PWC Notes re Meeting to Discuss Super Senior Valuations and Collateral Disputes

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Notes of a meeting to discuss Super Senior valuations and collateral disputes 11/29/07 at 8.30 am.

Attendees: M Sullivan; S Bensinger; M Roemer; Bob Lewis; Staisha Kelly; E Habayeb; Bill Dooley; D Herzog; K Shannon. By Phone J Cassano; A Foster; P Miccuits all of AIG. T Ryan; B Sullivan; H Daubeney of PwC

TR explained that the purpose of the meeting was to discuss the impact of the collateral and understand their interactions with the AIGFP SS valuation.

A spreadsheet was handed out summarizing the latest position with Goldman Sachs (GS)

JC: The current market segment is in chaos and there is a major dislocation. This is not exchange traded hence no values that way. Also he said that they was no formal dispute with anybody but GS they were still in discussions with other counterparties over their valuations.

MS confirmed there were disagreements and not disputes with other counterparties.

JC noted the GS issues are around the data - where can you get representative marks. As the market is so dislocated and in a state of panic it was very difficult to get marks for the underlying collateral. FP had 22,000 separate bonds that needed valuing. GS had priced internally (generically priced and rolled back via a model to arrive at a price.) FP did not have the data to dispute GS’ value and hence reached a standstill agreement - it was agreed to disagree however FP placed $1.95bn in cash with GS and FP will come back to GS with their view of value.

Currently getting market prices for every collateral item from the CDO managers. Eg for Dunhill managed by Vanderbilt - prices are obtained from the trustees of the underlying bond. (Latter get market price).

PM they went to the legal confirms to get the data - hence the prices are for cash items not CDS (ie MV of reference obligations). Need to reflect that there is some difference between bond and CDS prices due to cost of cash. When markets are stressed the differences generally increases. Do not have ABS evidence, but look at the auto sector could get a 150-200bp differences.

JC need to model underlying obligors and assess the impact. One of the key inputs is to check for prices and hence assumptions for spreads. Need to quantify CDS spread to the cash and could be as much as 10% but this is subject to review/change. Theoretically you could look in a gain by hedging the position by purchasing the cash security at the lower price than the CDS.

BS noted that we are seeing convergence in the market to undertake a detailed and granular analysis of what is happening and using this for the valuation of the positions.
JC FP are "going to ground" rebuilding everything to come up with a value for the SS but an issue is around the integrity of the inputs - for example the head of CDO trading at JPMC said they did not do a single trade in this month (November).

TR pointed out this was a major management judgment and will be based upon all the securities and the ability to get and calibrate market data. Clearly the collateral calls were a major data point in this process and their impact on the FP valuation will need to be fully understood.

JC Collateral calls are part of business. There are standard terms of ISDA GSA. Valuing SS is much harder than a 2yr IRS hence the dialogue about where the valuation is - working with counterparts to resolve - JC does not see this as a material issue with GS or any of the other counterparts.

JC noted if we agreed to GS values could be an impact of $6bn for the quarter.

MS noted this would eliminate the quarter's profits, SB agreed. JC noted this was not what he was proposing but illustrative of a worse case scenario.

SB what are we going to say about additional write down? JC could be another $2.5bn - ie value of $3.5bn and $1bn already disclosed but this is before any structural or basis benefits have been factored in and the number is still subject to review so too early to say. (107 $500m: 11/5 $1bn: 12/7 $1bn) pure high level estimate.

TR re-iterated the need to ensure the impact of the collateral dispute and disagreements be factored into FP's valuation and that management should ensure they did all in the powers to gain as much market information as possible about how there counterparts were undertaking their valuations.

The meeting ended.

After the meeting there was a separate meeting between SB MS and MR of AIG and TR, BS and HD of PwC.

TR explained that as a result of a number of issues that PwC had identified over the last 6 months he wanted to raise a concern that he had around the roles and responsibilities over risk management. He wanted management to be aware of his concerns as soon as they had arisen as he wanted to ensure there were no surprises late in the processes.

Specifically the following issues have arisen:

The late adjustment by FP to their SS valuation in Q3 as well as the posting of the $2bn of collateral without an active involvement of ERM and senior management. Also the way in which AIGFP have been "managing" the SS valuation process - saying PwC will not get any more information until after the investor day presentation.

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Secondly the issues in AIG Investment around the securities lending and the fact that if the exposure had been known prior to the q2 10Q being issued it is highly likely that the disclosures would have been changed.

Thirdly the independence of the UGC risk and finance functions and the $1bn error identified in their exposure disclosures in the analyst presentations.

Fourthly the fact that a trader in Nan Shan entered into a $1bn trade in a single company on one day.

Finally the fact the FP and AGF in late 2005 were reducing their exposure to sub prime while AIG Investment and UGC were increasing theirs - seemed to show a lack of cross AIG evaluation of risk exposure to a sector.

While clearly no conclusions had been reached and TR wanted MS and SB to be aware that we believe this items together raised control concerns around risk management which could be a material weakness,

SB did not agree that these were necessarily 404 issues and also disputed a material weakness.

TR reiterated PwC were in the early stages of their analysis and was raising the issue in the spirit of transparency and no surprises. Clearly we would need to discuss the issue in more detail but wanted management to be aware of our concerns.

MS was surprised but appreciate the early raising of the issue - he felt there had been much progress and felt FP and AGF had done a good job. However he was keen to avoid an MW and committed to do whatever had to be done to do that. He wanted TR to work with his team to fully understand the issue and implement whatever compensating controls were needed to avoid an MW.

TR committed to doing that and acknowledge these were initially thoughts but felt he had a responsibility to management to share them so there were no surprise.

As a final point he also highlighted what a significant judgment the SS valuation is going to be and FP and AIG need to get as much corroborating information as possible including from the collateral counterparties.

HJ Daubeney