S&P Capital IQ

CONTENTS



# American International Group, Inc. NYSE:AIG

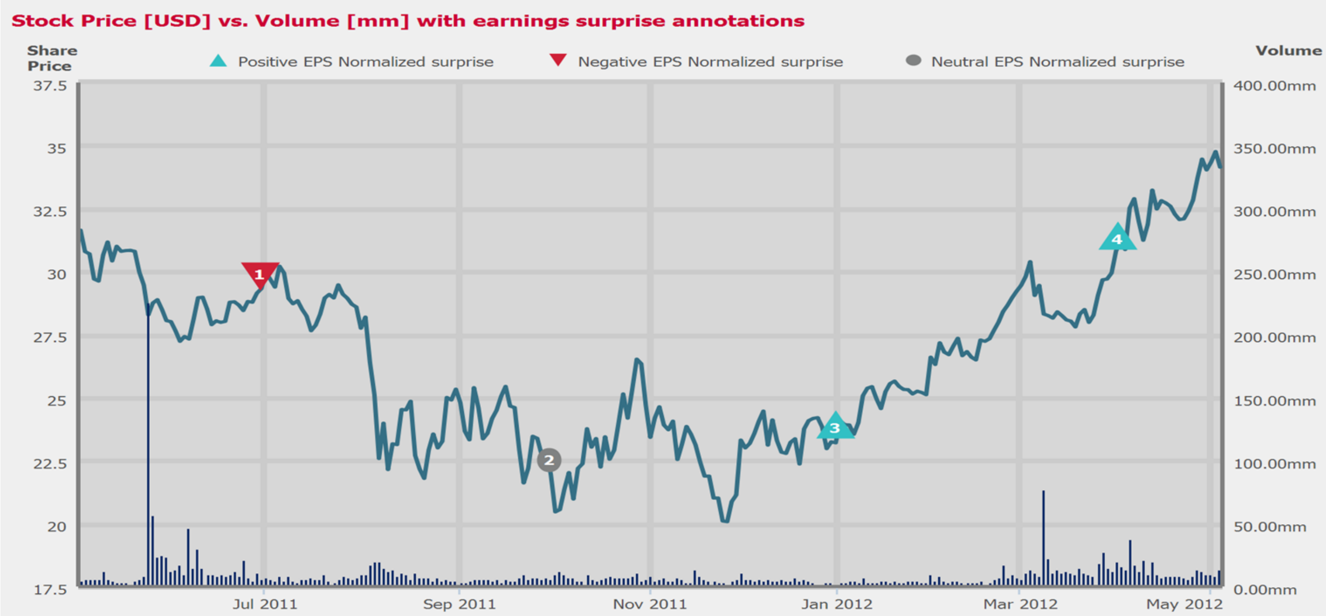
*FQ2 2012 Earnings Call Transcripts*

Friday, August 03, 2012 12:00 PM GMT

## S&P Capital IQ Estimates

| | -FQ2 2012- | | | -FQ3 2012- | -FY 2012- | -FY 2013- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| **EPS Normalized** | 0.60 | 1.06 | 76.67 | 0.66 | 3.85 | 3.39 |
| **Revenue (mm)** | 8821.20 | 8820.00 | (0.01 %) | 8707.60 | 34846.17 | 35340.50 |

Currency: USD
Consensus as of Aug-03-2012 11:22 AM GMT




- EPS NORMALIZED -

| | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| **FQ2 2011** | 0.96 | 0.69 | (28.12 %) |
| **FQ3 2011** | (0.28) | (1.60) | NM |
| **FQ4 2011** | 0.65 | 0.82 | 26.15 % |
| **FQ1 2012** | 1.39 | 1.65 | 18.70 % |

# Call Participants

## EXECUTIVES

**Brian T. Schreiber**
*Former Chief Strategy Officer, Head of Corporate Mktg & Communications and Executive VP*

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

**Elizabeth A. Werner**
*Head of Investor Relations and Vice President*

**James Bracken**

**Jay Steven Wintrob**
*Former EVP of Life & Retirement, CEO of AIG Life & Retirement and President of AIG Life & Retirement*

**Jeffrey L. Hayman**
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**Robert Herman Benmosche**
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*Goldman Sachs Group Inc., Research Division*

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# Presentation

**Operator**

Good day, and welcome to this American International Group's Second Quarter Financial Results Conference Call. Today's conference is being recorded. At this time, I'd like to turn the call over to Ms. Liz Werner, Head of Investor Relations. Please go ahead.

**Elizabeth A. Werner**
*Head of Investor Relations and Vice President*

Good morning, and thank you. Welcome to AIG's discussion of second quarter 2012 results. Speaking today will be Bob Benmosche, President and CEO; David Herzog, Chief Financial Officer; Peter Hancock, CEO of Chartis; and Jay Wintrob, CEO of SunAmerica Financial Group. Other members of senior management are also in the room and available for the Q&A period.

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 those described in our second quarter 2012 10-Q, our 2011 10-K and our Form 8-K filed on May 4, 2012 under the management's discussion and analysis and risk factors. AIG is not under any obligation to expressly disclaim any obligation to update any of our 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 our financial supplement, which is available on AIG's website, www.aig.com.

With that, let me turn the call over to Bob Benmosche.

**Robert Herman Benmosche**
*Former Chief Executive Officer, President and Director*

Thanks, Liz, and good morning, everybody. If we go back to the first quarter of 2011, it seems like a long time ago, but that was when we restructured. We talked about we're going to focus on as a management team, fixing the foundation of AIG, our basic businesses and how we run those businesses.

In May of 2011, when we went out and did our first re-IPO, if you will, of the company of selling our shares, then we talked about aspirational goals that we're going to achieve as we rebuild that foundation. And you've seen us perform very well for quarters since then. And if you look at this quarter, it's no exception. We had an outstanding quarter across the board, with all of our businesses contributing to profits in this quarter. We also saw ML III basically almost finished in terms of sell-off of the assets in ML III. So we have significantly de-risked the company this year with ML II and ML III. And by the way, we did buy almost $7 billion of ML III assets, which we feel are very good for this company on a yield basis going forward, and especially in this low-interest-rate environment.

And so when we think about capital management for our company, we think we're actually slightly ahead of our aspirational goals for 2015 with some of the stuff that's already happened. To date, we've given almost $37 billion back to America for the aid and support they've given to AIG. So we're well on our way to living up to our commitment to pay back all of the money given to us by the U.S. government, and you've seen numbers now that it's going to be very healthy profit as well.

So all of our businesses, as I said, have done well. I'm going to let -- then David will talk as well as Peter and Jay. So I'll let them do that. But on the non-core assets, let me talk a little bit about ILFC and AIA. We're continuing to work to take ILFC public. However, the markets have not been very receptive at this point in time, but we're continuing to manage that business very effectively. On AIA, we have a very good performing company out there. Mark Tucker has done an outstanding job with that business, and so we're looking for the right time and the right price to monetize our ownership of AIA.

We're often asked about regulation. We really don't know when we will be regulated, but we do believe we will be regulated by the Federal Reserve, probably. That seems the most likely candidate. And we are putting an enormous amount of effort and cost to make sure that we are Fed-ready, as the project is called, for that oversight.

So before I turn it over to David, just a comment about capital management. We are looking at making sure that we use that capital for the best performance of our shares for our shareholders. So buyback is one of the things we could do with that capital. Another is to buy businesses. And you can see, in a small way, we did an acquisition of Woodbury Financial advisors. It enhances our Advisor Group we have today and builds a stronger and bigger platform for our [indiscernible] continuing to invest in businesses that give us growth, but that also allows us to use money for share buyback. But it's not just for share buyback. It's doing what's right for the shareholder.

Let me turn it back over to David, and he'll pick it up from here.

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

Thank you, Bob, and good morning, everyone. I'm going to start with a discussion of our financial results. As evident from our results for the quarter, it's been another very busy quarter for AIG as we continue to execute on the capital management and operating fronts.

Year-to-date, we've repurchased $5 billion in shares, and as Bob has mentioned, we remain committed to our $25 billion to $30 billion of capital management through 2015. I'll discuss liquidity in a bit more detail in a minute.

Turning to our financials on Slide 4. You can see that after-tax operating earnings per share were up 56% to $1.06, which is driven in part by 26% pretax insurance operating earnings growth and overall strong non-core asset performance. Book value per share was $60.58 or $56.07 excluding AOCI. It was up 4% sequentially. Share buyback contributed $1.03 to this quarter's book value per-share growth. GAAP earnings per diluted share were $1.33 for the quarter, which reflects certain items that are excluded from operating EPS. The primary drivers for that difference in the quarter were $1.3 billion of tax valuation allowance releases or capital loss carryforwards, partially offset by an increase in tax reserves of approximately $300 million for legacy tax issues related to foreign tax credits associated with cross-border financing transactions and an increase in legal reserves of approximately $470 million net of tax associated with various legal contingencies. We also had some discrete items in the quarter that lowered our operating tax rate by 3 to 4 points or just under $100 million in taxes.

Slide 5 provides a breakdown of segment operating earnings, which reflect strong growth in insurance operations, and Jay and Peter will speak to that in just a minute. I'd note the gains in the Direct Investment book this quarter were driven primarily by positive fair value adjustments on DIB assets, CVA and unwind gains. At the end of the second quarter, the DIB had assets of a little over $37 billion and liabilities of just over $29 billion. I would note that much of the DIB's assets and liabilities were swapped, eliminating interest rate and FX risks in those books, and the bulk of the $3.5 billion of net assets in our global capital markets, as reported in our Q, can be ascribed to those assets and liabilities associated with DIB.

Slides 6 and 7 highlight our capital structure and liquidity. We remain well capitalized with a "debt to total capital" ratio of approximately 19%. During the quarter, the holding company issued $1.5 billion of senior unsecured notes, and ILFC raised a little over $750 million in secured debt. Liquidity remains strong as we have realized close to our target of $4 billion to $5 billion in annual dividends from our operating subsidiaries. In the second quarter, the holding company received $1.3 billion in dividends from the insurance companies, bringing the 6-month dividends and payments to roughly $4 billion.

Slide 8 summarizes Maiden Lane III at the end of the second quarter. At June 30, ML III liquidation value was $8.2 billion or an 11% sequential increase, reflecting the Fed's successful auction process. There have been 12 Maiden Lane III auctions, representing a little over $39 billion in par value, and there is a little over $6 billion in par value remaining to be liquidated. Maiden Lane III cash flow since inception paid down another $16 billion in par value. Going forward, we would expect continued strong cash flows on our Maiden Lane III-related investments. We participated in the vast majority of the auctions but were selective in our bidding and were successful in roughly 1/3 of the deals. There was strong demand for these assets, as Bob referenced.

We will receive cash as the proceeds of the completed auctions are paid. Through the end of July, we receive proceeds of $6.1 billion, and based on the auctions that have occurred since the end of the quarter, we would expect another almost $2 billion in cash in mid-August. The ML III assets were part of the DIB at the end of the second quarter. We believe the DIB now has more than $5 billion of liquidity, an excess of its needs to meet all of its maturing liabilities, even in stress scenarios, without having to liquidate DIB assets or rely on an additional liquidity from the parent.

Looking ahead to next quarter, given the ML III purchases, a portion of those acquired assets will remain at parent or within the DIB, and a portion of those will be in our insurance subsidiaries. The assets acquired from ML III will continue to be accounted for at fair value to earnings.

Slide 9 provides a summary of all the cash received on ML II and III along with our purchase activity. Our purchase decisions consider opportunities to improve operating earnings and returns and our capital management. The ML III purchases were a good fit for our insurance subsidiaries, and the ML III-related assets held in the insurance companies will be highly rated NAIC 1 or 2.

So at this time, I'd like to turn it over to Peter to discuss our progress on Chartis. Peter?

**Peter D. Hancock**
*Former Chief Executive Officer, President and Director*

Thanks, David. Good morning, everybody. I want to provide a brief update on Chartis' second quarter results, which is summarized in the earnings presentation, and comment on our progress, growing the value of this franchise.

AIG's second quarter property-casualty results highlight our commitment to improve the quality of our portfolio. We're seeing positive trends as a result of successful execution of our initiatives, including an improved accident year loss ratio, growth in products that produce high risk-adjusted returns and advancement of infrastructure improvements that ultimately make us more efficient and provide better customer service.

Turning to Slide 10 of the presentation. Chartis reported operating income of $936 million in the second quarter, a 20% increase over the prior year, driven by underwriting improvements and lower catastrophe losses, partially offset by an increase in expenses.

Catastrophe losses were $328 million in the quarter, largely from storm activity in the United States, Japan and floods in the U.K. While catastrophe losses were higher than expected, we're comfortable with the result given the general level of cat activity and the extent of our geographic mix of business. Our combined ratio includes net prior year adverse development of $117 million, which was partially offset by a favorable change in net reserve discount of $94 million. Favorable development from prior year catastrophe losses partially offset this adverse development.

Our reserves are subject to robust internal and external review. In the second quarter, several third-party studies, using diverse methods, confirmed that our reserves are reasonable. In addition, we continued our ongoing review of the bulk of complex environmental claims, supplementing traditional actuarial techniques with case-by-case, forward-looking engineering and litigation analysis, leading to reserve strengthening on a small number of individual claims.

The accident year combined ratio excluding catastrophes was 98.3, driven by improvement in the underlying loss ratio of 2.9 points compared to the prior year. The effective use of data and analytics has improved underwriting decision-making and allows us to shift our portfolio towards more profitable products and regions. For example, we're growing Consumer Insurance, which represents 40% of total net premiums year-to-date. We also increased our investment in consumers direct marketing business, which is currently operational in 50 countries.

We remain focused on international growth in the quarter, with 48% of total premiums generated outside of the U.S. and Canada, and growth economy nations or emerging markets represent 10% of total premiums.

In Commercial Insurance, we're using predictive modeling and analytics to optimize our mix of business and to identify profitable growth opportunities within this customer base. In addition, we're taking corrective underwriting action when returns are projected to be less than our cost of capital over a reasonable time frame. We continue to see general improvement in pricing, terms and conditions. Most notably, commercial rates in the U.S. improved 8%. In Europe, rate improvement was approximately 1% on average, reflecting the macro challenges affecting that region. While we've not characterized the environment as a hard market, it's certainly improving.

Overall, customer retention and new business remained strong and in line with expectations, given our business mix and improved risk selection initiatives. We balanced growth, profitability and risk by understanding customer preferences, including the value they attach to our distinctive product offerings. Expense increases offset some of the positive trends in the quarter, which were primarily driven by higher acquisition costs attributable to our business mix shift and higher general operating expenses tied to strategic investments in people and processes. You should expect to see further loss ratio improvement and a gradual decline in the expense ratio through the end of 2013.

Operating income, including $1.2 billion in net investment income, a slight improvement compared to the prior year. This is primarily due to redeployment of excess cash and short-term investments away from our concentration of nontaxable municipal bonds into high-yielding corporate and structured securities. This was partially offset by decreases in hedge fund returns.

Slide 11 summarizes the top line. Chartis' net premiums were down slightly compared to the prior year's quarter after adjusting for foreign exchange. The continued restructuring of our loss-sensitive business in the U.S. casualty reduced overall premiums by approximately 1%, but it improved capital efficiency. The remainder of the decrease reflected enhanced risk selection and rate discipline strategies, particularly in casualty lines. This was partially offset by increases in higher-value lines and growth across the consumer portfolio.

Capital management remains a critical focus for us. As David mentioned, we met our dividend payment commitment to AIG during the second quarter. Our capital adequacy levels are solid, and we maintain strong financial strength ratings that carry a stable outlook with the 4 major rating agencies.

Let me conclude by saying that second quarter results were encouraging as they reaffirm progress against our strategic initiatives. We'll continue to direct capital and resources to optimize risk-adjusted profitability where we see opportunities. We will remain confident that these strategies will help us achieve our aspirational goals as well as make us the most valued insurance company in the world.

Now let's turn it over to Jay.

**Jay Steven Wintrob**
*Former EVP of Life & Retirement, CEO of AIG Life & Retirement and President of AIG Life & Retirement*

Thanks, Peter, and good morning, everybody. Turning over to Slide 12. SunAmerica delivered another solid quarter with $933 million in pretax operating income, strong sales across most product lines, positive net flows and improved base net investment spreads. As a result of our strong statutory earnings and capital position, SunAmerica distributed over $800 million to AIG this quarter, and for the year, we've distributed $2.4 billion to AIG.

Our sales trends were perhaps one of the best indicators of the value of our diversified business model. While we remain disciplined in the fixed annuity market in this low-interest-rate environment, our increased sales of individual variable annuities and mutual funds drove overall positive net flows.

During the second quarter, individual variable annuity sales were $1.3 billion, up 51% year-over-year. Importantly, sales growth was driven by our new product launched earlier this year, which includes a volatility control fund and rider fees linked to changes in the VIX Index, both of which reduce our risk related to market volatility while offering customers an attractive benefit. Although we're seeing robust growth in variable annuities, you should expect us to continue managing risk through product design and redesign and maintaining an effective hedging program.

Individual variable annuities with living benefit guarantees represent 6% of total SunAmerica Financial Group assets under management. Thus, we have the capacity, the distribution rates, the risk controls and financial discipline to capitalize on the growing demand in this market while certain competitors are pulling back.

As expected, fixed annuity sales declined this quarter given the low-interest-rate environment, and I'll discuss the overall impact of low rates in the next couple of slides.

Sales of group retirement products were up 2% year-over-year as rollover deposits have begun to slow with the low-rate environment. Retail life sales continued to outpace overall life industry sales growth, increasing 3% year-over-year and 14% sequentially due to our continued focus on expanding distribution. Mutual fund sales were up significantly, contributing to positive net flows for the sixth consecutive quarter at SunAmerica, which again highlights the advantages of our diversified product portfolio.

As announced earlier this week, we're further strengthening our extensive distribution capabilities with the acquisition of Woodbury Financial Services from The Hartford. This transaction represents the first acquisition for SunAmerica Financial Group in recent years, and we expect the transaction to close by the end of 2012. Once the transaction is finalized, Woodbury Financial will become part of our Advisor Group, one of the nation's largest networks of independent broker-dealers. Woodbury Financial's approximately 1,400 advisors complement very well Advisor Group's network, which includes more than 4,800 independent financial advisors at SagePoint Financial, Royal Alliance Associates and FSC Securities Corporation. We're confident that the expansion of our broker-dealer network will provide growth opportunities for SunAmerica, for Advisor Group and for Woodbury Financial.

On Slide 13, you can see base yields for our major spread businesses continue to benefit from the cash redeployment in the second half of last year. On a sequential basis, we saw another slight uptick in base yields due to recent investments in structured securities. We've been opportunistic with our investments in these securities in order to increase net investment income and offset the impact of the lower-interest-rate environment.

During the quarter, SunAmerica Financial Group invested $1.5 billion in structured securities consisting principally of purchases from Maiden Lane III. Base net investment spreads for Western National, our leading fixed annuity writer, and VALIC, our group retirement business, also benefited from active crediting rate management. These net investment spreads were up 45 basis points from a year ago at Western, and at VALIC, they were up 47 basis points. Crediting rates for Western were down 21 basis points from a year ago, and at VALIC, they were down 31 basis points. We will continue to actively manage spreads for both annuities and universal life products. Approximately 56% of SunAmerica's annuity and UL account values are now at minimum guarantees, up from 51% last quarter and 38% at the end of the second quarter of 2011. Nearly 70% of total annuity and universal life account values have minimum guaranteed crediting rates of 3% or lower.

On Slide 14, we've provided additional disclosure on the impact of sustained current low interest rates. There's no change to our outlook for the remainder of this year or next year. Looking further out to 2014 and '15, you can see that there is additional pressure on earnings, assuming no changes in rates, but no meaningful impact to DAC or statutory capital is expected. Our projections are for a steady decline in base portfolio yields in this scenario and new money yields of between 4% and 5%. And to give some context, our new money yield in the second quarter was 5.03% in the aggregate.

So we continue to manage through the current interest rate environment and expect that we'll have opportunities to grow profitably through a continued focus on product innovation, strong in-force product management and strengthening and growing our distribution footprint.

And with that, I'm going to turn it back over to David to wrap this up.

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

Thank you, Jay. And before I turn it over to Liz, just a comment or 2 on Slide 15 for a few highlights of our Mortgage Guaranty business, United Guaranty. We continue to make good progress in terms of operating earnings, which, this quarter, were driven by favorable development and the continued decline in new delinquencies. We also continue to grow our new insurance in-force or new insurance written. And I think, most importantly, we've assisted over 24,000 Americans stay in their homes through modifications and refinancings. And so that continues to be a focus of the United Guaranty team.

So with that, Liz, I'll turn it back to you for Q&A.

**Elizabeth A. Werner**
*Head of Investor Relations and Vice President*
Thank you. Operator, at this time, we'd like to open up the lines for questions.

# Question and Answer

**Operator**

[Operator Instructions] And we will take the first question from Josh Stirling with Sanford Bernstein.

**Josh Stirling**
*Sanford C. Bernstein & Co., LLC., Research Division*

So a question for Peter. Could you help us better understand some of the actual operating levers that you guys are pulling on the initiatives to improve underwriting discipline and then separately, a critical initiative that you're pursuing in claims? We've talked a lot about the mix lever, which I think it makes a lot of sense, given the range of profitability in your businesses. But I think what's less clear for investors is exactly what you're doing, having -- and how you're affecting the lives of desk underwriters and claims adjusters as you guys manage through process changes and change your underwriting policy.

**Peter D. Hancock**
*Former Chief Executive Officer, President and Director*

Well, I think starting on the underwriting side, it's the process of really exploring best practices around the world through integration of the best thinking that has grown up in the historically rather separate cultures of the domestic broker group and the Lexington in the U.S. versus AIU internationally. And so the global management structure that we have for underwriting in commercial, it was announced when I took the role, but was really rolled out at the level of the underwriting management structure over the course of last summer. So we're starting to reap the benefits of those consistent global standards which allocate risk appetite, where we're getting best rewarded for the risk that we're taking. So that's, I would say [ph], how underwriting authorities are delegated, how technical pricing models are used, where underwriter judgment is allowed to alter the results for technical underwriting models. So these are a work in progress, but we made a lot of progress in the last 12 months, which is starting to feed through in our loss ratio. The business mix shift is both a macro point, recognizing that long-tail casualty lines are less attractive in a low-interest-rate environment than they were in the past. However, as we apply greater and greater understanding using analytical techniques, predictive modeling and other methods, we're finding attractive areas of business mix at a more micro level that are also coming to fruition. On the claims side, it's a long investment that started in '08 in our global claims initiatives, that it's starting to be rolled out around the world and giving us some very encouraging improvements in reduced leakage. And so one very tangible example of that in commercial auto fleets in the U.K., we've seen loss ratios drop by 10% by exporting best practices. So we're quite encouraged that the return on investment for using systematic claims management techniques all over the world is going to continue to reap benefits. And again, this is an area which lends itself to analytics and predictive modeling, especially in the area of fraud control where we have pockets of excellence, but a lot of the world has not fully embraced state-of-the-art, modern fraud control. So I think that we see some interesting opportunity to further improve that.

**Josh Stirling**
*Sanford C. Bernstein & Co., LLC., Research Division*

Great. And David, I very much appreciate the expanded disclosures on global capital markets and the direct investment book. I wondered if you could spend just a little more time talking about how the capital balances or at least the excess assets in these businesses we should think about tying those back to the holding company assets you've indicated that you have. And I guess a question that, ultimately, most investors are trying to figure out is if you sort of add up the holding company liquidity with liquidity that may be available in other buckets, if we look forward, say, 90 days, maybe we imagine a AIA transaction, markets dependent on that, what a reasonable level of liquidity that would be available and truly excess to the company would be?

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

Sure. And I'll comment, and if my colleague, Brian Schreiber, wants to add, he'll do so. I think we were pretty clear about our view of the excess liquidity and cash and financial resources that were now available that were coming out of the direct investment book that -- which is why we made the disclosure that we did, and we're trying to give people a better sense of the size and magnitude and the financial resources that stand behind the direct investment book and our confidence in those future cash flows in the stress-testing that we do in conjunction with our enterprise risk management people to assess how much is truly excess at this time. And I think that our disclosure around that is pretty clear. So I think, again, we're evaluating from time to time based on market conditions and where we are. And we've not made any decisions, as Bob said, with respect to either ILFC or AIA at this time. So I think it would be premature to comment on that and speculate about what we may or may not do. Brian, anything else on the Direct Investment book?

**Brian T. Schreiber**
*Former Chief Strategy Officer, Head of Corporate Mktg & Communications and Executive VP*

Yes, I think generally a simple way of thinking about it is, as David mentioned earlier, we are still standing by our aspirational goals for capital management. And when we did the re-IPO, we explained that the sources of available capital will come from non-core asset dispositions but also from excess capital being generated in the operating companies as well as maintaining leverage at the holding company. That said, the DIB will run off over time. It's got substantial NAV and a meaningful amount of pull-through intrinsic in its underlying assets. So over time, that NAV and that additional pull-through intrinsic will ultimately be freed up. And again, that's how we get to those aspirational goals of $25 billion to $30 billion.

**Josh Stirling**
*Sanford C. Bernstein & Co., LLC., Research Division*

That's great. And just a minor clarification. So the Direct Investment book, the excess assets in that are in addition to the $7.3 billion of holding company cash and investments that you guys have disclosed?

**Brian T. Schreiber**
*Former Chief Strategy Officer, Head of Corporate Mktg & Communications and Executive VP*

We consolidate -- again, the DIB liquidity is part of sort of overall parent liquidity. So in that number, you have a DIB. But keep in mind, the number in the Q is as of 6/30. And since then, we've received the proceeds from ML III. So if you're doing sort of a pro forma, you'd need to add that to the parental liquidity balance.

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

Yes, Josh, just to be clear, though, the NAV is different from cash. So -- I want to make sure you're clear on that, okay?

**Operator**

And now we'll move to our next question, and that will come from Jay Cohen with Bank of America Merrill Lynch.

**Jay Adam Cohen**
*BofA Merrill Lynch, Research Division*

I guess a couple of questions. The first is in the Q, you talked about some pressure in the Japanese Consumer business. I'm wondering, can you talk about what's happening there and what you're doing to address that?

**Peter D. Hancock**
*Former Chief Executive Officer, President and Director*

Yes, I'm going to ask Jeff Hayman to answer that.

**Jeffrey L. Hayman**

*Former Vice President*

Jay, so I think the Q commented on both auto and accident and health, so let's address them in that order. The auto severity issue that was highlighted really only is in relation to the Fuji Fire & Marine portfolio. Our legacy, if you will, auto portfolio has performed quite well in the quarter. The Fuji Fire & Marine portfolio is reported to us in the quarter lag, so this is actually first quarter months reported in the second quarter. It has a much lighter geographic spread than our historical businesses. And there was a lot of bad weather in Japan in the first quarter, a lot of heavy winter weather, and that affected our physical damage and property damage liability severity. So we look at that as episodic, not chronic. On the A&H front, we sell basically 2 chunks of business. We have an individual supplemental medical type of business, and we have a group benefit combination of at-work and 24-hour largely accidental death and dismemberment business. The AD&D business is basically a large loss business. So a number of industries where we have good penetration from a group benefits perspective have increased activity as a result of the reconstruction after the Tohoku catastrophe. So we've had to play catch-up in terms of rates. We just implemented an 11% rate increase in that portfolio on June 1. Renewals are already going out, and we've already done some rebalancing, remixing of benefits and some other product changes. There's also a small amount of individual AD&D business that we really don't sell much in the way of new business, but it's a historical portfolio that the rates are governed by the rating organization in Japan. And they've just promulgated a 15% rate increase that the industry will have to adopt at some point within the next 12 months. So we're confident that we can get a handle on those portfolios as well.

**Jay Adam Cohen**
*BofA Merrill Lynch, Research Division*

That's really helpful. And the second question, on the commutation of the insurance, reinsurance treaty which resulted in the change in the reserve discount, are there other internal reinsurance treaties that also can be commuted? Is this another source, potentially, of more reserve discounts to come?

**James Bracken**

So this is James Bracken. We do have internal reinsurance contracts within the organization to enable us to deploy capital effectively. The contract that we commuted in the current quarter was one of the few that actually ceded U.S. workers' comp business offshore, and so we shouldn't expect us to be -- to see this type of benefit arising from internal commutations on a go-forward basis. This was 1/2 of our overall restructuring of internal reinsurance for the organization, so we've been working through this for a fairly long time.

**Peter D. Hancock**
*Former Chief Executive Officer, President and Director*

I'll just put that in the broader context of the simplification of our legal entity structures around the world and the conversion of branches to subsidiaries, especially in Asia. While in Europe, we are converting to a series of branches in Europe of one central European hub in the U.K. and a revision of internal reinsurance and capital maintenance agreements that optimize our capital fungibility around the world.

**Robert Herman Benmosche**
*Former Chief Executive Officer, President and Director*

Let me be more candid. We did a lot of auditing to make sure that the reserve development and this action were absolutely independent of each other.

**Peter D. Hancock**
*Former Chief Executive Officer, President and Director*

It had been long in the works, in other words.

**Operator**

And now we'll move to the next question. That will come from Adam Klauber with William Blair.

**Adam Klauber**
*William Blair & Company L.L.C., Research Division*

As of the end of July, how much cash and short-term securities do you have at the parent company? And could you give us some range and how much of that may be used for near-term buybacks?

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

Okay. Again, in the Q, parental liquidity is at $7.3 billion. That includes the DIB numbers as well, but it also includes some restricted cash at some of our subsidiaries, so parental liquidity excluding some of the restricted cash is $6.5 billion. Then we've received roughly $6.1 billion so far in Maiden Lane III proceeds. We expect to get another roughly $1.9 billion by mid-August and then another roughly $0.5 billion at some point in the future. So we do have ample liquidity in the organization and ample capital. We did also buy a reasonable amount of the Maiden Lane III securities, which could use some of that liquidity. So as David mentioned, there was -- seemed to be $5 billion of excess liquidity that could be allocated to other uses of the parent. And other than that, I don't think we're going to comment any more on capital management.

**Adam Klauber**
*William Blair & Company L.L.C., Research Division*

Okay. And one follow-up on Chartis, you've obviously done a lot of hard work to get profitability moving in the right direction. Are we in a -- in baseball terms, are we in the fifth inning, eighth inning? Where are we at as far as really restructuring the portfolio?

**Robert Herman Benmosche**
*Former Chief Executive Officer, President and Director*

I thought we did pretty good so far. Let me turn it over to Peter.

**Peter D. Hancock**
*Former Chief Executive Officer, President and Director*

Yes, I think that the improvement in underwriting methods I see as a perpetual striving for improvement but with some low-hanging fruit that's more front-loaded. And I think that some of that's visible to you and some of that's going to be much more difficult to see. The most visible evidence of that is the reduction in top line over the last 4 quarters as we changed the way we looked at the loss-sensitive business, which is over $1 billion in premium, that produced negative risk-adjusted profitability the way it was configured. The customers were indifferent to us providing the same service for a fee. So that's just a very visible evidence with change in mindset where we're focused on value for our customers, not so much the appearance of volume in the top line net premium written number. We do see growth in net value, as our focus is around growing profitable lines, and that starts out at macro business mix shifts, which we talked about, but increasingly, micro ones. And the more micro, the more complex and the longer it will take. But I think that that's just natural competition. So I think that we've turned the corner in the most visible evidence of change in approach to underwriting. We have a full year underwriting cycle under our belt, and so I think trends as they emerge from here on out will be more representative of our progress.

**Robert Herman Benmosche**
*Former Chief Executive Officer, President and Director*

Let me give you a simple example. We've been talking about using information, and we talked about -- we paid in the last 10.5 years $27 million worker comp claims. We never did analytics on it. Peter, his team, the actuarial team are now working with Johns Hopkins University to study 27 million claims records. What's an example of things we're now learning? That if you injure your shoulder at your workplace and go to the emergency room, and they -- because it's painful, they put your arm in a sling. It'll generally cost us an additional $50,000, because generally, that will cause your shoulder to lock up. And so we're now thinking about how do we use that information to go out and tell hospitals how AIG feels you need to deal with this kind of injury to prevent it from getting worse. That's a huge insight. It allows us to market the company to the medical community that we're doing things that will help them heal their patients better. It also helps us deal with our costs. So that's just one example of many, many, many as we go through this database and begin to use information we've never used before. So as you asked what inning it is, I don't know. But all I can say is we're going to have a good inning in the first, the second, third and the fourth, because this data will continually roll out and give us an enormous competitive advantage over the next 4 or 5 years.

**Operator**

And the next question will come from Josh Shanker with Deutsche Bank.

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

Some items that were below the line, I'm wondering if you can walk through why we don't have to fear more litigation expenses in the future and talk a little bit about the legacy FIN 48 issues.

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

Sure, Josh. it's David. Let's take them one at a time. So the 3 big items with the valuation allowance release, we put some disclosure in our Q around, I'll say, why now and why that number? So we've been very active in developing prudent and feasible tax planning strategies and transactions. And we now believe we have met the standard to now project forward the benefits of those. So that's that. So we've made our best estimate of what that is, and so you can put that. That's the number, and we feel good about the trajectory and the path to that.

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

On the DTA, you're saying?

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

Yes, on the DTA. That's the value from the capital loss carryforward. That was the $1.3 billion benefit.

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

Yes, yes, yes. More the FIN 48 and an offset, I guess, or something?

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

Yes. So the next item was the FIN 48 related to the foreign tax credits associated with some cross-border financing transactions. And what I would tell you is that -- a couple of things. One, we observed a piece of litigation, not related to AIG, but it was a market event. And we researched that, understood that and then evaluated our entire portfolio of related transactions and made our best estimate of what the potential exposure is on those, and we made our adjustments accordingly. I would never tell you that there never will be another, but we made our best estimate based on looking at the entire portfolio based on facts and circumstances as we know. So again, we looked at the whole portfolio. And then I think you had a question on...

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

$719 million of litigation expenses.

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

Yes. And on the litigation, the only thing I would say, our disclosure speaks for itself. And we've made our best estimate on what the exposure is. And I wouldn't comment any further than that. Again, I would point you to our disclosure, and I wouldn't go any further than that.

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

There's no color in the disclosure, so it's just -- is it a general pool? Is it for specific -- is it one specific piece of litigation?

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

I'm not going to comment any further than what our disclosure says, Josh. I appreciate that.

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

Okay, okay. And then for Jay, how confident are you that you can fully hedge out the equity risk on the variable annuity sales that you're doing?

**Jay Steven Wintrob**
*Former EVP of Life & Retirement, CEO of AIG Life & Retirement and President of AIG Life & Retirement*

Well, I think we're very confident in the way we structured our VA hedge program. If you're referring to the equity risk exclusively?

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

Yes.

**Jay Steven Wintrob**
*Former EVP of Life & Retirement, CEO of AIG Life & Retirement and President of AIG Life & Retirement*

Yes, I think that we're very confident. I think that the market's deep with the contracts we used to hedge that out, and we've said in the disclosure that we basically are market-neutral terms of the equity markets. And then we've commented separately on our approach to interest rate hedging, trying to balance both the economic interest, the statutory capital interest and the GAAP reporting interest.

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

Is there a certain amount of growth that could occur where you'd find it difficult to continue to hedge out the equity risk?

**Jay Steven Wintrob**
*Former EVP of Life & Retirement, CEO of AIG Life & Retirement and President of AIG Life & Retirement*

I believe from where we're at, I think that the answer's no at this point. I think the market there is quite deep on that. So we'll continue to assess that, reevaluate it. But I think from where we are now, essentially the answer is no.

**Operator**

And now we'll move to our next question. That will come from Michael Nannizzi with Goldman Sachs.

**Michael Steven Nannizzi**
*Goldman Sachs Group Inc., Research Division*

Just one -- back to the kind of the cash in, cash out for a second, how much of the $7.1 billion in ML III purchases came from the $6 billion that you got in July? Sounds like $1.5 billion was in SunAmerica. Just trying to understand, is the rest from that? Or did it come earlier in the year? And then just one follow-up.

**Jay Steven Wintrob**
*Former EVP of Life & Retirement, CEO of AIG Life & Retirement and President of AIG Life & Retirement*

Well, through June, there were roughly $500 million, I think, of purchases, so most came subsequent to that. Again, I don't think we...

**Robert Herman Benmosche**
*Former Chief Executive Officer, President and Director*

I did, in fact, mention that we did about $400 million of the first tranche of the max, I think -- $600 million. I'm sorry, $600 million.

**Jay Steven Wintrob**
*Former EVP of Life & Retirement, CEO of AIG Life & Retirement and President of AIG Life & Retirement*

That's right, yes. And again, some of the purchases were done at parent. Some of the purchases were done directly into the insurance companies. And we haven't disclosed any additional details on that. So I think that's where we'll leave it.

**Michael Steven Nannizzi**
*Goldman Sachs Group Inc., Research Division*

And then just help me understand like how do you think about the decision to deploy into these assets versus to hold for other uses? And just trying to understand kind of what are the kind of trade-offs that you think about -- that you thought about in terms of choosing to buy in those assets.

**William N. Dooley**
*Executive Vice President of Investments*

This is Bill Dooley. This is just part of our normal evaluation on strategic asset allocation and where do we want to put both the free cash flow of the insurance companies and the reinvestment of maturities within the insurance companies. And you look at the overall interest rate environment, which everyone seems to be concerned about. And these assets fits our risk profile very well. It fits our duration on the book very well. And we allocate these type of assets between the life businesses and the property-casualty businesses. And with the blend of our, what I would say, core investing, with the additional yield that we make on these asset classes, it gives us, I think, a very acceptable return on our overall investment policies.

**Michael Steven Nannizzi**
*Goldman Sachs Group Inc., Research Division*

So $1.5 billion was in SunAmerica, a chunk happened. And do we know how much happened in Chartis?

**William N. Dooley**
*Executive Vice President of Investments*

No, we don't know. I don't have that number in front of me right now.

**Operator**

Next question will come from Mark Finkelstein with Evercore Partners.

**A. Mark Finkelstein**
*Evercore ISI, Research Division*

I guess a point of clarification on the disclosure around the DIB assets and liabilities. Just a confirmation, of the $39 billion of assets that you disclosed, roughly $8 billion of that relates to Maiden Lane III. Is that correct?

**Robert Herman Benmosche**
*Former Chief Executive Officer, President and Director*

That's correct.

**A. Mark Finkelstein**
*Evercore ISI, Research Division*

Okay. And I guess just how much capital do you think needs to manage that book or to support that book?

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

We don't look at a single measure of capital. We look at NAV in an absolute basis. We look at economic capital, which is, again, available capital versus required capital under various stress scenarios. And we also look at the cash flow efficiency of our assets to cover our maturing liabilities, and we look at that under stress as well. So it's not just one approach or methodology that we use. And I think, as David said, based on that analysis, we have -- we made the decision to reallocate some of the capital within the DIB. So that gives you a sense that we believe there was excess capital and excess liquidity. In addition, the portfolio is in wind-down. The assets and liabilities are matched up quite well. And then again, over time, we would expect to realize the freeing up of the NAV as well as the additional capital created from the pull-through intrinsic of the assets.

**A. Mark Finkelstein**
*Evercore ISI, Research Division*

Okay. On SunAmerica, you sold about $9 billion of assets to harvest gains. You released $1.3 billion or so of the capital loss carryforwards. Can you just expand upon the strategy of harvesting gains going forward? You did talk a little bit about that in the Q. And I guess what I'm interested in is, how much more should we be expecting and how do you expect these assets to be redeployed?

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

Well, this is David. I'll touch on the expectation of the strategy, and then Bill can talk about redeployment. We evaluated the totality of, again, the prudent and feasible strategies and transactions, including capital gain harvesting. So that was incorporated into our overall assessment for the quarter. We have, again, various transactions that have as a consequence tax outcomes. And then we've identified certain portfolios where capital gain harvesting is an appropriate step to take, again, balancing the need for maintaining capital sufficiency, statutory reserves, cash flow testing, maintaining margin and operating earnings. So we're, again, not looking at any one individual measure but trying to balance the need for operating earnings with the need to realize the benefits of the capital loss carryforward. I would say that the amount of expected realization is in line with what I had commented earlier, even going as back as far as when we run the initial offering back in May of 2011. So it's consistent with that. We're executing in line with that, with those expectations. So Bill, you want to talk about the redeployment?

**William N. Dooley**
*Executive Vice President of Investments*

Sure. I guess my first comment is that in just the normal course of business, on managing these portfolios, we take gains from time to time, and we continue to take gains from time to time as we take different views on different credits within the overall portfolio. So that was number one. Number two, if you look over the portfolio over the last 18 months or so, with the redeployment of the cash that built up over that period of time, the portfolio has undergone a lot of changes to its asset classes and things like that. And at the same time, it allowed us to take some of these gains that maybe in the past we would have during this period of time. The other aspect of the thing, too, is that we took this opportunity to rebalance the duration of the portfolios. So right now, particularly in the SunAmerica portfolios, we feel that the assets are reflective of the proper duration against the liabilities. And I think that's also very important given the interest rate environment that we find ourselves in and we could be looking at in the near term as well.

**Robert Herman Benmosche**

*Former Chief Executive Officer, President and Director*

And I just want to remind everybody, we did talk about SEC lending. And we've gone through a whole approach to our liquidity management here and one of the most effective ways to do that. And as part of that liquidity management, we've determined that we could do some securities lending, and that as a consequence of that securities lending, it would create capital gains. And so that's another form of harvesting capital gains, which is part of that liquidity program that we probably wouldn't take that approach if we couldn't cover some of the costs of those capital gains. But that's covered now, so it made sense to take that approach to how we handle our liquidity. So that's another thing that's allowing us to get there without actually selling up -- selling securities and losing the yield.

**Operator**

And now we'll take a question from Thomas Gallagher, Credit Suisse.

**Thomas George Gallagher**
*Crédit Suisse AG, Research Division*

Bob, and I guess just a question on your comment that you have a team who's preparing for federal regulation by the Fed. Can you comment at all about what your initial read on kind of what you guys are thinking behind the scenes on that? Is there going to be any meaningful change in terms of strategy businesses, asset allocation? Is there anything that you've sort of gleaned thus far as you've kind of reviewed what new regulation will mean?

**Robert Herman Benmosche**
*Former Chief Executive Officer, President and Director*

No, I don't think there's any concern we have about the businesses we have and so on. We are discussing internally the effects the Volcker rule could have on us, and so there's little concern there. We're thinking about that, and we are giving thought to whether we should now close the bank we have, because we're concerned about that aspect of it, and an insurance company invests very differently than a bank would. But aside from that issue, this is really about making sure that we have really good process and good controls, especially in the risk management arena, very good controls around how we determine we can handle a bump in the night that happened in '08, for example. And so that's the CCAR process that we go through. And we're doing it in the same discipline that -- look, a lot of us were frustrated with SOX 404 and so on. It was a lot of form over substance. But the process itself made sure companies really thought through the controls they need to have to make sure that they issued numbers that are correct. And so we see this as an enhancement to that process, and so it's really about process, policies and making sure we have really good controls over some of the assumptions around our liquidity and so on. So that's really the major change is just how we do things.

**Thomas George Gallagher**
*Crédit Suisse AG, Research Division*

Got it. And you wouldn't see, necessarily, an asset allocation change within the portfolio? And in particular, when you read some of the NPRs that have been put out by the Fed, and again, a lot of this, as it relates to you guys, is probably still somewhat uncertain. But when I look at, like, RWA charges for things like alternatives, it seems very high. So just curious from a high level whether there would be a change for you.

**Robert Herman Benmosche**
*Former Chief Executive Officer, President and Director*

We have the NAIC. They do a very effective job in the U.S. You have the FSAs around the world and so on. All of them have their capital charges with insurance companies. We're required to maintain RBCs and so on. So the insurance companies, in my opinion, are already there. And I think that we don't know because we don't know what we don't know. But my sense is that that's not going to be an issue. The real question becomes the amount of money that we hold at the holding company above all of the regulated entities and, to the extent that we own these regulated entities, what requirements the Fed may have.

And for example, at AIG, we have, as you know, the capital and maintenance agreement, which says that we can contribute money back into the insurance companies of RBC's fall [ph]. We've got to make sure that, that money is actually there and is available if, in fact, there is a crisis at the insurance company. And so having the Fed regulate that money and making sure that when we have a liquidity plan, we have one, that's reassuring for the insurance regulators that are looking at AIG's ability to live up to its commitments. So in a way, we see this as a big positive.

**Thomas George Gallagher**
*Crédit Suisse AG, Research Division*

Okay, that's helpful. And then just last question, just a question, in the Q, it references on the DIB that excluding the mark-to-market adjustments, there was a negative spread. I think that's just because ML III is its own entity on a segment reporting basis, and right now, technically it's in the DIB. But as we think about selling off or using potential proceeds from ML III for something else, how should we think about the earnings power of the DIB, assuming there's a drawdown of assets -- from use of assets from Maiden Lane III?

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

Yes, I think it's a good question. I think you're right. The spread number does not include Maiden Lane III. But what it also doesn't include is where the most significant source of earnings going forward in the DIB, is the pull-through intrinsic of the underlying assets. So to the extent there are assets going out of the DIB, the remaining assets will, as we said, will be sufficient to meet maturities, and you'll see the pull-through intrinsic coming through over time. And excess liquidity to the extent it exists within the DIB could be used to make further attractive investments or to retire debt. So as the DIB winds down, you'll see more and more of that kind of activity.

**Thomas George Gallagher**
*Crédit Suisse AG, Research Division*

So in other words, there's a lot of assets within the DIB that had an element of below par that you would expect to get to par over time?

**David Lawrence Herzog**
*Former Chief Financial Officer and Executive Vice President*

It may be not par but to intrinsic. But they're trading at deep discount to what believe we believe intrinsic value.

**Elizabeth A. Werner**
*Head of Investor Relations and Vice President*

Thank you, everyone. Operator, at this time, I think we're going to take all the remaining questions offline. So please don't hesitate to give us a call if you're in queue. And thank you again for joining us for our second quarter earnings call.

**Operator**
And ladies and gentlemen, with that, that will conclude your conference for today. We do thank you for your participation. Have a wonderful day.