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09/16/2008 09:59 AM

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Subject Fw: Summary of AIG Bankruptcy Impact

----- Forwarded by Timothy Geithner/NY/FRS on 09/16/2008 09:56 AM -----

Alejandro LaTorre/NY/FRS
09/16/2008 03:16 AM

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Subject Summary of AIG Bankruptcy Impact

Tim,

Attached is a document that summarizes some of our discussion earlier. The key takeaway is that AIG could be more systemic in nature than Lehman due to the retail dimension of its business. Insolvency should be managed in a way that insulates the retail activity from contagion arising from the wholesale part. Stating the obvious, intervention needs to insulate retail acitivities (inc. those in the parent, like stable value wraps) in a way that inspires confidence among the public to avoid a potential crisis of confidence. Coordination issues among state regulators could make this difficult.

The counterparty exposure figures you asked for will be sent by Supervision under a seperate cover.

Regards,

Alex

Systemic Impact of AIG Bankruptcy.DOC

Systemic Impact of AIG Bankruptcy

I. Key Differences between Impact of AIG and Lehman Failure

1. In important ways, AIG's failure (hold co. and subs) is more systemic in nature due to size, franchise, and, the wholesale and retail dimensions of its business.

   - AIG's focus on a single name strategy has made it one of the most recognized corporate names worldwide. In benign periods, this represents significant strength of franchise, while in disrupted periods it introduces significant name risk and potential contagion.

   - AIG has over 700,000 agents, brokers, and sales representatives worldwide; serves 74 million customers in more than 130 countries and derives nearly half of its revenues overseas.

   - In contrast to Lehman, failure would be more global and have a retail impact; significant retail presence through insurance, notably in stable value funds, variable rate annuities.

   - The unique blend of a global distribution network, focusing on retail customers, with strong name recognition, hinders the public's ability to discern financial health and delineate among operating companies.

2. Similar to Lehman, unwinding of trading books contains rebalancing and feedback loops perhaps of smaller scale b/c trading are smaller size but could pose difficulty in unwinding due to complexity of book (ABS CDO and exotic derivatives).

II. How the Bankruptcy Process Might Unfold

Impact on unregulated subsidiaries if parent Holding Co. files for bankruptcy

1. The bankruptcy process for unregulated companies will be under the federal bankruptcy code; no state regulators.

2. If holding co. is guaranteeing the products of the unregulated financial products company, the filing by the holding co. will likely automatically put the subsidiary into bankruptcy.

3. The main subsidiaries of concern are a financial products company (derivatives trading business) and an investment management company (securities lending).

Impact on regulated insurance subsidiaries if parent Holding Co files for bankruptcy

1. If the insurance subsidiaries are financially healthy:

- Filing at holding co. level should not, in theory, impact the insurance subsidiaries' operation as a going concern.

- Filing at holding co. level may, however, cause liquidity stresses at the insurance subsidiary level because of exposures to affiliates, and/or runs because of name aversion (risk of run mainly at the life insurance subsidiaries).

- Under normal conditions, all inter-affiliate transactions must be approved by the insurance regulator; if the parent company has filed for bankruptcy, such approvals will be more scrutinized.

2. If the insurance subsidiaries are NOT financially healthy:

   - Once the holding co. files, the state insurance commissioner will likely step-in and initiate either liquidation or rehabilitation proceedings.

   - Rehabilitation proceedings are the predominant approach: insurance commissioner takes control over subsidiaries to preserve value, sell certain business, or reconstitute so as to continue as going concern; equivalent to ring-fencing; impact on consumer confidence is unclear.

   - If the going concern value cannot be preserved, then commissioner may liquidate in an orderly manner.

III. Impact on Financial Counterparties (see details from Bank Supervision)

1. AIG to fails to perform on balance sheet CDO swaps, which provide reg capital relief to European banks; failure would lead to increase in European bank capital requirements.

   - Swaps allow banks to hold 1.6% in regulatory capital as opposed to 8%.

   - Total notional exposure of $290B; down from $80B as deals wound down.

2. ABS CDO exposures unlikely to be re-balanced as other counterparties not willing to provide protection; exposes dealers to market risk.

IV. Impact on Market Liquidity and Related Spillover Effects

1. Larger surprise factor than Lehman; AIG CDS priced in 35% probability of default on Friday vs. 67% today.

2. Occurs on the back of Lehman bankruptcy; market currently unsure of their positions and functioning is being tested.

3. AIG derivatives book more complex than Lehman.

4. Bankruptcy of AIG CP ($20 bn) has significant contagion potential (GE CP is $90 bn). If CP can't be rolled over, issuers draw down on bank lines; credit extension dries up, banks capitalization further deteriorates, rating downgrades ensue.

5. Investors could lose confidence in subsidiaries, withdraw cash from securities lending, leaving liquidity shortfall; induces forced liquidations and leads to losses.

6. AIG would fail to perform on annuities and stable value wraps; latter drives asset sales and breaking-of-the-buck for money funds.