Q2 2018 Earnings Call

Company Participants

- Brian Duperreault, President, Chief Executive Officer & Director
- Elizabeth A. Werner, Vice President & Head of Investor Relations
- Kevin T. Hogan, Executive Vice President & Chief Executive Officer, Life & Retirement
- Peter Zaffino, Executive Vice President and Chief Executive Officer-General Insurance
- Siddhartha Sankaran, Executive Vice President & Chief Financial Officer

Other Participants

- Elyse B. Greenspan, Analyst
- Jay A. Cohen, Analyst
- Josh D. Shanker, Analyst
- Kai Pan, Analyst
- Larry Greenberg, Analyst
- Ryan J. Tunis, Analyst
- Thomas Gallagher, Analyst
- Yaron Kinar, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to AIG's Second Quarter 2018 Financial Results Conference Call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Ms. Liz Werner, Head of Investor Relations. Please go ahead, ma'am.

Elizabeth A. Werner {BIO 1557593 <GO>}

Thank you, Kevin. Before we get started this morning, I'd like to remind you that today's presentation may contain forward-looking statements, which are based on management's current expectations and are subject to uncertainty and changes in circumstances. Any forward-looking statements are not guarantees of future performance or events.

Actual performance and events may differ possibly materially from such forward-looking statements. Factors that could cause this include the factors described in our second quarter 2018 Form 10-Q and our 2017 Form 10-K under Management's Discussion and Analysis of Financial Conditions and Results of Operations and under Risk Factors.

AIG is not under obligation and expressly disclaims any obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise. Today's presentation may contain non-GAAP financial measures. The reconciliation of such measures to the most comparable GAAP figures is included in the slides for today's presentation and our financial supplement, which is available on our website.

The format for today's call will follow past calls. We will have one question from each analyst and a possible follow-up question and then we would ask that you get back into queue. We would like to answer as many questions as possible this morning and today you'll have the opportunity to hear from members of our senior management including Brian Duperreault; our CEO; Sid Sankaran, our CFO; Peter Zaffino, our CEO of General Insurance; and Kevin Hogan, our CEO of Life and Retirement.

With that, I'd like to turn the call over to Brian.

Brian Duperreault {BIO 1645891 <GO>}

Thank you, Liz. Good morning, everyone, and thank you for joining us. On today's call, we will provide an overview of our second quarter financial results and an update on our strategic and operational objectives for the second half of the year. We continue to work with a sense of urgency as we take actions designed to establish a culture of underwriting excellence and to leverage the strength and flexibility of our diversified businesses to invest what we see meaningful opportunities for value creation. The actions we are taking to design the position AIG for long-term sustainable and profitable growth.

For the second quarter, we reported $1.3 billion in adjusted pre-tax operating income which included low cat losses and high severe losses in General Insurance. Our calendar year combined ratio was 101.3 and our adjusted accident year combined ratio was 101. Going forward, we will continue to highlight relevant noteworthy items, but these will be two of our primary metrics.

As I mentioned last quarter, we expect to deliver an underwriting profit including AAL and General Insurance as we exit 2018. And we remain confident we will achieve this goal. The restructuring charge we announced this morning reflects our focus on cost reductions in General Insurance and at AIG headquarters, which will continue over the balance of the year and which we expect will contribute approximately two points of decline in the combined ratio.

In addition, Validus should contribute approximately one point and we expect the remaining improvement will come from our underwriting actions and reinsurance strategies. Looking ahead to 2019 and beyond, our goal is to deliver top quartile financial performance relative to the industry.

General Insurance continue to execute on its other strategic priorities such as improving core performance by refining the portfolio, adding highly respected industry executives to its leadership team, strengthening the underwriting organization by recruiting seasoned underwriters and continuing to build out end-to-end business units in North America and International.

I'm also pleased that our acquisition of Validus is complete which deepens our value proposition for clients and partners. We are confident that Validus will deliver a compelling value for our shareholders and enhance our overall growth opportunities.

Turning to our Life and Retirement business, we had another quarter of strong earnings and return on equity. We also announced the strategic acquisition of Ellipse, a U.K. group life business which will complement our existing U.K. Life business. Life and Retirement saw sales momentum across many product lines and Kevin will provide more information on the opportunities we see throughout their broad business mix and distribution channels.

You also saw we took further action to efficiently manage our Legacy liabilities and maximize financial flexibility with the sale of 19.9% of DSA Re. These steps put DSA Re on the path to independence while allowing AIG to free up capital and participate in the build-out and growth of the business.

Looking ahead, I remain confident in our team's ability to deliver improved operating and financial performance as we continue to execute against our strategic priorities and importantly, reinforce AIG's position as a leading global insurer, a responsible corporate citizen and a rewarding place for our talented and committed colleagues.

Now, I will turn the call over to Sid, who will provide information on our financial results.

Siddhartha Sankaran {BIO 17003278 <GO>}

Thank you, Brian, and good morning, everyone. This morning, I'll comment on our second quarter financial results, our capital and liquidity position and provide an update on Validus and DSA Re.

Turning to slide 4, we reported adjusted after tax EPS of $1.05 per share and an adjusted core ROE of 8.2%. Adjusted book value per share which excludes AOCI and DTA had solid growth and was $57.34 at quarter end, up over 2% for the quarter. Book value per share excluding AOCI was $68.40.

On slide 5, we've highlighted specific noteworthy items for the quarter. In addition to the items Brian noted, General Insurance second quarter net premiums earned also included $115 million nonrecurring increase related to multiyear installment policies in North America Commercial. Our Life and Retirement businesses delivered another strong quarter with the reported adjusted ROE of 15% which benefited from $51 million of net pre-tax actuarial adjustments. This reserved adjustment was comprised of a $98 million benefit related to the domestic Life Insurance, offset by an unfavorable adjustment of $47 million for Individual Retirement.

As Brian mentioned, we also recorded additional pre-tax restructuring charges in non-operating results of $200 million during the quarter, largely related to General Insurance and our ongoing efficiency program, which we expect will generate approximately $450 million of annual run rate expense savings.

In addition, we are making progress in reducing non compensation expense such as vendor spend and remain confident in hitting the expense goals required to deliver an underwriting profit. Net investment income from our insurance operations including the Legacy insurance portfolios totaled $3.1 billion in the quarter or almost $6.5 billion year-to-date which is tracking the $13 billion full year guidance that we provided in the fourth quarter.

While our returns on alternatives and fair value option securities were weaker than expected this quarter, on a year-to-date basis, alternatives approximate our 8% annual expectation. Our fair value option fixed maturity securities have returned just shy of 4% year-to-date and are expected to return the low end of our historical 6% to 8% assumption if rates remain at current levels.

As we have stated, we view a steady rise in interest rates as an incremental positive for our businesses. Reserves were stable again this quarter with no prior year development of note and overall actual versus expected claims trends continued to come in better than expected. The $63 million of reported net favorable reserve development this quarter largely results from a quarterly amortization of the deferred gain on the ADC.

Favorable development in Commercial was offset by adverse development in North America Personal Insurance, which was mostly related to development on the 2017 Southern California wildfires. I would also note that our ultimate loss estimates on Harvey, Irma, Maria continued to hold up well. We reviewed claims trends across the portfolio and completed Detailed Valuation Reviews, or DVRs, on roughly 20% of total reserves during the second quarter and did not see any material changes in reserves or loss picks.

With respect to our adverse development cover shown on page 44 of the financial supplement, cumulative payments on ADC subject business to the end of the second quarter 2018 were $17.1 billion. Paid claims continue to remain in line with our original payout and ultimate loss projections at inception. Our estimate of our full year adjusted effective tax rate increased to between 22% and 23% as a result of tax discrete items and our continued analysis of the impact of U.S. tax reform on our operations. As a result, the second quarter adjusted effective tax rate was 25% to catch up to the full year expectation.

Our balance sheet and free cash flow remained strong. As shown on slide 6, parent liquidity at quarter end was $9.3 billion, not yet reduced for the $5.5 billion paid for Validus in July. We continue to view the target level of liquidity at the holding company to be between $3 billion and $4 billion.

Cash proceeds in the quarter included $1.4 billion of dividends from our insurance subsidiaries and tax sharing payments of $400 million. Our base case for annual dividends and tax payments from our insurance subs remains $6 billion, although we see potential upside from non-recurring flows. Our capital ratios for our Life and Retirement companies are above target levels as are the capital ratios for GI and DSA Re. Our strong balance sheet should continue to provide us ongoing financial flexibility. During the quarter, we deployed approximately $350 million towards the purchase of common shares at an average price of $53.47.

Since quarter end through August 2, we repurchased an additional $150 million of common shares leaving our remaining authorization at approximately $1.5 billion. We will continue to deploy capital opportunistically, prioritize investing in our growth and use share repurchase as a tool.

Slide 7 depicts our capital structure and ratings. Our financial leverage ratio remains within our target range. Since closing the Validus acquisition, we have guaranteed Validus preferred stock and senior notes thereby ending Validus' requirement to make periodic filings with the SEC and initiated the process to amend Validus' senior note indenture to more closely align it to AIG senior indenture.

Turning to slide 8, we recently announced the sale of 19.9% of DSA Re to Carlyle. As an 80.1% owner, we will retain the benefit of tax sharing payments. DSA Re is a standalone run-off composite reinsurer with $42 billion of assets and $39 billion of liabilities that can be scaled over time to provide solutions for P&C and Life Insurance liabilities globally.

I'd like to comment on the strategic rationale for our transaction, valuation and capital implications. We've monetized almost $11 billion in Legacy assets over the last two plus years, and at its peak Legacy represented roughly 24% of our deployed capital. Our transaction with Carlyle further advances our objective to reduce capital tied up in long-term risks that don't meet our hurdle rates.

We view Carlyle as an ideal partner to help build out DSA Re for long-term success, given their operational expertise, and investment alignment to ensure we originate high quality assets at competitive fees. Our focus is on working with Carlyle to ensure the entity is operational on a standalone basis, which we would expect would take about 18 months. Subject to certain adjustments specified in the purchase agreement, Carlyle will pay us approximately $476 million, of which $381 million will be paid at closing and $95 million will be paid five years from now.

Currently, we've also planned a non-pro rata dividend to AIG within 18 months following closing. If we're unable to make this distribution, Carlyle will pay us an incremental $100 million to account for the unrealized dividend. As a result, the valuation for the 19.9% stake is effectively one times DSA Re total shareholders' equity at March 31, 2018 of $2.9 billion.

As part of the transaction, we've also agreed to provide Carlyle a five-year cover against adverse development on $5 billion of General Insurance reserves up to their investment amount. Note, there is no reserve cover provided on the approximately $31 billion of life and annuity reserves. The proceeds from the transaction are free to be deployed for capital management purposes and we do not see any material impacts to EPS or ROE.

We will highlight in the 10-Q that the intercompany transactions to set up DSA Re resulted in prepaid insurance assets on the ceding subsidiaries GAAP balance sheets. In addition to realizing a GAAP gain or loss in the event of a potential sale of our controlling interest in DSA Re, we may recognize a loss for the portion of the unamortized balance of the intercompany prepaid reinsurance assets and related DAC that are not recoverable. These last two items currently total about $3 billion after tax.

Despite this, if we were to sell our remaining position in DSA Re today, we would improve our excess capital position and free cash flow as our statutory capital ratios would not be impacted. Our estimates for the net impact of any potential sale will depend on a wide range of factors including the ultimate valuation, timing, reserve development, and market performance.

Our build-out of DSA Re affords us great flexibility to consider our options around participating in the run-off market. As always, we'll continue to evaluate all of our strategic options and keep you updated. I would also like to call your attention to some other noteworthy changes to our financial supplement this quarter.

First, you will see that we added disclosure of quarterly ceded premiums for General Insurance on page 13 of the financial supplement as well as NPW by product on page 14. Page 14 now presents investment portfolio returns by asset class on an operating basis to better align with how we report results. This schedule had previously included our fair value hedges of living benefits which are reported below the line in GAAP results.

Finally, we added the balance sheet breakdown by segment on page 10. To sum up, we continue to make progress towards delivering long-term profitable growth, reducing volatility and maintaining a strong balance sheet and free cash flow profile.

Now, I'd like to turn the call over to Peter.

Peter Zaffino {BIO 15942020 <GO>}

Thank you, Sid, and good morning. My comments today will focus on the progress General Insurance has made in executing against our key priorities and update on the Validus acquisition which recently closed, our second quarter financial results including an overview of current market conditions and our expectations for the second half of 2018.

As Brian shared, we continue to focus on achieving underwriting profitability on an exit run rate basis by the end of 2018. Our top priority is to improve the core performance of General Insurance through risk selection, altering our mix of business, managing gross and net limits to reduce volatility and continuing to add high quality underwriters to our team.

Tom Bolt, our Chief Underwriting Officer, is partnering with our business leaders to implement a new underwriting framework to better position us in the market. We started to reduce gross and net limits in both property and casualty during the first half of the year. And we are taking actions to improve financial performance in challenged areas of our business.

As I've discussed previously, our revised underwriting and reinsurance strategies will result in a better net mix of business and an improved risk profile. Since last quarter, we expanded our European Casualty excess of loss program to cover the entire international business and entered into a new U.S. terrorism facility that reduced net exposures for our in-force commercial property policies.

In addition, we're actively engaging with our reinsurance partners on opportunities for the second half of 2018. From an organizational perspective, we continue to make significant progress. The General Insurance leadership team is in place with Anthony Vidovich, our Chief Claims Officer; and Mark Lyons, our Chief Actuary, having joined AIG during the second quarter. As a team, we have invested a significant amount of time meeting with business leaders to assess performance and align on operational principles.

As a result, we've made a number of changes in leadership and structure in underperforming businesses. While making these changes, we continue to build momentum in recruiting talent with track records of strong underwriting performance and have hired 125 senior underwriters globally since the beginning of the year. We were pleased to recently announce that David McElroy will join AIG as CEO of our Lexington business on October 4. David's leadership will have a meaningful impact on our positioning and performance in the excess and surplus lines market.

With respect to our end-to-end business units, we are transforming the way we operate, optimizing our businesses and instituting cost transparency. As Sid stated earlier, the second quarter restructuring charges illustrates our ongoing efforts to eliminate redundancies, streamline our operations, drive process improvement and instill accountability for expenses.

Finally, we're excited about the recent closing of Validus acquisition. The addition of Validus to our organization signifies demonstrable progress in pursuing profitable growth, adding deep expertise in several segments of the business and strengthening the capabilities we bring to our clients. I'm very pleased to welcome our new Validus colleagues to AIG and look forward to bringing our collective skills together to bring greater value and more compelling solutions to the market.

Turning to our second quarter results for General Insurance, slide 10 provides details on overall performance. Second quarter net premiums written increased 2%, excluding FX compared to the prior year quarter, primarily driven by growth in Personal Insurance. We continue to expect that 2018 net premiums written will be relatively flat to 2017, while our mix of business shifts as a result of our underwriting and reinsurance strategies.

With respect to profitability, the second quarter calendar year combined ratio benefited from lower than expected CAT losses and favorable prior year development. The adjusted accident year combined ratio was 101 and core business results were largely in line with expectations. The adjusted accident year loss ratio of 65.4% includes 4.5 points of severe losses, which is about 2.5 points higher than our historical average compared to benign severe and attritional losses activity in the prior year quarter.

The severe losses were largely attributable to policies incepted in 2017 and earlier and we believe the underwriting changes we are making will address the root causes of these losses as they earn into our financial results over time. During past earnings calls, I've shared our intent to balance gross and net limits, while bringing quality and consistency to our underwriting guidelines to stabilize performance. To that end, one of the initiatives we've undertaken is to reduce property, underwriting limits from $2.5 billion globally to $1 billion in the U.S. and $750 million internationally with the exception of fronted policies, which coincides with changes being made to authorities that will result in lower exposures across the portfolio. We are also in the process of revising our use of deductibles, reducing exposure to certain industries and putting new team of seasoned underwriters in place.

When assessing our severe loss exposure, we believe it's appropriate to look at the full year results versus quarterly year-over-year comparisons. For 2018, we have a severe loss aggregate cover with a $415 million attachment point against which we've incurred approximately $290 million in year-to-date losses, thereby limiting our exposures in the second half of the year to bring us in line with our full year severe loss ratio expectation of approximately 2% to 2.5%.

With that in mind, the adjusted accident year loss ratio in the second quarter was in line with the full year 2017 result, reflecting improvements in mix. The second quarter expense ratio increased approximately 150 basis points compared to full year 2017. This increase was driven largely by higher acquisition expenses in Personal Insurance, a trend we discussed last quarter and that we expect will continue as we shift the Personal Insurance business toward lower loss ratio and higher commission business.

The quarter also included a benefit from $115 million non-recurring multi-year policy adjustment that Sid discussed. As Brian described, reducing expenses approximately 200 basis points from our current run rate remains a significant priority and will be a leading driver of our profitability improvements in the second half of the year.

Slides 11 and 12 provide North America's and international second quarter financial results. North America Commercial showed an improvement in non-severe attritional losses and a reduction in CAT exposure. Personal Insurance's adjusted accident year loss ratio was largely in line with the full year 2017 result and its business mix changes were the main driver of North America's increased acquisition ratio.

In International, we were pleased that Personal Insurance had another strong quarter delivering an adjusted accident year combined ratio of 93.5%. That result was partially offset by severe and non-severe attritional losses in Commercial.

With respect to Japan, it has been seven months since we completed the merger of AIU and Fuji Fire Marine. Current retention levels are in line with our expectations and new business has shown sequential improvement following some anticipated fluctuations shortly after completion of the merger.

Moving on to current market conditions, rates have remained broadly consistent with our experience over the past few quarters. In North America, overall rates increased approximately 3% during the quarter. North America property continue to show the highest rate improvement, and increases range from approximately 7% to 10% on average across segments with the most significant changes in E&S property.

North America admitted casualty rate increases were approximately 3% in the aggregate with wide variation among individual risk space on the line, attachment point and loss history. We have observed increasing loss cost trends in certain lines with the exception of workers' comp and we carefully review these trends as we make underwriting and pricing decisions by line of business.

Transitioning to our outlook for the remainder of the year, our path to improving the adjusted accident year combined ratio will be driven by several factors. These include execution of our expense run rate initiatives discussed earlier, the inclusion of Validus in General Insurance's financial results which could provide up to 100 basis points of improvement; partial realization of our underwriting actions to remediate underperforming lines and grow profitable business; and reinsurance agreements entered in during the second half of the year.

While the first half of the year has been focused on addressing volatility and underperforming businesses within the portfolio, we expect to provide additional clarity on the impact of our strategic changes during our third quarter call.

In closing, over the last three quarters, General Insurance has made meaningful progress against our strategic priorities that will improve core financial performance as we enter into 2019. We are confident that the decisions we have made and the actions we are taking, will position the business for the future and create long-term value for all of our stakeholders.

With that, I'll turn the call over to Kevin.

Kevin T. Hogan {BIO 4650423 <GO>}

Thank you, Peter, and good morning, everyone. As you can see on slide 14, Life and Retirement delivered strong results for the quarter with $962 million in adjusted pre-tax income and an adjusted ROE of 15%. As Sid mentioned, our results benefited from net positive actuarial items with positive and negative adjustments in some of the business lines. This benefit was offset by lower yield enhancement and alternative investment income as well as higher gross operating expenses compared to the prior year quarter.

Last year, gross operating expenses benefited from the release of a legal reserve in Group Retirement. Asset growth over the last 12 months drove increases in total investment income and fee income. We continue to deploy capital to attractive opportunities, leveraging our broad product portfolio and channel strategy. We increased premiums and deposits across our businesses emphasizing growth in Fixed Annuities, Index Annuities, Group Retirement and Life Insurance and executing opportunistic transactions in Institutional Markets.

We continue to see growing contribution from our international businesses and strengthened our U.K. individual life platform with the bolt-on acquisition of Ellipse, a small technology-driven group life business focused on the small and medium sized employer market. Ellipse represents an excellent strategic and financial complement to our U.K. business, which has performed well and already represents around 20% of our worldwide life new business.

Now, I will briefly discuss results for each of our businesses. Turning to Individual Retirement on slide 15, Variable Annuities sales remained low in the quarter as we chose not to deploy capital at returns below our hurdle rates. We delivered strong Fixed Annuity and Index Annuity growth for the quarter and net flows improved for both of these product lines.

Overall Individual Retirement net flows remained negative and were down from the prior year quarter due to higher outflows of Retail Mutual Funds. Fee income increased, driven by growth in assets under management. We continued our practice of active spread management, but as expected, we saw continued compression for our Fixed Annuity portfolio due to the runoff of higher yielding assets and lower reinvestment yields. Base net investment spread for Variable and Index Annuities benefited from higher accretion and other investment income. After adjusting for these items, spread increased slightly for these product lines.

Turning to Group Retirement on slide 16, we increased premiums and deposits with growth in periodic deposits and strong new group acquisition. Our net flows for Group Retirement remained negative and were down from the prior year quarter with surrenders impacted by the loss of a few large plans.

As I have mentioned on previous earnings calls, we expect to see natural attrition among some larger groups due to planned sponsors, reducing the number of providers and their plans and M&A activity in the healthcare market. We continue to believe that our differentiated model which combines high touch and high tech service positions us well as a leader in the growing not-for-profit defined contribution market.

Similar to Individual Retirement, assets under administration grew and we continue to actively manage spreads. Base net investment spread for Group Retirement benefited from accretion and other investment income. Adjusting for these items, spread was in line with the prior year quarter. While new money rates have increased, they continue to be below portfolio yields and spreads continued to be at historically tight levels.

Looking forward across Individual and Group Retirement, absent significant changes in the overall rate environment, our current expectation is that our base net spreads will decline by approximately 0 basis points to 2 basis points per quarter.

Let's now move to Life Insurance on slide 17. It is important to note that adjusted pre-tax operating income was impacted by positive actuarial adjustments of $98 million for the quarter. We continue to make progress in our Life business and our planned separation from DSA Re will allow us to further focus on our new business platform. Total premiums and deposits increased and we continue to grow sales in the U.S. and the U.K. with particularly strong new business growth in the U.K. Lastly, our overall mortality experience was within pricing expectations.

Turning to slide 18, in Institutional Markets we continue to execute our opportunistic strategy. We executed a large GIC transaction during the quarter. Although we do not participate in any notable pension risk transfer deals during the quarter, the market pipeline to these transactions over the next 12 months to 18 months continues to be robust. Overall, our Institutional Markets business continues to be well-positioned to capitalize on available growth, while remaining focused on achieving targeted economic returns.

To close, our results for the quarter reflect our ongoing strategy to leverage our broad product expertise and distribution strength to deploy capital to the most attractive opportunities, which we believe continues to position us well.

Now, I would like to turn it back to Brian.

Brian Duperreault {BIO 1645891 <GO>}

Thank you, Kevin. Before we open it up to Q&A, I want to highlight all the progress we've made to-date, and how well positioned we are going forward. When I rejoined AIG, I said we would pursue profitable growth that is organic and inorganic. This past July, we closed on the company's first acquisition of size in 17 years by acquiring Validus. You also heard us speak of the year of the underwriter and we created a leadership team of industry experts with proven track records.

As said, our composite structure provides meaningful value to our stakeholders and this quarter showed the balance Life and Retirement's consistent earnings double-digit returns and strong cash flow bring to AIG. And finally, we described our prudent approach to managing capital. Yesterday, we announced the partial sale of DSA Re, another significant step to exit our Legacy business allowing us to deploy capital at higher returns.

All these actions move AIG towards profitable and sustainable growth. We continue to pursue top quartile performance with a strong sense of urgency. I could not be more pleased with the leadership team and colleagues across AIG, and I'm confident that our financial results will soon reflect their efforts.

And with that, we'll turn it over to Q&A.

Q&A

Operator

Thank you. We will now take our first question from Ryan Tunis of Autonomous. Your line is open. Please go ahead.

Q - Ryan J. Tunis {BIO 16502263 <GO>}

Hey. Thanks. Good morning. I guess my question was in General Insurance looking at the attritional loss ratio, and even assuming, I guess, just the average cap – I'm sorry, severe loss load. There wasn't any sequential improvement, it was around 63%, 63.1% just like last quarter. Just curious why wouldn't (34:46) I see more improvement there on the non-property side?

A - Brian Duperreault {BIO 1645891 <GO>}

Peter, do you want to do this?

A - Peter Zaffino {BIO 15942020 <GO>}

Sure. I think we have. If you were to take our 2017 year-end exit and you adjust and taking what we saw for increased frequency on the severes, what we've done in terms of some of the Personal Insurance has actually seen a benefit of around 100 basis points. I think some of that is just, again, masked with some of the other things that are happening where we had a little bit more frequency on attritional and our International Commercial and a little bit of business mix shift in the United States, and saw a little bit more frequency in our high net worth book than we have on keeping up with loss cost trends. So I think all-in-all, we had seen a slight improvement. It's just that there's a little bit more variables in the second quarter that doesn't necessarily identify it.

Q - Ryan J. Tunis {BIO 16502263 <GO>}

Yeah. Thanks. And then...

A - Brian Duperreault {BIO 1645891 <GO>}

Okay, Ryan?

Q - Ryan J. Tunis {BIO 16502263 <GO>}

Yeah, sorry, I guess just on reserves curious about an update on what you guys have, I guess, gotten through year-to-date? And is it that there's more in the Casualty stuff still to be looked at in the third quarter and fourth quarter? That was one question.

And the second part of that was mentioning in some lines you guys are seeing some signs of elevated loss trend but then your actual or expected still look pretty good on the reserves. I guess just trying to square those comments and why we shouldn't necessarily be concerned that pickup in loss trend could translate to some charges. Thanks.

A - Brian Duperreault {BIO 1645891 <GO>}

Okay. Well, we did about 20% of the reserves in the second quarter. Obviously, 80% to go, some of that was Casualty, there's some Casualty to go. But I think you had to keep in mind that we look at all of it. I mean we don't just look at the 20% and not look at the 80%. So if we had seen something untoward, we would have pulled it forward. We didn't see that. So, I think, all-in-all I'm quite pleased with where we are with the reserves activity.

Yeah, you could see increases in maybe some loss activity which might adjust our 2018 accident year numbers, so we would raise those a little bit but that would not necessarily affect loss reserves for 2017 and prior. And there, things are holding well. So we're not, as I say, going back to looking at 100%. All of that seems to be fairly stable. So I hope that answers the question, Ryan. Next question - next questioner? Josh?

Operator

We will now take our next question from Josh [Deutsche Bank Securities].

Q - Josh D. Shanker {BIO 5292022 <GO>}

Hello. Thank you. So my two questions are very similar. One is what is the improvement expected on a run rate basis from the inclusion of Validus' numbers into your combined ratio?

And two, how much improvement do you expect to see in the expense ratio in 4Q from the restructuring initiatives you report during the quarter?

A - Brian Duperreault {BIO 1645891 <GO>}

Yeah. In my prepared remarks, I said one point for Validus.

Q - Josh D. Shanker {BIO 5292022 <GO>}

Only one point, okay.

A - Brian Duperreault {BIO 1645891 <GO>}

Well, you know it's about 10% of the portfolio and it produces a good combine. So I think that's a pretty good number one point because it adds a very significant good underwriting combined business to our portfolio. But it is 10%. I also said that we've got a restructuring charge in the second quarter, we're going to continue to do work in the remaining second half of the year. All-in-all with the restructuring and other things that we're addressing in expense, we would expect the expense ratio for General Insurance to improve by two points.

Q - Josh D. Shanker {BIO 5292022 <GO>}

In the next six months or over the longer-term?

A - Brian Duperreault {BIO 1645891 <GO>}

Well, no, I put that out so you could get some understanding of when I talk about entering 2019 that business would be showing a 2% expense ratio improvement. Now, you know you could have expense ratio improvements but it won't necessarily all show up in fourth quarter because you could still have some spend -- partial spend in the quarter that would be discontinued by the end of the year. So it's an entry rate into 2019.

Operator

We will now take our next question from Yaron Kinar of Goldman Sachs. Your line is open. Please go ahead.

Q - Yaron Kinar {BIO 17146197 <GO>}

Thank you very much. My first question is around -- some clarifications around the exit target for 2018. When you say exit, is that a 4Q target or is that really where you're starting 2019? And then, when you've talked about the 1% improvement -- potential improvement from Validus, is that with or without PGAAP adjustments, namely is it with lower amortization for deferred assets -- deferred acquisition cost, sorry?

A - Peter Zaffino {BIO 15942020 <GO>}

Well, let's take the exit first. So the fourth quarter will be based on earned premiums that were produced over the previous -- written premiums over the previous 12 months. So I'm not saying the fourth quarter is going to be under 100, but what I'm saying is the earned premiums that we produced which enter into 2019 in the first quarter we expect to be producing a combined ratio under 100. And we would expect further improvement through the year.

I'm not going to tell you what my numbers might be. But I'm trying to get across to everyone that there is improvement in this book. It's not a straight line, but the line is an improvement line. And we will start to show underwriting profitability, not anywhere near where it should be, but we'll start to show underwriting profitability as we enter 2019 and exit 2018. And Validus is the – it's the published results to Validus, so it's going to include all the adjustments that would be made.

Q - Yaron Kinar {BIO 17146197 <GO>}

So in other words the Validus part will not include the deferred acquisition amortization?

A - Siddhartha Sankaran {BIO 17003278 <GO>}

Well, we haven't concluded on our PGAAP work. We'll update you in the third quarter on our numbers if that's what you guys are asking for the size of that.

Q - Yaron Kinar {BIO 17146197 <GO>}

Okay.

Operator

We will now take our next question from Mr. Kai Pan of Morgan Stanley. Your line is open. Please go ahead.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you and good morning. First question to follow up in the combined ratio. And if I start with 101 percentages combined ratio in the second quarter you take out two points from above average severe losses and then two points improvement from expense ratio and one point from Validus, then adding back four points AAL you're essentially at breakeven 100%. So my question is that you probably won't stop there. So where do you see opportunities for further improvements beyond 2018?

A - Brian Duperreault {BIO 1645891 <GO>}

Well, thank you for the arithmetic on that. I said why wouldn't it be the top quartile and how do we get there? You got to continue to address the underwriting that we've been doing. We have to see the results and believe the results saying Casualty where it takes a while for the improvements to manifest themselves. So we will have loss picks which we will be -- which will have some conservative nature to them as all reserves should and we'll let those emerge and we'll see what happens. So our expectations and improvements we're doing will show up even great over time, but we need to see it. And you need to see it. So it's a market that is dynamic and prices are -- movement all the time. So you have to continually address what you're doing on a daily basis. And that could mean, you buy more reinsurance, it could mean the volumes go down, it could mean that prices are hardening and your volumes go up. So it's an actively managed portfolio. That actively managed portfolio will continue to improve and one of the big issues is our expense levels.

Our expense levels even with that 2% improvement is nowhere near where it needs to be. So you'll see us address not just the pricing side and the loss ratio, but you'll see us address -- continue to address the expenses. Expense management is a way of life. It's got to be a way of life in this company. And I think those are the two things will get us down to -- get us to that top quartile position.

Q - Kai Pan {BIO 18669701 <GO>}

That's great. My follow-up on the DSA Re, do you think the partial sale make it even harder or easier to eventual divest the remaining 80%? And what are your plans for the other three Legacy books?

A - Brian Duperreault {BIO 1645891 <GO>}

Well, okay. So it's a partial sale, make it easier or harder. Well, we have a partner and we are working together to create the companies -- a truly standalone company with an operational capability that I believe would make it easier not harder. And it gives us the optionality to do that or not do that. So I think it's a very good trend that we have.

The rest of the Legacy, as Sid pointed out, we've been managing the Legacy for a long time. I think the results speak for themselves. We'll continue to look at it. If there's opportunities to do something else with the remaining Legacy, we will. But I think it's getting to a point where it stops being as noteworthy. Sid?

A - Siddhartha Sankaran {BIO 17003278 <GO>}

Yeah, I mean I think with this transaction that addresses the vast bulk of our Legacy portfolio, there are some remaining pieces which are both on the liability side and investment side. But we'll deal with those, of course, in what I would call normal course here. I think we're very pleased with the progress that this transaction represents.

A - Brian Duperreault {BIO 1645891 <GO>}

Next question.

Operator

We will now take our next question from Elyse Greenspan of Wells Fargo. Your line is open. Please go ahead.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Hi, good morning. So my first question, going back to the General Insurance margin discussion, so if we back out the severe losses -- the access level you guys are about in line with like you said the exit run rate from last year. So you've spoken a lot of time on the last several calls about all these business mix improvement initiatives, re-underwriting, purchasing and more reinsurance which seems to be a big part of the improvement you expect. Should we start to expect to see some of that flow through in the back half of the year in the third quarter or the fourth quarter that would drive some improvement away from the expense initiatives and bringing on Validus? Or just given how the earned comes in, is that more a part of improving on the combined ratio once we get into 2019?

A - Brian Duperreault {BIO 1645891 <GO>}

Peter?

A - Peter Zaffino {BIO 15942020 <GO>}

Yeah. So what Brian said in his opening comments, I mean really the components we talked about expense, we talked about Validus, we expect to see improvement in the accident year loss ratios over time and so was an example of that. We're getting rate on property. We saw a positive trend. It was one quarter, but on the attritionals and property. And so if you normalize out some of the severe and see some of the attritional as we go from a large limit strategy to a more concentrated, we still have a very big presence in the market in terms of our ability to put out limit, but we're going to watch deductibles, we're going to watch in terms of how much risk we take on any one in particular account. But that also goes into how we are positioning excess Casualty financial lines and a lot of our businesses across all of AIG.

And then I think the reinsurance, Elyse, was what we had talked leading up until now has been heavily focused on reducing volatility, making sure we're addressing some of the large limit. We saw benefit in the PML. We've seen benefits in AAL and property. And as we look to the back half of the year, we're going to look at our entire portfolio, in particular, Casualty and be very strategic on how we look at the reinsurance with partners in the reinsurance market and we would expect to see a benefit from that in 2019.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay, thank you. And then my second question you guys just recently closed on the Validus transaction. Brian, you've spoken a lot about M&A and your aspirations to continue to grow the company. Now that that deal is done we're sitting halfway through the year, how are you thinking about additional M&A opportunities from here? And what things are you considering on both the Property Casualty as well as the Life Insurance side?

A - Brian Duperreault {BIO 1645891 <GO>}

Yeah, thanks, Elyse. Well, I think I've said this quite a few times in these calls about what priorities we would have. And yes, I always look for acquisitions. But we have our standards and Validus was a great example of our standards. I mean it filled in parts of portfolio that we didn't have, it added great people and capabilities to the company. So we continue to look for businesses that do that that, that bring great people make us better and add to the portfolio mix.

So Life Insurance would be a place I would look if I could. So where we have somewhat -- we're somewhat confined geographically if we could spread our capabilities out, we have got great skill sets around retirement, the demographics of this world are pretty consistent, people getting older and more in need of our capabilities every minute. If we could find that, that'd be great. We have an international footprint. I'd love to maximize that better than we have in the past and then there's elements of our General Insurance business in the U.S. where we're dominated with large Commercial where I'd like to have some balance large and small.

Now, having said that, acquisitions are very difficult to predict, a lot of things have to go right and I can't tell you we'll do one anytime in the near future. I just don't know. But I do look and you can't find a great one if you're not looking. So we look.

Okay, next question.

Operator

Thank you. Our next question comes from Mr. Tom Gallagher of Evercore. Your line is open. Please go ahead.

Q - Thomas Gallagher {BIO 3311667 <GO>}

Good morning. First, say, just on DSA Re, the $3 billion potential GAAP book value write-down that you'd referenced for the reinsurance. Would that – if you do take that and that assumes if you divest it, would that reduce allocated equity to the Legacy segment or is that not going to be an adjustment there?

And my related question is because if you strip out the $3 billion from DSA Re, it would imply you still have, what, $5 billion or $6 billion of allocated equity in Legacy. So I'm just curious, what is left in there and is there that much capital or equity still in the run-off lines?

A - Siddhartha Sankaran {BIO 17003278 <GO>}

No, Tom, I think you're spot on. The intercompany that we referenced is in Legacy, and so any impact would reside in the Legacy segment to book equity. And the remaining – in response to Kai's question, the remaining pieces of Legacy outside of DSA Re and this would be relatively small. So there's a small subset of insurance liabilities, which we feel we largely can manage in normal course and then a small subset of invested assets, which I think our CIO, Doug Dachille and the team have done a great job on over the last couple of years.

Q - Thomas Gallagher {BIO 3311667 <GO>}

Got it. And then my follow-up is, Brian, if I'm following the numbers here correctly, you get the 1 point from Validus, an improvement in the combined that you're expecting 2 points on expense ratio. And if you're run rating right now 103, 104, those two levers pretty much get you to your target. Does that imply you're not expecting much improvement in the underlying loss ratio or is that incremental? How should we think about that?

A - Brian Duperreault {BIO 1645891 <GO>}

Well, I highlighted the two just to let you know that there is quite significant clear work that has already been done. So the rest of it is the activity around the loss ratio, and we expect that to improve. We expect that to improve. And I said the further improvement between that – the reinsurance is also an additional part of how that's going to improve. And you want to make sure you cross the line. So, you need to make sure you go a little farther than maybe indicated so you go far enough. So we would expect all of that puts and takes to get us under that 100 as we cross into 2019. Next question?

Operator

Thank you. Our next question comes from Mr. Jay Cohen of Bank of America Merrill Lynch. Your line is open. Please go ahead.

Q - Jay A. Cohen {BIO 1498813 <GO>}

Thank you. On reserves, you have a new Chief Actuary one with really great experience. Is there any plan to change the methodology with which you examine and assess your reserves?

A - Brian Duperreault {BIO 1645891 <GO>}

Yeah, he's a great addition. We talked about him earlier. Well, look, he's a thorough professional and he will, I hope, do continuous improvement on what we do so that we remain – that we continue to improve constantly. So I can't imagine that we would stay status quo. Now having said that, I've said earlier in previous discussions, I'm comfortable with our methodology and process, but everything can be improved. So I fully expect that he will continue to improve it. Yes, absolutely. Go ahead, Jay.

Q - Jay A. Cohen {BIO 1498813 <GO>}

Got it. And then the second question, with the transaction with Carlyle, does that transaction suggest the pace of the run-off of DSA will accelerate or slow down or not change?

A - Brian Duperreault {BIO 1645891 <GO>}

Sid?

A - Siddhartha Sankaran {BIO 17003278 <GO>}

Well, I think, Jay, it's Sid, as we've reminded you, I think obviously the liabilities for DSA of course are very long duration in nature, so well north of 10 years. So just simply by executing the transaction, I think we've accelerated the pace. And everything we do is around evaluating what maximizes value and we felt this transaction maximizes value for us.

A - Brian Duperreault {BIO 1645891 <GO>}

Yeah. I mean, it's going to run off the way it runs off. I mean, I don't think the sale of it in any way changes how it's going to run off. If it goes faster, it goes faster.

Q - Jay A. Cohen {BIO 1498813 <GO>}

Okay.

A - Brian Duperreault {BIO 1645891 <GO>}

Next question?

Operator

Our next question comes from Larry Greenberg of Janney Montgomery Scott. Your line is open. Please go ahead.

Q - Larry Greenberg {BIO 16478161 <GO>}

Good morning. And thank you. So it looks like you removed the AAL line from the supplement this quarter. I'm just curious your rationale for that? And then if you could, I know with Validus you, I believe, said that your aggregate shouldn't increase. But can you give us an idea of how to think about CAT loads going forward?

A - Brian Duperreault {BIO 1645891 <GO>}

Sure. Let me – I'll let Peter talk about the Validus and the aggregate and everything. So look, we are cognizant of AAL, mentioned it earlier. We know we've got to recognize that there is a recognition of the long-term nature of the catastrophe exposures that we take on. But I want to be consistent with the way we report versus everybody else and so we will update our thinking on AAL. But I just – I'm not going to go through all the arithmetic of with and without so that when we talk about our numbers, they're easily comparable to the rest of the industry. But you will have the information that you need to do whatever you need to do to include the AAL. Now, Peter, do you want talk about the Validus and our aggregates?

A - Peter Zaffino {BIO 15942020 <GO>}

Yeah. So we talked, I think, in the past couple of quarters about the PML reductions. The AAL's for AIG alone dropped about 20% from five to four through actions of re-underwriting as well as reinsurance. When we were doing diligence on Validus, again, we will need to refresh it but we just basically kept them flat where they had about an 8% load for AALs and made that – the combination has AIG and Validus down about in the 4.5% plus or minus range. So even with the addition, we're below where we were at this time last year and as we exited 2017 and expected that the combination will be slightly lower than where last year. We'll give you an update as we look to the third quarter and fourth quarter.

Q - Larry Greenberg {BIO 16478161 <GO>}

Okay. Thank you. And my second one and this is probably not a question you would look for to answer, Brian. But I think the world is just kind of wondering. There was a restructuring program prior to you getting to AIG. And I think the world is just wondering if anything was really accomplished during that time? I mean it really feels like you guys have had to go back to ground zero and start from scratch and just wondering if you'd be willing to comment on that.

A - Brian Duperreault {BIO 1645891 <GO>}

Well, I don't know, Larry. In fairness a lot was done. $2 billion of expenses were taken out. I mean, please, that's a lot of -- that's heavy lifting. That's a lot of stuff. But once that was all done and you take a look at the results, the expense ratios remain high.

And so, all it said was more needed to be done. That was a beginning but not an end. And I said expense management, it's got to be a way of life around here. And so we'll continue to look at it. We have to address, maybe some things weren't addressed. We're addressing it now like our manual processes and things like that. But no, I don't want to -- no, it's not fair. There was a lot of good work being done prior to my arrival in expenses. We just have to continue it. That's all.

Well, we are running out of time. So I think at this point, we should end this and I just want to, once again, thank the investor community for staying with us on this. It's not a straight line, but it is an improving line and the results will begin to show themselves. I want to thank all my colleagues the great work that you're doing as we make this company a great company. So thank you, everybody.

Operator

This concludes today's call. Ladies and gentlemen, thank you for your participation. You may now disconnect.