AIG PWC Section I Audit Committee document extracts Detailed Section on Super Senior

PricewaterhouseCoopers (PWC)

American International Group, Inc. (AIG)

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AIG Financial Products

Key Estimates, Significant Judgments and Key Audit Procedures

Super Senior Valuation

We have detailed in this section of the report the evolution of the valuation of the AIGFP Super Senior credit derivative portfolios, and the key judgments and estimates management have made.

AIGFP's portfolio of Super Senior transactions as at December 31, 2007 comprised of the following:

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>Notional Exposure</th>
<th>Fair Value at December 31, 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multi-sector CDO</td>
<td>$78,205</td>
<td>$(11,236)</td>
</tr>
<tr>
<td>Corporate</td>
<td>70,387</td>
<td>$(226)</td>
</tr>
<tr>
<td>Regulatory</td>
<td>378,742</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>$527,334</td>
<td>$(11,462)</td>
</tr>
</tbody>
</table>

Corporate Portfolio

AIGFP's Corporate portfolio comprises 36 transactions with a total net notional at risk to AIG of approximately $68 billion. Approximately half of the portfolio unwinds within two years, with the majority of the book expiring within 8 years.

For the second and third quarter, this book had been evaluated against the BET model, using the relevant market information for the assets underlying the portfolio of each transaction. This showed no significant change in value between the second and third quarter.

As the effect of the subprime events spread to other markets (including corporate assets) and the economic outlook in the US and Europe deteriorated in the fourth quarter, and after discussions with PwC, AIG management evaluated alternative techniques to assess the fair value of this book. They decided that a more appropriate method was to make a comparison against observable indices such as the CDX (primarily US investment grade assets) and the iTraxx (primarily European investment grade assets). This comparison more fully captures the change in market perceptions in the structured product over the fourth quarter arising from the increased market volatility.

The mark-to-market charge on the portfolio for the fourth quarter using this approach was $177 million

This approach can be validated by a simple comparison of market spread levels versus the weighted average spread on the AIGFP portfolio. As the chart below shows, spreads on the two senior tranches of each of the indices widened towards the end of 2007, and in doing so causes a mark-to-market loss on the AIGFP book when compared against the levels the AIGFP contracts were written.
The mark-to-market losses recorded for both the year ended December 31, 2007, and for the quarter ended September 30, 2007, appears reasonable when compared against the index.

Going forward, this portfolio will need to be further calibrated to the CDX and iTraxx indices, and the sensitivity of the portfolio at this point is approximately $21 million per basis point change in the market level of spreads. In other words, if the average spreads for the portfolio were to approximately double, reflecting a widening of spreads by 20 basis points, the adverse effect to AIG would be approximately $420 million.

Regulatory Portfolio
Management is currently finalizing its evaluation of the regulatory trades. It believes that these trades have structural differences from the Corporate and multi-sector CDO transactions. The rationale for these transactions is to enable the counterparty to obtain regulatory relief, they are pay as you go and in the majority, the counterparty has the ability to exit after a regulatory event, e.g., Basel II. The pricing is more of a fee-based pricing and not risk-based. Since the year end, about $50 billion of these trades have either been unwound or AIGFP has been notified of the counterparties' intent to unwind them. In some instances, the counterparty is paying to get out of the trades. Management believes that these unwinds confirm that they do not contain credit risk transfer. Furthermore, given that some counterparties are paying to get out of the trades, management believes this supports its view that the existing fair value of zero is appropriate.

We are still reviewing management's analysis and evidence, and will report our findings to the Committee at the meeting.

Multi-sector Portfolio - CDOs of ABS
The multi-sector CDO ABS market has seen dramatic changes over the last six months as the subprime crisis has evolved. As a result, AIG management devised a valuation approach using the Moody's Binomial Expansion Technique (the "BET" model) for its super senior CDS and then refining this model to better reflect market changes as they have occurred.

These developments reflected both the use of the BET model as well as changes to the sources and inputs used to derive the value for this book.
Recap of Third Quarter Approach

The model developed during the third quarter was to apply a modified version of Moody's BET model which was adapted to derive actual loss profiles for the portfolio using market observable credit spread data.

Consistent with some other market participants at that time, AIG applied generic credit spread information for synthetic products obtained from JP Morgan Chase as the inputs into the model during the third quarter. This provided a basis for management's assessment of the mark-to-market at the end of the third quarter of $352 million.

At the end of the third quarter, the calculation of the benefits that accrue to AIG through the "waterfall" was not sufficiently supportable and hence was not recorded in the September results, but was disclosed in the 10-Q. The "waterfall" refers to the way that cash flows are diverted in the underlying transactions to accelerate the paydown of the senior noteholders interests as the performance of the underlying assets deteriorates.

Evolution of the Model and the Market Through the Fourth Quarter

During the fourth quarter, the evolution of the model and inputs continued. During this time, the credit environment deteriorated significantly. This was accompanied by a recognition in the market that particular vintages of assets, those related to 2006 and 2007 issuances, were more susceptible to losses than earlier vintages. Furthermore, the JPMC spread information applied previously was becoming less relevant as input because it began to reflect the credit spreads on new issuances with enhanced underwriting criteria, and not the credit risks that were inherent in pre-existing transactions.

The chart below shows the deterioration over the second half of 2007 on the ABX 2006-1 index. Although the AIG portfolio is typically 2005 and earlier transactions, the ABX 2006-1 index from the first half of 2006 represents the most similar observable index for comparison. The graph below shows the bond price equivalents for this index over time, and shows the further significant deterioration during the fourth quarter of 2007 for the AAA which most reflects AIG's exposure.
Due to management's concern over the JPMC's data, they sought and were able to obtain for a large number of the values of the specific bonds acting as collateral within the structures over which protection had been written. This involved AIG requesting collateral managers to provide them with underlying collateral prices which was not something the managers had done previously. AIG was not always successful in doing this and for December 31, 2007 they had obtained prices for approximately $77 billion of the total collateral of $99 billion underlying these transactions. These inputs replaced the JPMC data as the primary source of information for deriving credit spreads.

By using the underlying collateral prices rather than the JPMC spread data the model was now calculating a value for the cash bond upon which protection was being written and not the actual CDS. This introduced a potential basis difference called "negative basis" which we discuss later.

Another significant driver of the change in value for the portfolio is the market deterioration. The written credit protection can be considered akin to a written put option, where the protection buyer (AIGFP's counterparty) can sell the asset back to AIG at par in the event of default. As with any option the change in value is non-linear - the option value is extremely insensitive to the price changes in the underlying assets as the likelihood of the option being exercised is very small i.e. what happened in the third quarter. As the likelihood of the option exercise increases, the value of the option becomes more sensitive to the changes in prices of the underlying assets, to the point at which the option passes a "tipping point" (close to the attachment point of the CDS) it becomes probable of being exercised, the value of the option tends to mirror the changes in the prices of the collateral.

This feature is illustrated in the graph below. The "tipping point" for many of the transactions was surpassed in the fourth quarter, as such the portfolio became much more sensitive to changes in the price of the underlying collateral.
This sensitivity in pricing is effectively illustrated in the table below which shows the number, BET model value and notional of the SSCDS that had passed their attachment point at the end of the third and fourth quarters, based on the BET model values:

<table>
<thead>
<tr>
<th>Date</th>
<th>No. of deals with BET loss</th>
<th>Notional at risk on these deals</th>
<th>Raw BET model valued loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>September 30, 2007</td>
<td>41</td>
<td>$30.2 billion</td>
<td>$223 million</td>
</tr>
<tr>
<td>December 31, 2007</td>
<td>89</td>
<td>$58.7 billion</td>
<td>$8,053 million</td>
</tr>
</tbody>
</table>

Of the 41 deals in September that had surpassed the "tipping point," only 9 deals had losses greater than 1% of the notional at risk. The remaining deals were close to the tipping point and would start to suffer directly as the market deteriorated further. Of the 89 deals in December, 49 deals had losses greater than 10% with an average loss of over 13% of the notional at risk (i.e. well past the "tipping point").

The final development that management undertook during the fourth quarter was the building of a Monte Carlo simulation onto the BET model which enabled them to model the structural benefits for each of the individual Super Senior contracts. The effect of including these structural benefits was a benefit of approximately $600 million.

Collateral Disputes
As reported to the Committee on November 6, 2007, AIGFP had received a number of collateral calls from counterparties which were below the value that AIGFP had recorded for the Super Senior CDS.
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on their books. During the fourth quarter, PwC became increasingly concerned about the size and number of the collateral disputes. We discussed with senior management at AIG the need to understand these data points and how they may impact AIG's valuation methodology and approach.

At PwC's request, AIG Corporate management met with Goldman Sachs in January 2008. In connection with the debrief on the GS meeting between management and PwC, it became apparent that obtaining additional third party quotes from other market principals for the specific cash bonds was an approach that AIG should pursue further. As such, we requested AIG to, wherever possible, obtain such quotes themselves. Via this exercise and using the data from the collateral counterparty valuations AIG was able to obtain a high level of coverage from third party sources as to the value of the specific cash positions on which AIG had written credit protection.

This was factored into the valuation as discussed below.

"Negative Basis"
As described above, during the fourth quarter one of the key evolutions in the valuation of the Super Senior CDS was to move from generic credit derivative spreads from JPMC to actual prices or spreads on the underlying collateral within the CDO of ABS structures.

This change in approach meant the value derived by the BET model was for the equivalent cash position and not the actual CDS instruments written by AIG. In normal markets, there is a difference between the yield on the cash bond and the credit derivative which is known as a "basis adjustment". In the Super Senior market the cash bond historically paid a higher yield than the CDS and hence the term "negative basis adjustment" became relevant, representing the amount one needed to reduce the yield on the cash position by to get to the CDS valuation.

During our audit of management's proposed negative basis valuation adjustment of approximately $3 billion at December 31, 2007, it was apparent to us and management that the evidence management had collected was not sufficient to demonstrate the existence of the "negative basis" for these specific positions in the current market conditions. The impact of not recording the negative basis adjustment is discussed below.

Development of the Mark-to-market Levels for the 10-K Reporting
The initial estimate of fair value provided by management in early January showed a mark-to-market loss (the "mark") for the portfolio of approximately $6.4 billion, which was then adjusted as follows:

<table>
<thead>
<tr>
<th>BET model output</th>
<th>$billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benefit of cash flow diversion</td>
<td>(0.6)</td>
</tr>
<tr>
<td>Benefit of &quot;negative basis&quot;</td>
<td>(3.0)</td>
</tr>
<tr>
<td>Proposed mark-to-market</td>
<td>2.8</td>
</tr>
</tbody>
</table>

During the course of our audit procedures and discussions with management, the mark evolved, with some of the key changes and judgments noted below:

- **Negative basis**: Although the concept is recognized in the capital markets in certain products, management was not able to obtain sufficient independent market information to demonstrate that the basis existed in the current market environment and could be reliably quantified to adjust the value of the book. This resulted in a reversal of the $3.0 billion benefit applied above.

- **Errors in inputs**: Refinements to the model inputs were noted as being required as a result of our audit procedures performed. These impacted the way that prices and credit spreads were derived
from the information obtained from the underlying collateral managers resulted in approximately $0.6 billion of adverse adjustments, with over $900 million of absolute errors identified.

**Treatment of 2a-7 puts:** Within the portfolio of transactions, certain contracts are written as "2a-7 puts" which have strongly similar economic characteristics to the normal portfolio CDS transactions. The decision to include these transactions in the overall valuation process was evaluated and considered to be appropriate, and consistent with that treatment adopted by other market participants.

**Roll-forward of prices:** The initial valuation was based on the information available at the end of December, which primarily related to collateral manager prices "as of" the end of November. These prices were updated in early February based on prices obtained during the month of January which reflected market values as of the end of December 2007. This resulted in a deterioration of the BET model output from $6.4 billion to approximately $8.0 billion.

**Evaluation of third party data:** As discussed above, during the course of investigating some of the significant collateral disputes between AIGFP and their counterparties, further information was obtained that indicated quotes on the cash position could be obtained. As the information on this was gathered by management it became apparent that a range in values for the portfolio could be inferred to be between $8.0 billion (BET value) and $13.7 billion (based on the lowest of the unadjusted third party data).

In evaluating the variety of different evidence that AIG had accumulated in connection with its process to value the Super Senior CDS, management made reference to the Center for Audit Quality's white paper "Measurement of Fair Value in Illiquid (or Less Liquid) Markets". This paper provided clarification of existing guidance in FAS 133 and FAS 157 around how to estimate fair value in the challenging markets that existed during the fourth quarter of 2007 and continue to date. Specifically, it noted that evidence of market transactions needed to be considered in determining fair value and such information should not be presumed to be "fire sales" without strong evidence to support that argument.

Consequently, AIG undertook a deal by deal review of all its multi-sector Super Senior CDS to assess the relevance of the third party data obtained. Management created a set of rules that they followed in performing the exercise and these are detailed below. While there are management judgments within these rules we believe they provide a reasonable basis upon which to evaluate the output of the model against the third party data collected.

**AIG rules for evaluation of super senior pricing**

1. If the BET value is the lowest or the only data point use the BET value

2. If the BET value and the highest of the third party value are within ten points of each other use the average of BET and third party (Rationale for 10% is this is a reasonable view of the bid/offer spread and hence AIG will always be within 5% of the third party price, which is consistent with what AIG Investments are applying on its AFS book)

3. Where the value is a Goldman Sachs ("GS") value this will be adjusted up by 7% being the average difference between GS values and third party values provided by GS. This is done based on the GS conferences call and follow up call with GS where GS indicated that their values were low quotes and open to negotiation.

4. If the difference is more than 10%:
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a. Take the highest of the third party data (if exiting would always exit to the highest quote); and
b. Undertake individual review of transactions to confirm reasonableness of third party data. If no issues book third party value; or
c. Undertake a review using the NAV, comparing the value of the Super Senior position to the implied value of Junior tranches and if the Super Senior position is lower make a systematic adjustment ("equilibrium" pricing)

5. If any value is >95, cap at 95 as in the current market management does not believe values above 95 would be attained, hence implying a spread of 5%.

As a result of this approach, the final valuation for the Multi-Sector portfolio was determined to be $10.9 billion.

Sensitivities and Other Judgments
Due to the stressed nature of the current market, the single most significant driver to the ongoing change in the value of the portfolio is the valuation of the underlying collateral. At current valuations for the underlying bonds, the valuation of the contracts moves almost directly with each 1% drop in asset prices adversely impacting the value of the Multi-Sector portfolio by close to 1% of the notional amount at risk i.e. approximately $700 million. The average change in prices for the underlying collateral between the end of November and the end of December was approximately 2.5%, with a corresponding change in the BET value of approximately $1.6 billion.

At this point, the portfolio is much less sensitive on a relative basis to changes in the other inputs. Management's analysis shows that the order or magnitude of small moves in other inputs is much less significant

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Single Unit Move</th>
<th>Book Sensitivity to Single Unit Move</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diversity Score</td>
<td>+1</td>
<td>+$9.6mm</td>
</tr>
<tr>
<td>Recovery Rate</td>
<td>+1%</td>
<td>+$14.5mm</td>
</tr>
<tr>
<td>Weighted Average Life</td>
<td>+1 year</td>
<td>-$354mm</td>
</tr>
</tbody>
</table>

Source: BET Model Sensitivities*, Peter Robinson & Martin Cloke, 21 January 2008

Nevertheless, in time if the markets return to a more normal environment and greater transparency emerges over losses and asset pricing, the ability of the BET or other model to respond to changes in these input factors will become more relevant and perhaps require additional analysis.

PwC Audit Procedures
Given the difficulties management experienced in estimating the value of its liability and the new material weakness, we expanded our scope surrounding the Super Senior credit default swaps. The audit procedures undertaken by PwC can be broken down into 3 primary areas addressing the BET model inputs, the evaluation of the BET model itself, and the evaluation of the final pricing matrix applied by management. Note that the procedures below relate solely to the multi-sector CDO portfolio.

BET Inputs
- Tested transaction data back to 3rd party source (Intex) and tied into the BET model inputs
- Tested flow of ratings and transactional information back to Bloomberg system downloads

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- Tested (with IAD) information related to diversity score and asset industry classification back to trustee reports and other information sources
- Tied prices for underlying collateral back to external collateral manager sources, and tested the creation and application of the matrix prices for those assets for which direct prices were not available
- Tested other inputs e.g. recovery rates back to 3rd party sources
- Tested structural benefit features back to Trust Indentures and other agreements and validated back to work performed by Cadwalder (external law firm) and the implementation into the BET model
- Reviewed sample transaction documents to support management's assertions regarding the nature and structure of the transactions.
- Performed analytical review over the pricing inputs, evaluating collateral managers, ratings and vintage comparisons, linkage back to index sources, NAV (net asset value) comparisons etc.
- Review of management's validation back to IDC pricing used by AIGGIC for collateral manager prices. Average differences are approximately $3.5 (per $100) for the whole population, and $2 (per $100) if those variances greater than $10 are excluded.

**BET Model**
- Review of the model approach applied including management's validation documentation
- Review of C++ coding used to build the model
- Independent implementation of key elements of the model calculations
- Independent sensitivity analysis and comparison against AIG's own sensitivity analysis
- Interaction with ERM and review of their review process

**Final pricing matrix**
- Tested collateral manager pricing information back to collateral counterparty correspondence
- Tested 3rd party pricing quotes back to support provided by management
- Tested BET model prices back to final BET model output
- Tested application of management's rule set for evaluating prices

**PwC observations on AIG's process**
During our audit, we raised to management several concerns associated with AIG's Super Senior credit default valuation process, which, when resolved, led to material changes, and which ultimately led to the conclusion that a new material weakness at December 31, 2007 existed in the valuation and oversight thereof associated with the Super Senior credit default swap valuation process. The details and circumstances behind this weakness have been discussed with the Committee at our February 6, 2008 and other meetings with Committee members, and we are pleased to address these details again, if necessary. These concerns are described in the material weakness description in the "Results of Sarbanes-Oxley Procedures" section of this report. Notwithstanding the new material
weakness, both management and PwC were able to perform expanded and sufficient procedures to obtain comfort that the valuation was fairly stated at December 31, 2007.

Conclusion
Based on the procedures performed, we believe management's determination of the final mark for the Multi-Sector portfolio is reasonably stated as at December 31, 2007 in relation to the financial statements taken as a whole.

Management will continue to need to evaluate the model and other market information over the coming quarters and ensure that this continues to reflect management's best estimate of the market levels for these transactions.