risen materially and continue to run at close to historical lows. Only two of the 59 (i.e. 3%) of the corporate loan portfolios show defaults over 1% as of year-end: Promise I Mobility 2005-1 (1.33%), an early 2005 trade; and Promise-1 2002 (5.1%), a seasoned trade that has been terminated in 2008. In addition, only three deals reflect any realized losses in the underlying collateral pools at all, and none are larger than sixty basis points. Only four deals totaling $14.5 billion, all originated in 2006, have W-VaRs to subordination over 90%, the largest of which is Sea Fort/Sampo, a Finnish corporate loan trade.

The European residential mortgage portfolio has an average attachment point of $18.3% against a loss rate of 3 basis points. Here again, most attachment points have increased over time. Only two deals out of 34 transactions (i.e. 6%) have realized losses in the underlying collateral pools over 1% as of year-end (see attached schedule below for more details):

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AIG Credit Risk Management has determined that there was no evidence in any of these transactions that would suggest that a significant credit deterioration has occurred or is about to occur. Indeed a memorandum issued by Credit Risk Management on Feb 23rd, 2007 (see attachment below) indicates that none of the Super Senior regulatory capital trades shows any serious deterioration as of 12/31/2007. Notably, the memorandum discusses the worst Value-at-Risk (W-VaR) calculated for each of the transactions and highlights the fact that in each case the W-VaR is beyond the attachment point, thus preserving the super AAA credit rating equivalent of the CDS transactions. Furthermore, many deals have seasoned and the attachment points have actually increased over time. .

AIGFP monitors those transactions closely and on a continuous basis. While AIGFP is highly comfortable with the risks in these trades and believes that its risk position is very remote, AIGFP continues to constantly monitor and assess all of its trades. Such work is performed daily with further formal quarterly meetings involving representatives from trading, risk, legal and credit. All of AIGFP portfolios are reviewed every three months and the results formally noted and presented to AIG. It is clear from these results that the portfolios are not displaying any material change in credit quality. The levels of defaults and delinquencies along with the degree of credit migration continue to follow the same historical paths as expected at inception of all of the trades. The portfolios remain exceptionally solid and in many trades our attachment point is actually becoming even more remote as natural amortization increases our effective seniority (see below).

The mortgage trades only cover prime European mortgages and the delinquency rates in that sector continue to stay at or near historical lows. All of the delinquency rates are tracked and recorded by AIG's Credit Officers. In the corporate loan sector, deal performance is also tracked for each deal and none is currently displaying any heightened cause for concern. Small rises in loss rates may well occur in the future as this is expected with natural economic cycles but none will likely cause real concern given AIG's extremely remote attachment points, which as mentioned above also typically rise through time on many transactions as the portfolios naturally amortise.

All of AIGFP's portfolios are positively selected at inception and AIGFP takes care in creating risk averse, highly diversified portfolios that are expected to outperform the general portfolio of the counterparty even in an economic downturn. As credit transfer is not the motivation of these trades, the counterparties are also happy to allow for this positive selection. To the greatest extent possible, AIGFP excludes sectors or names that it perceives could be problematic during the life of the trades.

Therefore, the credit quality of the portfolios is not expected to deteriorate to the point where the counterparties would change their views or intentions to maintain the CDS in place, so long as the capital relief provided by these CDS transactions is needed.

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Early Termination

In order for these transactions to be recognized from a regulatory perspective, their legal maturity date must match the legal maturity of the underlying assets. However, the counterparties want to be able to exit these transactions upon their adoption of models compliant with Basel II requirements. Without such an ability, the counterparties may be bound into transactions that are costly past their need for such transactions under Basel II given that they do not enter these transactions for credit risk transfer purposes. Accordingly, as part of the negotiations and structuring of the CDS, Banque AIG works with the counterparties to determine their needs and offers them a customized structure that gives the counterparty the ability to exit the transaction sooner than the scheduled termination. The contracts typically have a termination clause or call provision, whereby the counterparty can call the transaction following a regulatory event or, specifically, the implementation of Basel II, and/or whereby the counterparty can early terminate for any reason after a certain pre-determined time period. This was accomplished in a number of ways:

- Some transactions include explicit regulatory call provisions. In the event of a regulatory change (including adoption of Basel II), the counterparty can exit the transaction.

- On some deals including those with regulatory calls, a call was included that enables the counterparty to exit the transaction by 2008 or early 2009, concurrent with when the counterparty expected to have obtained regulatory recognition for the ability to apply reduced regulatory capital requirements against super senior securities tranches.

- On a handful of deals where the deals were expected to have amortized significantly during 2008, a call may not have been included on the premise that most of these assets would have been amortized by then. For example, in the cases of Fortis and Westpac, the transactions have no call option; however, the underlying assets are very short in tenor and will amortize within a one- or two-year time period from when the CDS was written.

Should the counterparty elect to early terminate the transaction (such as in the case of regulatory calls), the early termination is at no cost, assuming Banque AIG has already received any agreed minimum fee amount, which is generally specified in terms of a fixed dollar amount less fees paid to date or a make-whole provision equal to the present value of certain remaining fees, had the counterparty not cancelled the transaction early (refer to section on pricing below). Typically, the minimum guaranteed fee on recent transactions is equal to the premiums due to Banque AIG through the first call date (which is the first date on which the counterparty can cancel at no cost).

Irrespective of the structure of the transaction, each transaction was structured in a manner to enable the counterparty to exit around the same time as the new rules regarding regulatory capital credit for super senior layers of securities were expected to become effective to it.

As previously mentioned, the recent termination activity by Banque AIG's clients provides further evidence that these transactions are motivated primarily by regulatory capital management needs and not risk transfer needs. By January 2008, approximately $54 billion notional of such transactions were already canceled. Such termination activity would not be expected in such a market, if risk transfer were even now the primary motivation. For AIGFP's counterparties those instruments were in-the-money and would have provided an inexpensive form of credit protection in comparison with the premiums that would have been required on the markets, if we take the CDX/ITRAXX indices as an indicator. Therefore, from a pure credit risk viewpoint the counterparties would have had no economical reason to call the trades, as it would have been more costly to replace them in the market. These transactions were terminated because the counterparty no longer needed them after the implementation of Basel II. For instance, the mapped corporate portfolio (Promise-I 2002-1) with the highest level of default (5.1%) in the corporate loan category was terminated in early 2008. Also AIG has obtained direct confirmation from BNP that it indeed entered into the transactions with AIGFP for regulatory purposes only and continues to view these transactions as regulatory motivated. AIGFP expects that these regulatory capital motivated transactions will be terminated in the future due to the implementation of Basel II and in no cases AIGFP will be required to make any payment as part of the early termination. On the contrary, AIGFP may receive a termination payment from the counterparty in cases where a minimum fee is guaranteed.

The 16 transactions that have been terminated in 2008 (five of the residential mortgages portfolios for a $10 billion exposure and eleven corporate loan portfolios amounting to $44 billion) are reflective of and in no way different from the rest of the CDS portfolio that remains in existence as of today. They were all capital motivated and represent a meaningful sample of the entire portfolio as they were entered into from year 2000 to September 2007, their default rates range from 0.0% to 5.1%, the notional amounts vary between $656 million to $10 billion, the subordination level ranges from 8.15% to 98.14% and the W-VaR from 0.03% to 11.74%. They also involve different counterparties located in different countries such as Commerzbank, ING, IKB, Barclays, DB and Standard Chartered. Therefore the transactions that have been terminated do not share any specific common pattern that would differentiate them from other transactions. They all have been entered for capital relief purposes like the other remaining transactions.

Attached below is a listing of the transactions terminated in 2008.

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One of the main consequences of the key regulatory capital motivation behind these transactions is that the determination of the premium on these transactions is not a function of a pricing model that incorporates external market factors. Instead, the size of the premium is determined through a negotiation process between Banque AIG and the counterparties. Given the remote level of risk that Banque AIG will be exposed to through these transactions, credit spreads and other market indicators of credit risk are not a factor in sizing the premiums. The features that most influence the determination of such premiums are the amount of capital relief afforded to the counterparty, the counterparty's specific situation and motivation for capital relief, the level of effort required on Banque AIG's part, along with ensuring an acceptable profit, and Banque AIG's skills at negotiating the premium. For example, the more the counterparty is under regulatory capital pressure, the higher the fee. Hence, the pricing takes into account entity-specific considerations. Consequently, in some cases the premiums received by Banque AIG are higher in comparison with previous transactions having substantially the same terms. This again is essentially driven by the specific needs of each counterparty and how much the counterparty values its own need for regulatory capital relief. This has notably been the case during the fourth quarter of 2007 when premiums received by Banque AIG have significantly increased. One example is a transaction entered into with Hypo Real Estate in December 2007. The premium charged by AIGFP was 30 bps and clearly reflects the strong need for capital relief by the counterparty at this time. AIGFP negotiated its premium according to the demand and benefited from the specific situation of Hypo Real Estate at the end of the year 2007. Given the recent market turmoil, certain banks had heightened concerns with regards to their overall regulatory capital positions and hence wanted to reduce the capital they needed to hold against certain low economic risk portfolios of assets. This demand was specifically due to the fact that certain banks were required to consolidate other assets (e.g. SIVs) during this period and/or were unable to monetize their assets through their normal methods (such as securitizations), as such methods were not generally available during this period. Banque AIG principally targeted the banks where it: (1) already had an existing and strong relationship; (2) understood their internal credit processes; and (3) knew they had increased needs for regulatory capital relief in this period of time.

Under Basel II the banks will be able to implement models that provide more favourable regulatory capital treatment than under the current regulatory environment. The banks that have their internal models approved by their respective regulators under Basel II will no longer need to enter into these types of regulatory capital relief transactions. As these new capital rules are now in place and an increasing number of banks are obtaining regulatory approval for their internal models, these CDS transactions will lose their economic rationale and are therefore expected to be terminated early by the counterparty banks. This will save the banks the cost of the premium without increasing their regulatory capital requirements. For instance, one of the transactions entered into during Q4 2007 with Deutsche Bank and two with Barclays have been early terminated in January 2008 as a consequence of Basel II implementation.

Consequently, Banque AIG has structured its most recent regulatory capital transactions to ensure that it will earn a sufficient level of premiums over the shorter expected lives of the transactions (due to the prospect of Basel II implementation) to meet its minimum target profit and cover its costs. This is achieved by charging a higher basis point fee and, in most cases, establishing a minimum period during which the premiums will be paid. The basis point fees in the recent transactions appear to be higher than those for similar trades previously entered into by Banque AIG. However, since these trades are expected to be of much shorter duration than the previous transactions and can be early exited within a very short notice period, and Banque AIG has insisted on a minimum level of return for the effort involved, the counterparties to these transactions have accepted the higher basis point fee as fair pricing for these transactions.

As a result of the above, premiums obtained from current transactions are not indicative of premiums from past transactions. While the premium on recent trades is generally higher than the premiums earned on earlier transactions, the increase in the premium is not indicative of a change in value of the older portfolio. Furthermore, as indicated above, the expected average lives on the recent transactions are far shorter than on the past transactions. The transactions entered into in the fourth quarter of 2007 have an expected average life of approximately 12 to 18 months, as compared to previous transactions with an expected life in excess of 4 years.

Fair Value Measurements

SFAS 157, *Fair Value Measurement* (the Statement), issued in September 2006, paragraph 5, defines fair value as the price that would be received to sell an asset or paid to transfer a liability in the market in which the reporting entity would transact for the asset or liability, i.e., the principal or most advantageous market for the asset or liability at the measurement date.

This definition of fair value retains the exchange-price notion contained (either explicitly or implicitly) in many earlier GAAP definitions of fair value. However, in accordance with FAS 157 fair value is based on the exit price (the price that would be received to sell an asset or paid to transfer a liability), not the transaction price or entry price (the price that was paid for the asset or that was received to assume the liability).

Conceptually, entry and exit prices are different. The exit price concept is based on current expectations about the sale or transfer price from the perspective of market participants. Under FAS 157 a fair value measurement should reflect all of the assumptions that market participants would use in pricing an asset or liability.

This Statement emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, this Statement establishes a fair value hierarchy that distinguishes between: (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs); and (2) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The notion of unobservable inputs is intended to allow for situations in which there is little, if any, market activity for the asset or liability at the measurement date. In those situations, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity must not ignore information about market participant assumptions that is reasonably available without undue cost and effort.

This Statement clarifies that market participant assumptions include assumptions about risk, e.g. , the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique. A fair value measurement should include an adjustment for risk, if market participants would include one in pricing the related asset or liability, even if the adjustment is difficult to determine.

Availability of Market Observable Information and Fair Value

In evaluating how to determine fair value, one must consider available market information and what assumptions would a market participant make about the valuation of these derivatives. With respect to the regulatory capital relief transactions, there are very few market participants with the same attributes (from the counterparty's perspective) as Banque AIG, and there are no observable market data, such as indices or spreads, that can be used to estimate a fair value for this portfolio of derivatives. In addition, the derivatives are deep out-of-the money and do not change much in value until they are close to the attachment point.

Another difficulty lies in the fact that the referenced assets are carried and measured on an accrual basis by the counterparties. As such, they do not provide any fair value indication in the Super Senior CDS transactions between AIGFP and the counterparties.

Finally, the pricing on Banque AIG's regulatory capital transactions is not a data point that is available to a market-place participant. A market-place participant willing to take on a position from Banque AIG will need to perform its own analysis of the economic fundamentals of the reference assets, as no other information is likely to be available. AIGFP believes that the price that would be received to sell the CDS or paid to transfer the CDS as of December 31st, 2007 is negligible, given the ongoing changes in the regulatory environment and the prospect of Basel II. Therefore, there is no exit price, and the entry prices observed are customer specific and therefore not relevant from a FAS 157 perspective. The most relevant indicator lies in the price provided by the settlements under the exercise of the calls. This is the most appropriate price, as it is supported by evidence of the $54 billion transactions that have been cancelled in 2008 as of today.

Collateral Calls

Some of the capital relief transactions include collateral call provisions.

Reg Capital Review
Chart_#696593.DOC

The requirements of the collateral postings vary by counterparty. AIGFP has reviewed the terms of the collateral calls for each trade to establish how and whether they could help AIGFP determine a value for the Super Senior CDS. They have concluded that the collateral arrangements do not provide valuable information regarding the fair value of the CDS derivatives. The collateral calls are much more likely, in AIG's opinion, to be a reflection of the perceived creditworthiness of AIG rather than the trade itself. The counterparties want to ensure that they can continue to demonstrate to their regulators that they have an effective trade in place with a creditworthy counterparty and the existence of a CSA helps them with that objective. In the current environment, the need to demonstrate that they have an effective hedge with a creditworthy counterparty has potentially increased.

There are only 17 of the regulatory capital trades on the list that are currently subject to CSAs or where exposure under the CSA has not been set to zero (although there are further trades where a downgrade of AIG below a certain rating would mean a CSA for that trade may be put in place). As there is no way to mark the trades to any discernible market, the method of the theoretical valuation varies across trades (please refer to the file showing those trades with CSAs and how the valuation process works). Most of the trades simply use defaults and declining credit enhancement to help them value the trades. A few, such as two from BNP (Global Liberté IV and V), further discussed below, and the trades with Standard Chartered take a different approach and use a combination of credit indices as a proxy. As of December 2007, none of these trades had had a collateral call against them. In February 2008, there was a call from BNP under Global Liberté IV and V of $51mm and $69mm, respectively. These calls are, in our view, simply a reflection of the collateral mechanics that are in place and cannot be taken as substantive evidence of any material decline in credit quality or change in view from the counterparty as to the purpose of the transaction. These trades continue to form an important part of each counterparty bank's regulatory capital management.

BNP had entered into previous transactions with AIGFP without collateral call requirements. However, due to an increasing exposure to AIGFP, BNP required that a CSA be established as a risk mitigant. Absent any observable data and market prices, BNP decided to use movements in the CDX and ITRAXX indices and a blend of the two indices as a proxy and the driving factor for collateral calls in its Super Senior transactions with AIGFP. However, AIG believes that this reference to the CDX and ITRAXX indices is not correlative of the fair value of the Super Senior CDS themselves, because the transaction is entered into for regulatory purposes only. Again this has been confirmed during the call Elias Habayeb and Andrew Forster had with BNP on February 25th, 2008. Their contact in BNP indicated that he was not familiar with the collateral calls made on Global Liberté IV and V but confirmed that BNP's collateral calls are an automated process and that, once a trade is agreed, the collateral terms are entered into a system that produces automated collateral calls when applicable. BNP viewed the specific CSA valuation methodology in the Global Liberté trades (which uses spreads on tranches of the Itraxx and CDX indices) as the best approach available at the time of the original transaction, but he agreed that the methodology was not reflective of the trades' value (which he thought was not possible to ascertain accurately given the lack of available prices in the market). BNP also confirmed that they will exit these transactions as Basel II phase in. Additionally, the BNP trades' underlying assets are mostly unrated and illiquid and for a number of them secured corporate loans, while the CDX's and ITRAXX's have rated and unsecured underlying credits. In addition, the time horizon of the ITRAXX and CDX indices used by BNP is 5 years, while most of the underlying assets in the portfolio are shorter dated. Finally, AIGFP does not believe that using this blend of indices as a valuation proxy for the BNP transactions and a different approach for other transactions with different counterparties is appropriate or relevant, as all the transactions, whether with BNP or another counterparty, are capital-motivated, and their motivation is no different from each another. Again BNP confirmed that this was indeed the rationale for entering into the Super Senior CDS with AIGFP.

Conclusion

It is our opinion that the fair value of these contracts continue to approximate their book value amount at December 31, 2007.

A key basis for this conclusion is that these transactions can be and are expected to be terminated by the counterparties in the short-term for no cost other than the pre-determined minimum fee with Banque AIG. Sixteen transactions representing about $54 billion and 17% of transactions have already been cancelled in the first two months of 2008, as the regulatory environment is changing and Basel II starts being implemented by the counterparties. These transactions were entered into primarily for regulatory capital management purposes, not for risk management. Had they been entered into for risk management purposes, they would have been most likely maintained, as they provided an inexpensive form of credit protection to the counterparties. The fact that the credit indices such as the CDX and ITRAXX have significantly widened since July 2007 without deterring the counterparties from terminating these sixteen transactions in January and February 2008 provides further evidence that the transactions were not entered into for credit risk management purposes. Indeed at the time of termination, the premiums paid by the counterparty to AIGFP under the CDS were inexpensive in comparison to the spreads of these indices. Given the adoption of Basel II in Europe, these transactions are of decreasing value to the counterparties, as their principal benefit and purpose cease to exist. Market participants would not necessarily pay the same substantial premium if they were to enter such transactions today. Furthermore, while the recent transactions may carry a higher premium rate, the reasons Banque AIG is charging a higher premium are: (1) Banque AIG targeted banks under regulatory capital pressure: and (2) Banque AIG adjusted the premium rate, such that it earns a minimum fee over a shorter duration.

Additionally, the transactions are bespoke and are not actively traded. Their pricing stems from a highly negotiated process, is not determined by market factors and cannot be linked to a valuation technique applicable to the underlying assets. As such, prices of new transactions are not indicative of prices of previous transactions. Moreover, the valuation of the transactions does not necessarily reflect the assumptions that market participants would use in pricing them, since they each have unique aspects pertaining to non-observable attributes (such as the degree of need to obtain regulatory capital relief). Given the unique nature of these transactions and the lack of observable market information, it would be difficult to attribute any value to these contracts, and their book value remains the best estimate of their fair value in the absence of an exit price.