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OTS (CK Lee) Letter to AIG Board Of Directors re Supervisory Concerns

C.K. Lee

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Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6035

C. K. Lee

Complex and International Organizations

March 10, 2008

American International Group, Inc.
Attention: Anasztasia D. Kelly, Executive Vice President, General Counsel
and Senior Regulatory and Compliance Officer
70 Pine Street, 27th Floor
New York, NY 10270

Members of the Board:

I am writing to inform you that the disclosures contained in the Form 8K filed on February 11, 2008 by American International Group, Inc., (AIG), supplemented by discussions with Price Waterhouse Coopers (PwC) and AIG management raise supervisory concerns regarding the corporate oversight of key AIG subsidiaries. Recent discussions also indicate that these concerns are shared by other functional supervisors of AIG. We are concerned that the corporate oversight of AIG Financial Products (AIGFP), International Lease Finance Corporation (ILFC), and American General Finance, Inc. (AGF) lacks critical elements of independence, transparency, and granularity.

A material weakness exists within corporate management's oversight of AIGFP's super senior Credit Default Swap (CDS) valuation process and financial reporting. Recent supervisory review work and discussions with PwC indicate that AIGFP was allowed to limit access of key risk control groups while material questions relating to the valuation of the super senior CDS portfolio were mounting. The control groups included Enterprise Risk Management (ERM), the Corporate Comptroller's Group, and the CFO of the Financial Services Division.

The super senior CDS valuations reviewed by corporate management lacked the accuracy and granularity necessary to understand the impact of key valuation components on AIG's accounting and financial reporting disclosures. Corporate management did not obtain sufficient information to completely assess the applicability of the negative basis adjustment, a critical component of the valuation method. In view of this occurrence and the observed similarity in reporting by other key subsidiaries, we are concerned that risk metrics and financial reporting provided to corporate management by AIGFP and other key subsidiaries may lack the independence, transparency, and granularity needed to provide effective risk management oversight.

We note that two business units, AGF and AIGFP, limited their exposures to subprime markets in view of deteriorating market conditions, while two other units, United Guaranty Corporation and AIG Investments, increased their subprime exposures. The lack of a cohesive mechanism to share information on subprime exposures leads to incomplete central oversight across the conglomerate.

In light of the identified material weakness in the oversight of the valuation of the super senior CDS portfolio, and gaps noted within corporate oversight, we have downgraded AIG's holding company Risk Management, or "R" CORE component rating.

Risk management practices need improvement to ensure that management and the board are fully able to identify, monitor, and control all significant risks.

We have downgraded AIG's holding company Earnings "E" CORE component rating

This action reflects our supervisory concern with the high degree of earnings volatility that currently exists due to the holding company's exposure to the US subprime market. Though we also acknowledge the demonstrated earnings strength of the holding company to absorb material unanticipated losses, the significant negative impact to earnings from the super senior CDS portfolio valuation adjustment, combined with the portfolio's potential to significantly impact future earnings, are of increased supervisory concern.

We have also downgraded AIG's holding company Composite rating

Given the seriousness of this matter, please respond by providing a corrective action plan to address our concerns contained in this letter. The following elements will be important factors in our assessment of your corrective action plan: (1) correction of all control weaknesses over financial reporting relating to valuation methods; (2) demonstrated improvement of central corporate oversight of AIG's key subsidiaries including AIGFP, ILFC, and AGF; (3) meaningful benchmarks to measure the effectiveness of corrective actions; and (4) monthly progress reports. Please provide your written response and the corrective action plan to OTS no later than 30 days following receipt of this letter.

This letter is provided to the holding company for its confidential use. Except as provided in 12 C.F.R. Section 510.5, the holding company, its directors, officers, or employees may not disclose this letter, or any portion of it, to unauthorized persons or organizations. Unauthorized persons or organizations include anyone not officially connected with the holding company as an officer, director, employee, attorney, auditor, independent auditor, subsidiary institution, or affiliated holding company.

If the holding company receives a subpoena or other legal process calling for production of this document, notify the Managing Director, Complex and International Organizations immediately. Advise the attorney and, if necessary, the court of the above prohibition and refer them to 12 C.F.R. Section 510.5.

If you have any questions, please call me at [REDACTED]. If I am unavailable, please call Alexandria Luk, Acting Director, Conglomerate Operations at [REDACTED].

Sincerely,

C.K. Lee
Managing Director, Complex & International Organizations

Attachment:
Federal Register Notice, OTS Savings and Loan Holding Company Rating System