S&P Capital IQ

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American International Group, Inc. NYSE:AIG

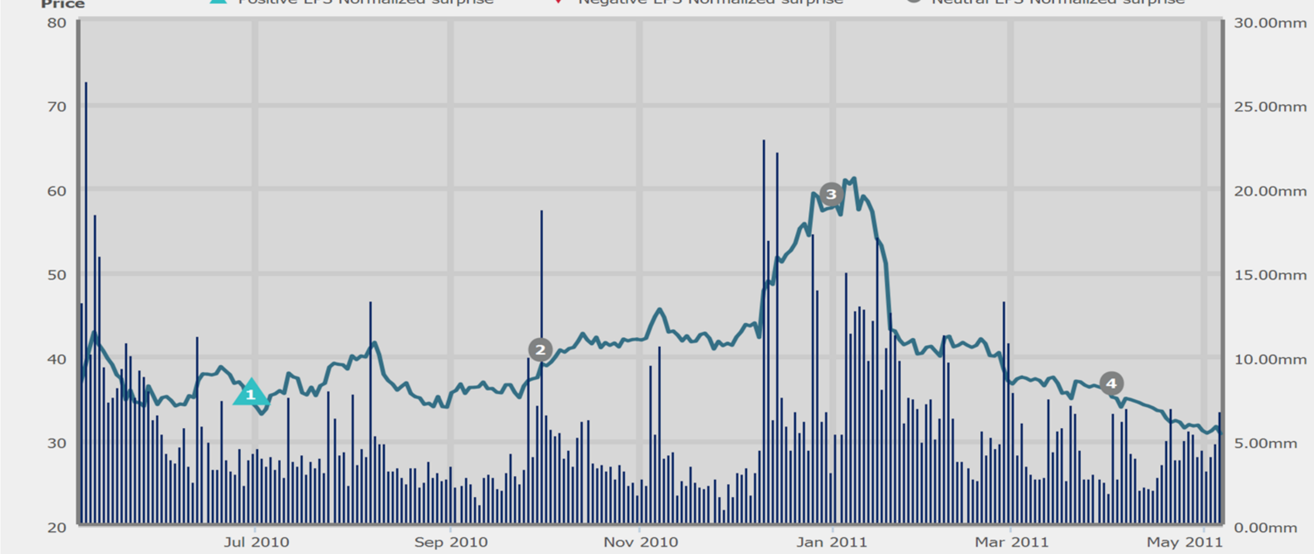
FQ2 2011 Earnings Call Transcripts

Friday, August 05, 2011 12:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2011-			-FQ3 2011-	-FY 2011-	-FY 2012-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.96	0.69	▼(28.12 %)	0.67	3.48	3.12
Revenue (mm)	13755.22	17638.00	▲28.23	13823.22	52704.51	53446.72

Currency: USD
Consensus as of Aug-05-2011 12:23 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2010	0.98	1.99	▲103.06 %
FQ3 2010	0.93	(1.47)	NM
FQ4 2010	(14.02)	(16.20)	NM
FQ1 2011	(0.09)	1.30	NM

Call Participants

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Presentation

Operator

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

Elizabeth A. Werner
Head of Investor Relations and Vice President

Thank you, and good morning, everyone. Before we get started, 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 factors described in our 10-Q, under Management's Discussion and Analysis and in our 2010 10-K and subsequent 10-Qs under Risk Factors. AIG is not under any 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 reconciliations of such measures to the most comparable GAAP figures are included in our financial supplement, which is available on AIG's website www.aig.com.

At this time, I'd like to turn our call over to Bob Benmosche, our CEO

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

Thanks, Liz, and good morning to everybody. And we have a lot to cover, so I want to be pretty brief, and then I'll turn it over to David. The key for this quarter though, and I do want to comment and stress it, is that we completed the last hurdle for this company and for the conditions of closing for our restructuring. And so by issuing 100 million shares and raising that equity capital, it allowed the treasury to terminate the Series G preferred, and so therefore, in my mind, AIG's crisis is over.

We no longer have any direct obligation that we have to be concerned about vis-à-vis the government. Whatever is owed to the government for what was -- they gave us in the beginning is all covered by collateralized partnerships for the common shares that we issued to them back in January.

So today, we are independent of government support, which is very important for our employees and our clients, as we go forward. There's clarity. AIG is here, we're an investment-grade company. And if you look at our results for the quarter, our top line is strong, our retention of clients is strong, our retention of people is strong, and so all of the fundamentals of running this company are moving in the right direction.

You can see in Chartis, for example, that the combined is now 97.7 for this quarter, working its way down. And you know that's a huge book of business, so it takes time to do that. You also will see in SunAmerica the strong top line, in terms of those products that they sell. That's a good story, as they move back in all of the distribution systems.

UGC has a good control over its mortgage business. In fact, they're now leading in market share and -- in terms of that business and have a very strong performance in terms of losses relative to their competitors. That's going well. And, of course, as you saw in ILFC, we've been able to deal with our legacy aircraft with the announcement of this acquisition of AeroTurbine. So that will give us more options in the late cycle of the life of those airplanes, which we did not have before.

So when you look overall, we're in good shape. I also should mention that Nan Shan looks like it will close. That will finally get done. That's another $2.1 billion, $2.2 billion we'll be able to bring in house and deal with paying down the SPV with the U.S. Treasury. So that's another good sign.

So overall, we're in great shape. We can look forward and focus on operating results, which we have over the last 4, 5 quarters, in particular. You could see it in our performance. And I'll have David now take you through the details of that, so you can reconcile what we reported and some of new nuances in those numbers. David?

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

Thanks, Bob, and good morning, everybody. Let's turn to Slide 7 for the earnings highlights. Second quarter net income was $1.8 billion, up from a loss of $2.7 billion a year ago. Importantly, our after-tax operating income attributable to AIG, which is our principal non-GAAP measure, was $1.3 billion versus $800 million a year ago. On a per-share basis, after-tax operating income was $0.69 for the quarter versus $1.18 a year ago. Book value per share was $49.18, up 2% sequentially. Adjusted ROE was 6.3% for the quarter, 8.3% year-to-date.

Let's turn to Slide 8. Chartis reported pretax operating income of $789 million, down $166 million from a year ago due to an extraordinary level of natural catastrophe losses. CAT losses in the second quarter this year were $539 million, largely from U.S. tornadoes and storms versus $300 million a year ago.

SunAmerica posted $743 million in operating income in the second quarter, down $115 million from a year ago. The SunAmerica results included $176 million decrease in the value of our Maiden Lane II investment due mainly to spread widening on the underlying non-agency RMBS securities.

We also increased our reserves for IBNR by $100.6 million, as a result of enhancing our death claim practices. ILFC operating income was $86 million for the quarter compared to $182 million a year ago. ILFC had $60 million of interest and other costs associated with their debt issuance and the subsequent tender offer for bonds, and took an impairment charge of about $42 million on a handful of aircraft that we're either going to sell or put into part out.

As you might have read, again, as Bob mentioned, we announced the acquisition of AeroTurbine, the part-out business, which will provide new opportunities and options for us to manage the older aircraft in our fleet.

Turning to United Guaranty. Our mortgage guaranty business reported $13 million of operating income versus income of $226 million a year ago. Last year's income benefited from $232 million of favorable prior year development, while this quarter included $25 million of unfavorable prior year loss development.

To put this in context, United Guaranty has roughly $3 billion in net loss reserves. In addition, the second quarter included a $40-odd million favorable settlement with a former underwriting customer. Newly reported delinquent loans continued to decline yet overturned for previously declined or rescinded claims increased. Domestic first lien reserves per delinquency remain steady at about 29,000 per delinquency.

Turning to our other reporting unit. It has reported a loss of $984 million in the quarter versus $135 million a year ago due largely to the mark-to-model loss of $667 million on our Maiden Lane III investment, and to a lesser extent, our capital markets' wind-down portfolio. As you know, Maiden Lane III is a special-purpose vehicle that holds both multi-sector CDOs purchased in the fall of 2008, in which we own a subordinated tranche plus a 1/3 residual interest.

As of June 30, the value of our share of Maiden Lane III was $6.4 billion, down 10% sequentially, but importantly, up 28% from our initial investment. We essentially gave back the $744 million gain in the first quarter. Prior to the second quarter, we reported 8 consecutive quarters of gains. In the second quarter, credit spread widening and the corresponding impact on fair value model discount rate assumptions were the key drivers in the Maiden Lane III value. Cash flows within the underlying CDOs remain steady, and we still anticipate receiving payouts beginning in 2014. The Maiden Lane III cash flows, to date, have paid down $12 billion to the Federal Reserve Bank in New York or about half of their senior loan.

Asset management, which is included in other, had income of $92 million for the quarter, down from $303 million a year ago, due largely to the tightening of credit spreads in the asset book from a year ago.

Capital markets had a loss of $160 million -- or roughly $160 million due to the unrealized mark-to-market loss on the super senior credit derivative portfolio versus a gain last quarter. The loss was driven by a decline in values of the multi-sector CDS book. The wind down, again, it continues to progress very significantly. This book had 7 quarters of favorable marks before the second quarter, and our view of intrinsic value hasn't changed.

Remaining in the multi-sector book is about $6 billion of notional, for which we hold liabilities of roughly $3.2 billion, most of which we've already posted collateral against. Independent views support our belief that the actual settlements under these contracts will be less than the GAAP liability and the collateral postings we have, thus giving rise to the potential intrinsic gains, we believe are worth the GAAP P&L volatility that we are required to report.

As previously disclosed, the second quarter marked the end of the active wind down of AIGFP. The remaining derivative portfolio at the capital markets are predominantly non-complex market derivatives entered into to manage the risks of AIG and its affiliates or our hedges on those positions.

At the end of the second quarter, approximately $29 billion of notional remains in the CDS portfolio, of which $22 billion does not require active trading management. The remaining $8 billion CDS, which is being actively managed, has over $1 billion of upside, we believe, against the modest contingent liquidity need going forward.

Also during the second quarter, AIGFP agreed to terminate 2 super senior regulatory capital transactions with a combined net notional of over $24 billion, that notional as of March 31, and those have had previously been subject to possible additional collateral postings. Finally, our remaining investment in AIA appreciated by about $1.5 billion in the quarter.

Turning to Slide 9, which shows the after-tax income reconciliation. Reconciling items have declined meaningfully as most of the structuring activities are behind us. Also, we adjust for taxes since we apply a pro-forma tax rate to our operating earnings. The taxes are added back here to the GAAP net income to get to GAAP net income, since we aren't paying much tax, and we currently have a full valuation allowance.

Jumping to Slide 11, our capital structure. This reflects the January 2011 recapitalization and reduced leverage. Our leverage is currently in the low end of the range of our long-term target, and we still assume a 20% to 25% debt to total capital as part of our aspirational goals.

Turning to Slide 13, Chartis. Overall, I would note that Chartis' reorganization in the global commercial and consumer business is beginning to develop some positive momentum. Net premiums written, excluding Fuji and the impact of foreign exchange, increased about 2.4%. Prior year development was insignificant for the quarter after considering related loss sensitive premiums.

The 4 business lines with the largest reserve strengthening at year end 2010 saw little activity in the quarter. The combined ratio on an accident year basis, excluding CATs was 97.7%. The expense ratio remained essentially flat. We are intensely focused on reducing general operating expenses in a thoughtful and deliberate way, but we will continue to make strategic investments and projects that better position Chartis for the future.

Turning to Slide 14, net premiums written benefited, as I said a minute ago, from our Fuji acquisition, but otherwise were around 2.4%, up for the quarter. Pricing is trending positively overall. In particular, in the U.S. market, we're experiencing low single-digit increases on average led by commercial property and workers' compensation lines. Customer retention, as Bob mentioned, is also strong.

Turning to Slide 15, Chartis' investments. Net investment income for Chartis was $1.14 billion in this quarter, up 2.6% from a year ago. The primary driver of the increase is improved interest in dividends and the effects of consolidation of Fuji. Chartis continued to reduce its muni bond position, which was 28% of Chartis investment -- invested assets in the quarter, down from 31% last quarter.

On Slide 17, turning to SunAmerica Financial Group. SunAmerica's operating income was $743 million in the quarter, down $115 million from a year ago. As you can see, SunAmerica's operating income has been relatively stable for the last 5 quarters. This quarter's volatility relates to market volatility for RMBS, and in particular, in its effects on the value of Maiden Lane II, which is included in the SunAmerica Group. We also increased our reserve for IBNR by roughly $100.6 million, as I mentioned earlier. Our business remains diverse, strong, good momentum in sales and deposits, customer retention, and importantly, net flows.

Turning to Slide 18, premiums, deposits and other considerations. Life insurance CTPE sales increased 29% sequentially, largely driven by retail sales. Western National, while continuing to maintain its pricing discipline, again achieved sales of over $2 billion in the quarter, due largely to certain bank partners negotiating lower commissions in exchange for higher crediting rates for our customers. All in, total net flows for retirement services of $726 million were positive for the second consecutive quarter.

Turning to Slide 19 for SunAmerica investments. Net investment income was $2.46 billion, down $167 million from a year ago. As I mentioned, Maiden Lane II negatively affected this quarter by $176 million versus a positive $120 million a year ago. Partnership income was strong again this quarter due to performance of our private equity and hedge fund investments, which are reported on a one-quarter and one-month lag, respectively. Excluding Maiden Lane II, investment income increased by 5% on increased interest and dividend and partnership income. Most importantly, our base yields increased sequentially as we redeployed cash. More on that in a minute from Bill Dooley.

Turning to SunAmerica spreads on Page 20. Reported spreads declined despite the redeployment of cash. Declines and other enhancements, which is mainly Maiden Lane II, more than offset the growth in interest and dividends. Looking ahead, as we continue to take capital gains to realize the economic value of our substantial capital loss carryforward deferred tax asset reported spreads could be pressured. We're choosing economics over reported GAAP measure.

Now a few words on income taxes on Page 22 and 23. More fully described in our second quarter 10-Q, we apply a framework for evaluating the need for valuation allowances. Among other factors, AIG must emerge from its recent cumulative loss position, demonstrate a level of sustainable profitability. AIG's U.S. consolidated income tax group has reported taxable income over the first half of 2011 and is currently projecting taxable income for the full year of 2011.

In addition, the group expects to emerge from the cumulative loss in recent years in the second half of 2011. If these factors are met, the valuation allowance for the net operating loss, the non-loss life capital loss carryforward and the foreign tax credits could be released during the fourth quarter. Realization of the life capital loss carryforwards remains more challenging, and that portion of the valuation allowance will be released as the carryforwards are realized.

We still expect an effective tax rate of roughly 25% to 30% for the rest of the year on our operating income, driven by our substantial investment and tax rate immunities. Other discrete items, in any given quarter, will impact the rate as well. This quarter, among other things, we settled disputes previously reserved for, and the effect was favorable on the quarter.

And finally, a word on our outlook. Consistent with the next steps of our company and our increasing focus on long-term operating results, we outlined a number of long-term aspirational goals in our first quarter 10-Q, which we affirm again this quarter. We expect to continue to execute on the operating and capital management actions to achieve these goals.

At this time, I'd like to turn it over to Bill for a few comments on the cash redeployment.

William N. Dooley
Executive Vice President of Investments

Thank you, David. As we entered 2011, we had high investable cash balances in the insurance companies. And over the course of the first half of the year, we invested those cash proceeds in various asset classes to give the various durations necessary for the insurance companies.

So in the first half of the year, we invested just under $50 billion, and the average yield across the board on those investments were roughly between 4.5% to 6%. So when we entered the third quarter, we were fully invested with that -- with all the cash that was available at the beginning of the year.

Elizabeth A. Werner

Head of Investor Relations and Vice President

Okay. Operator, at this time we'd like to turn the conference call over to Q&A. We'd like to try and take one question, one follow-up from all the analysts, then hopefully we'll have time to do more. And they can get into the queue.

Question and Answer

Operator

[Operator Instructions] We'll hear first from Josh Shanker with Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

My question -- I'll give them up front, and they're not related, but they're similar. I try to understand the $100 million reserve charge in SunAmerica for incurred but not reported debt. And two, it seems for 2 quarters in a row, we've taken charges on a revision in outlook on cash flows for life settlement contracts. Given about 6,000 contracts, it seems like a pretty significant charge over 2 quarters. I wanted to talk about whether that will moderate, and what your outlook is there?

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

We'll have Jay just briefly give you an update on what the process changes were, and then we'll have Peter talk about the life settlements. Jay?

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

Good morning, Josh. It's Jay Wintrob. The increase of $100.6 million in the IBNR was in response to industry-wide regulatory inquiries, which we were in receipt of, regarding our life insurance claim settlement practices and compliance with the unclaimed property laws. Our practices in that area are currently, and have been, completely consistent with all the applicable legal requirements and all of the historical industry standards. Now having said that, we used this is as an opportunity to enhance our practices, and we voluntarily initiated a review using, for example, the Social Security Administration's Death Master File. And as a result of that review, we chose to post the IBNR of $100.6 million. So that's the background on that.

Joshua David Shanker
Deutsche Bank AG, Research Division

Is it most certainly non-recurring in nature?

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

Right now, most certainly, this is now part of our claims practices going forward. We will continue to use this and other information as it develops. And again, the inquiry was industry-wide, not specific towards America in general or SunAmerica Financial Group.

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

But the answer to the question is I believe that the process change that Jay talked about and it's more about a process change. There's a question about what practices are, but we just looked at our practices and said we think we should do it a different way. On the basis of what we've changed our practice to be, the team believes that they got this worked out in this IBNR, and this puts the problem behind us. And on a go forward basis, it will be part of the normal operating procedure. So you would see that it's just part of our numbers. So I think this closes it out from what we can see right now. Let me turn it over to Peter.

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

On the life settlements impairment charge, I'd like to just put it in the context of the overall life settlement portfolio, which totals a carrying value of $4 billion. We have instituted increased scrutiny of the longevity assumptions with updated medical information on individual life. This is a book, which has fairly large insured value per life. And as a result of those updated actuarial assumptions, which were validated by third-party scrutiny in this quarter as well, we have added the impairment charge. We would not anticipate future charges, anything of that scale. But on the other hand, as I said, it's fairly lumpy in terms of individual lives. But when we take an impairment, it's an asymmetrical charge, when any single contract is impaired. But you don't take positive news when it comes in, so there's an asymmetrical aspect of it. When we take an impairment, we basically look at current yields on similar contracts to mark down the position.

Joshua David Shanker
Deutsche Bank AG, Research Division

In the Q, you described it as an enhanced process change. You had $60 million of charges in 1Q and you're $180 million here. Is the process change fully in effect, so that we don't expect this to recur as sort of a change in the outlook, or just to be mark-to-market from here on out?

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

It's not mark-to-market, it's effectively cost accounting. So you're basically looking for impairments of individual lives. And so if you've got evidence that your assumption there is too aggressive, then you mark that to market, but you don't mark up the opposite, lives where you have information that suggests that you have it valued too low. So the enhanced process is just increased scrutiny on this book with additional third-party scrutiny to validate our own assumptions. That's what changed. And I would not expect charges of this magnitude going forward. But on the other hand, I would not expect it to be 0 either. There will be some volatility, and it's asymmetrical, because the positive news comes in the form of a higher expected yield over the approximately 10-year duration of these contracts.

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

But we also have taken a -- completed a very deep strategic review of what we're doing here. We're going to think about how we modify it. But this is not an area that we're going to be emphasizing going forward. We're just thinking about how to deal with it. So over time, we're studying this as an asset class, and we don't to think it's something that we're going to be growing.

Operator

We'll hear next from Donna Halverstadt with Goldman Sachs.

Donna Halverstadt
Goldman Sachs Group Inc., Research Division

I have a question about a business. It's a small size of your business mix pie, but I'm just not clear how you think about it. And I wanted to understand philosophically or strategically how you're viewing United Guaranty, whether it's core or non-core, or just merely a place holder until some future point in time, when we know if there's going to be a more robust future demand function for private MI? And as a follow-up to that the pace of flux in the MI industry is picking up rapidly, and I was curious whether or not you'd be interested in participating in any restructuring of the current industry make up.

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

We see UGC has really done a dramatic turnaround of that business. I feel they have employed excellent technology now behind their claims process, and so they've got themselves very much under control for the legacy book. They've done a wonderful job of reinventing how they underwrite mortgages. So they have a model now that works very effectively on new business. And the experience that we've been seeing over the last -- it started in '09, so you look at '09, '10 and '11 so far. That experience is exceptional relative to our history, as well as the industry. So we are pricing for the right risks, and we're getting the risk that makes sense for us, as a company. And we're not competitive in those risks, which we, obviously, are concerned about. Having said that, our market share has grown dramatically and -- with that performance. So we don't see any need to help anyone else out. And so for now, the business we operate at, as well as ILFC has done no harm to the core franchises of the company. But unlike ILFC, we feel that UGC does provide us a tremendous insight into a major aspect of our investment, which is residential mortgages and so on. We also believe that as the government begins to pull back, in some way, out of the Mortgage Guaranty business. There may be a better market for us in here. This may grow. And so for now, it's running very well, and it's enhancing whatever we do here, not only from a small amount of earnings, but also by the intelligence it provides us with what's going on in the economy. So for now, we see it as a keeper.

Operator

Our next question comes from Jay Cohen of Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Yes. I've got one question and Ed Spehar also has a question as well on the life side. My question on the property casualty side, I'm wondering if you can talk about some of the claims trends you're seeing. Obviously, with the review last year, there were some negative surprises in claims trends in various businesses. As you've entered now 2011, I'm wondering if can update us on the claims trends, particularly, in places like excess casualty and excess comp?

Robert S. Schimek
Executive Vice President and Chief Executive Officer of Commercial

It's Robert Schimek speaking. I think you can see from our quarterly review of our carried reserves that we did not experience any significant deviation from our expectation during the quarter, with respect to claims trends. That's one of the things we focus on each quarter. We have an expectation based off of our carried reserves of what should happen during the quarter, and we compare that to what actually did happen during the quarter. And I think, we, generally speaking, right now, it's a "class of business by class of business" distinction here. But generally speaking, we're seeing rate change in line with loss cost trends, in particular, for example, with respect to workers' compensation, where you're seeing rate increases. But it is "line of business by line of business" specific. I think the overall point is that actual results are trending in line with our expectations.

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

The other -- it's important to stress that they've enhanced their processes. What you're seeing us do is enhancing a lot of process, because we really want to tighten this place up and really improve the quality of our performance. And about $10 billion of our reserves this quarter were looked at by third-party actuaries. We're going through it quarter by quarter. And they validated that our reserves are, if anything, just slightly above what they saw as essential estimates. So I think it's $10 billion, but as we go through it, we're seeing everything coming in line that the reserves continue to be what we said, very strong.

Edward A. Spehar
BofA Merrill Lynch, Research Division

This is Ed. I have a question for David. Can you give us any thought on how much of this life capital loss carryforward -- this $23 billion of gross attribute, how much you think you might be able to realize?

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

Yes, sure. Ed, as we said earlier, the -- we've got about $7.5 billion of DTA, net DTA, related to the life capital loss carryforward. And as we look at the life portfolio, it has about -- I think, about $8 billion or so of gross gains. And so that -- and then if you tax back [ph] the gain, that sort of gives you a sense of how to think about the real opportunity right now, because that's the inventory of gains that we have. And then the question is how do we go about achieving that. In part, we are realizing capital gains in the life company themselves actually selling the securities. And then there are other strategies involved, where we have other opportunities to realize at least for tax purposes, the gains. And we are in the process of evaluating it. My sense is, Ed, as we said, maybe up to 25% of that number, of the $7.5 billion, we would expect to get, because the expiry dates run between 2013 and '14. And so time is a very different than on the NOLs, which run out until 2028. So the fourth quarter evaluation, as I was commenting on, will be around the NOLs, which we expect to realize fully. The foreign tax credits, we expect to realize fully. And then the non-life capital loss carryforwards, we expect to realize fully. Hope that's helpful.

Edward A. Spehar
BofA Merrill Lynch, Research Division

Yes. It's helpful, so if you expected to maybe up to 25% of the $7.5 billion, that would suggest about $3 billion of gains harvested in the portfolio, right?

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

Well, no. Think of it differently. If there's about $2.5 billion -- again, $2 billion to $2.5 billion of DTA, and the DTA is -- effectively, that's 35% of the actual gain, so you need gains of -- if we were to realize $8 billion for the gains.

Edward A. Spehar
BofA Merrill Lynch, Research Division

I got it. I had the math backwards. I guess, the question though if you had $6 billion of gains, wouldn't that be, probably, given up, maybe around $700 million of annual investment income?

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

There's a trade-off, and I'd say we're balancing economic here against a GAAP reported number and a GAAP reported spread. And we're sensitive to that, but that's why there are other ways to realize those gains other than just straight out harvesting.

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

Yes, I think, that's -- Ed, I think what we're doing right now is we're assembling, I guess, a world-class team in my mind, because there may be somebody as good, but there'll be nobody better, that put their minds around how we begin to deal with this and how we can do things in a way such that we trigger a taxable gain on what it is we have here. So sometimes you don't actually have to sell it, that you get caught with the taxable gain. So there's all kinds of theories and strategies we're putting together, and we're going to do everything we can to maximize this number. However, we're also mindful that we don't want to do it to the extent it would harm Jay's business, so we're being mindful of the NII there. And that's the challenge. We have a team to do it. And that's why David is going to be conservative, come the fourth quarter, as what he think's going to be realized of this.

Operator

Michael Nannizzi of Goldman Sachs has our next question.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Just a couple of questions here. I'm trying to reconcile the development. So we've got a 98x CAT combined ratio. Chartis, 9.77 x CAT in prior development. The development shows as being 0, 91 adverse and then 91 in return premiums. And then in the queue it looks like about $100 million in additional adverse development from the first quarter. So just trying to -- that's Page 125 of the Q. Just trying to reconcile those, if I could. Then one follow-up.

Robert S. Schimek

Executive Vice President and Chief Executive Officer of Commercial

It's Rob Schimek. So let me just provide clarity here. But first of all, I think you generally said this correct. So the prior year development for the second quarter is adverse, but we write loss sensitive business, and on the loss sensitive business, we have accrued premium. And so the net of those 2 items in the second quarter are largely offset. The way that it works in the combined ratio itself though is that the prior year development affects the numerator, but the accrued premium or the loss sensitive premium affects the denominator. So it's not exactly 0-some gain in the combined ratio itself. And then I think we talked about it in the first quarter. One of the significant drivers on our development in Q1 was the fact that we had a settlement of a historical issue associated with one particular line of business as disclosed, I think, reasonably clearly in the 10-Q. But it was that item, that really drove prior year development all in the first quarter of 2011.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Okay. But -- so in the second quarter, you had -- it looks that you had about the adverse. So just on that, adverse versus the loss sensitive. So is that the same business that you had adverse, and then in addition, you had additional premiums related to that adverse development, because it was business you had written on a loss-sensitive basis, or are they 2 separate items?

Robert S. Schimek
Executive Vice President and Chief Executive Officer of Commercial

Yes. You said it exactly, Mike. So we had adverse development on business that was written years ago, and the premium accrual is on that same business. If you recall or just remember the way that this actually works is we do our analysis across the entire portfolio, maybe in excess of 1,000 different cohorts of data that we're analyzing. So the adverse development is the sum of all of those ins and outs. All of the accrued premiums on the loss-sensitive business, 100% of it, relates to business that also being included in, and this is the driver of the net adverse development that we experienced for the quarter. So the answer to your question is absolutely, positively, these are directly and specifically interrelated. So [indiscernible] exact match between adverse development and the premium accrual in the loss-sensitive business. I'm just saying to you, there's thousands of different ways that we slice this data. And so there are other pieces of increases in prior year development, and other places where there's decreases in prior year development. But the primary driver of why you have adverse development is related to those -- net adverse development is related to those premiums that we also accrued on loss-sensitive business.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

I'll follow-up on that one. I just have another math question. But if I could, I just wanted to understand what happened. Again, Chartis U.S., is it -- consumer lines, it sounded like, from the Q, you discontinued a couple of programs, otherwise saw some growth there. Commercial lines, you had a big E&O policy, it sounded like higher rates and comp commercial decline in specialty comp. Just trying to understand, what got you to the plus 4.6%? Is it a combination of those items, or is it underlying that got you there? And then the expense ratio, it was about a 200 basis point client sequential, just trying to understand how to think about those as well?

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

Well, I think, the first thing is as we have looked at all of our lines of the business, all of our individual relationships through the scrutiny of whether they meet our risk-adjusted profitability targets, certain programs just didn't make the cut, and the particular consumer, example you'd sight was one that whatever way you look at it just -- it didn't it make sense going forward, so we terminated that program. In terms of the overall trend, we saw an increase in ratable exposure, which helped the general positive trend. Hopefully, the economy continues its recovery and the trend doesn't reverse itself, but we're not holding our breath. And in terms of other favorable rate trends, property is probably the most promising, especially property -- and especially outside of the U.S. But in the U.S ., we're also seeing a slight hardening.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

And then the expense ratio?

Robert S. Schimek
Executive Vice President and Chief Executive Officer of Commercial

One other thing that I would mention for you there, Mike, is that in the second quarter of last year, we did our first CAT bond, and so the prior year premium associated with commercial property is reduced by the amount of premium that we ceded on that CAT bond, which was approximately $100 million. So we're higher in the 2011 quarter, simply because we did not see the premium again on a new CAT bond. So just wanted to add that.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Very fair. Real quick on the expense ratio, just -- if that's okay. About 200 basis point decline, just trying to understand. You're clearly making some changes, cutting some specialty comp lines. I imagine there's still some outstanding claims on those. Just trying to get a handle on how the expense ratio goes down? Is that where we think it's going to be? Or is that just kind of a dip here in the second quarter?

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

Let me start with an overall comment on the expense ratio, and then I'll hand it over to Rob. The expense ratio is not something we target, it's an outcome of things that we do target, which is improvement in our costs regardless of whether they appear in the expense ratio or the loss ratio. And I think that we're very conscious of the importance of reducing our fixed costs and then focusing on unit costs associated with claims management. And so, as we do that, that has an effect on the expense ratio. Secondly, as our business mix shifts from high- to very low-frequency to a higher-frequency, low-severity businesses, then the expense element goes up, but the amount of capital intensity goes down. So as we factor in capital costs, that again, is another important shift. So as we shift towards these lower-risk consumer lines, then we expect the expense ratio to go down, and the acquisition costs obviously, higher, as well in those lines. So it's an outcome of our strategic shift towards lower-risk businesses, with better repeatable earnings characteristics. But we're very focused on expenses, however, they're categorized. And so as far as the specific shift maybe Rob -- why don't you explain that shift.

Robert S. Schimek
Executive Vice President and Chief Executive Officer of Commercial

Well, I'll just give you a couple more things to keep in mind. Especially here in 2011, and I think, certainly for the first part of 2012, we have embarked on a number of very important strategic fundamental investments in our platform, including, for example, work we're doing on Solvency II in Europe, and we're also undergoing a very significant finance transformation effort inside of the Chartis finance organization, put us all under one single, common financial platform around the world. Each of those items and among others, are investments that we think are very important for the long term, to the viability of our platform. And those will cost our expenses to go up, as we go across the next year or so, however, you will see us also continuing to demonstrate progress on the items that we've been targeting as a overall reduction of GOE. One thing you will see from us is, as we now have a full year of Fuji, consolidated into our operations. Fuji carries a higher expense ratio, and you should expect that, that will also have an impact on us, as we move forward in the rest of the year. We do a lot of work on a quarterly basis to make sure that we've got an appropriate evaluation of bad debt, whether it's on premiums or whether it's just on any receivables that we have on the books. And so one of the things that benefited us from the current quarter was a reduction in bad debt expense also. And that will be lumpy on a quarter-to-quarter basis, really just based off of the facts and circumstances of that analysis.

Operator

We'll hear next from JPMorgan's, Jimmy Bhullar.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

I had a question on capital flexibility. Obviously, you had to raise equity earlier this year to replace the Series G preferred, and maybe you have to hold [ph] that as a question. But you sold Nan Shan since, so what do you believe your current excess capital position is on the balance sheet? Also, how much free cash flow you expect to generate this year, given the high CAT losses? And then any comments on potential uses of this capital?

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

The one time -- I'm going to turn over to David, but I want to stress that raising the 100 million -- selling the 100 million shares was a condition of closing to demonstrate we could. Remember, for us, to be allowed to be where we are today, completely independent of government support, that we had to prove we can get unsecured debt at all the way through de-risking FP and our credit ratings, and also raising equity capital. So the G was put in, as a stock CAT until we demonstrated that, so that's really about bringing us to that level, at this point in time. And we've also told you that we want to over-solve the liquidity during this period of time, so that the rating agencies can absorb where we are and see how we operate throughout 2011. So that's what we did. And again, keep in mind that we had to demonstrate our strength, having given up $30 billion of committed government support plus the implied support above that. So that was all part of that condition of closing and maintaining strong investment-grade ratings on a stand-alone basis. Having said that, David can now talk about that we're going to do with the proceeds.

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

The Nan Shan proceeds will be used to repay or pay down the AIA SPV balance. So there's about $11.5 billion of obligation that the SPV has to the U.S. Treasury. The Nan Shan proceeds of nearly $2.2 billion will be used to reduce that balance. So again, which is a great outcome for all the stakeholders. So that's where those proceeds are going to go. And I would point you to our 10-Q disclosure, Page 142, we talk about the capital liquidity availability at the holding company, the nearly $13.1 billion. As we discussed earlier, it's not so much about excess capital today as much as it is about the generation of distributable available capital, as we continue to execute on our business. And again, we reaffirm our aspirational goals, which we set forth in the first quarter Q that the $25 billion to $30 billion of capital management activities, over the course of the next several years, we believe, are still very achievable, particularly in light of the continued progress that we're making. So again, we'll continue to optimize the capital structure of the company. We're building sufficient liquidity at the holding company. Again, that final determination of whether or not we are designated a SIFI will ultimately be determined sometime later this year, we expect. And so, again, all those will play into when and how much and to what degree we commence our capital management. But at this time, it's about building the pool of available capital.

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

And by the way, we have done a lot of sensitivity testing around SIFI, and we're very confident that SIFI will not cause us to go up, but if we are well above wherever SIFI is at, so that we don't see it getting in the way of our flexibility and our thoughts at this stage of the game from what we've studied.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

Okay. And then any comments on free cash flow that you expect to generate this year?

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

Well, we have -- as we laid out, as part of our earlier equity markets discussions, capital dividend capacity at our operating companies and those expectations have not changed. And so we will continue to expect to receive dividends from our operating companies to bolster the $13.1 billion we have.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

And lastly, on AIA, you have restrictions on selling that. I think you can sell some of that in October -- beginning in October. But how do you view that asset? And obviously, it gives you exposure to the international markets to the extent you continue to own it, but do you think you're going to hold on to it? Or is it more going to be opportunistic?

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

I think we're going to study it, and when we get to October, we'll know what the markets are, we'll know where we are. As we talk about the SPV, that it's collateralizing, as David just said, we're 11.3. We got about $2.6 billion of cash that's sitting there in support of contingencies for MetLife, because of the sale of the MetLife stock and the deal with ALICO. And so when you take that out, we're down to about $6.5 billion, after Nan Shan comes in. And that's collateralized, for example, by ILFC as well as AIA, and so there's a huge amount of money. We're going to be taking a look at strategically where we are, what we need to do, what makes the most sense come October and then the team will do that, which we believe will give us the best shareholder value for the company going forward. It's all about having to create shareholder value into the fourth quarter as quickly as we possibly can.

Operator

Andrew Kligerman of UBS has our next question.

Andrew Kligerman
UBS Investment Bank, Research Division

Going back to the SunAmerica, question for Jay. So $8.4 billion in cash and short-term investments were deployed during the quarter. You go from a base yield of 5%, up to 5.36%, but you also harvested, I think, it read $3.4 billion of gain. So now we're at 5.36%, if nothing were we've done going forward in terms of harvesting that $8 billion of gains that you have left, where does the base yield go? And then the other part of it is, if you're willing to discuss how much of that gain you want to harvest, what kind of impact would it have negatively?

William N. Dooley
Executive Vice President of Investments

This is Bill Dooley. Let me just make a comment on the base yield increases on future cash flows. A lot has to determine on, obviously, where the market goes in that period of time, so that's a harder question to answer. But when we're taking the gains on the SunAmerica portfolio, we're doing it in a deliberate way, so we can kind of close the gap between the give up and what we're getting. The other thing we don't want to do is to create another large cash balance at the life company level. So I'm looking for offsetting assets that are basically the same type of assets, even though there's going to be a yield difference because of the movement of the marketplace. So everything is being done in a very deliberate way.

Andrew Kligerman
UBS Investment Bank, Research Division

So you want to minimize the impact that it won't be too...

William N. Dooley
Executive Vice President of Investments

We're trying to minimize the impact, but at the same time, pick up the gains.

Andrew Kligerman

UBS Investment Bank, Research Division

Got it. So then with the $8.4 billion that you deployed, shouldn't that yield of 5.36% go up next quarter, barring any -- taking gains on the other stuff?

William N. Dooley
Executive Vice President of Investments

Well, as the sales take place, the gains are coming in. But I'm redeploying those funds at lower yield levels, just because of the movements of the market. But economically, as David was saying, for the consolidated entity, we're much better off by taking those gains and having a smaller yield on the underlying assets of the insurance company.

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

Andrew, it's David. We -- just to make sure we've got our facts right, the -- I think we've taken about $350 million of gains, thus far, this year in that zip code, not $3.5 billion.

Andrew Kligerman
UBS Investment Bank, Research Division

I'm sorry, that was what you sold for -- you $3.5 billion, if you get that in gains, right [ph].

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

Okay. That's fine. So good, just want to make sure you understand, where...

Andrew Kligerman
UBS Investment Bank, Research Division

Yes. I know, I do.

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

If I could just add to what Bill and David said. A couple of things, Andrew. One is some of the cash we redeployed rather late in the quarter, so I don't think we've seen the full impact of that yet in the base rate. All subject, as Bill mentioned, to reinvesting new cash flow in this quarter. But again -- that's one point. The other thing is that the -- in terms of being deliberate, we are still in a negative IMR position in our life company. So 100% of these gains are going also to increase our statutory capital, at this point, as opposed to increasing our IMR reserve. So that's the kind of thing we're taking into account, as we do this in a deliberate way.

Andrew Kligerman
UBS Investment Bank, Research Division

Got it. So that's good, Jay. So there is some yield -- so there is some interest income pickup as we go into the third quarter. Nothing you could kind of give us a sense of to model for?

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

Yes. I'm not comfortable with that, only because there's still this third quarter to go. But we know that all of the activity in the second quarter is not reflected in the base yield.

Andrew Kligerman
UBS Investment Bank, Research Division

And just while I got you, the discipline around Western National, in terms of -- there was a big tick-up in deposits. Maybe just give a little clarity on what was so disappointing there?

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

Well, we continue to target approximately 12% to 12.5% after-tax internal rate of returns, and we're getting our pricing. We're closely coordinated with our Asset Management Group on the investment side and Bill. We're back reinstated in all of the distribution that we were in, prior to the fourth quarter of 2008. And I believe we have going now, the most we've ever had, I think 12 separate rates for compensation trade-off programs across all of our different banks, large, medium and small. And that's been a big, big driver of the activity, where banks are trading off commission compensation in order to offer to customers moderately higher crediting rates. And that's a win-win for everybody. So we feel good about what's happening at Western and in our fixed annuity business. The absolute level of interest rates historically has had an impact on that. Higher is somewhat better. On the other hand, we see our customers more and more interested in guaranteed returns for some meaningful part of their portfolio. So the pricing is solid and the sales activity has remained solid. And I think Western and everyone there is doing an excellent job with it.

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

Andrew, the one thing to keep in mind and for everybody to keep in mind is Western has a product chassis that is unique to the industry, so it's not -- think about it as, today, I think, they priced maybe 230 different combinations and permutations of different capabilities. So they -- here's how much money we have, and how do want to slice and dice it. And as Jay just said, several very, very large banks have decided to finally see what happens when you cut commissions and go ahead and see if you can get the volume to do better. And we've seen huge volumes in these institutions that are very large. And so this is a competitive advantage because of the way -- and the uniqueness of that front end. And you add to it a have a very, very strong low cost operation that comes out of Amarillo, Texas for now, which is very high-quality group. Now you put that together, and it gives them the opportunity to get this kind of price with this kind of volume. So it really is unique, and it's very hard for competitors to get to this overnight, but you've got to build that model and then get people comfortable in using that model. So it's a -- it really is an incredible capability.

Operator

We'll move on to Tom Gallagher with Crédit Suisse.

Thomas George Gallagher
Crédit Suisse AG, Research Division

First, Bob, I just have a follow-up on the comment about the treasury SPV in terms of the $6.5 billion that would be left in potential assets or sources to repay that. You had cited AIA and ILFC. Any thoughts on Maiden Lane III -- your Maiden Lane III's stake $6.5 billion. Should we assume that, that's not on the table? Because it's, I guess, fully in control of the Fed? Or is there a chance that you can monetize that, say, within the next couple of years? That's my first question.

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

[Indiscernible] I got some extra money, I guess, we can talk. I don't know how anybody's going to buy our interest. It's totally under the control of the Fed. All I can say is that the cash flows, remember, in the 2 years or so, it's gone from $24 billion to $12 billion. It's doing about $350 million a month in cash flows, so the cash flows are strong. Regardless of the pricing that's going on here, we're all trying to figure the pricing better to reflect the real value here. But there's no question Maiden Lane III has a tremendous amount of value for us down the road. And so we would think, if you do the numbers, that sometime during 2014, it depends on how strong they stay, that our $6.5 billion to $7 billion that's sitting in there will start to flow in here. And so you just have to take that out of the equation. It's just something coming down the road, just like Maiden Lane II. We had hoped to take the volatility out of Jay's earnings, that didn't succeed. But again, that's another one. It has a lot of economic value overtime to flow in. So the only properties -- and remember, those are collateralized, so in order to free up the collateral, you're going to have pay it down. And those are 2 major properties that are there, supporting -- and I think, Maiden Lane III is there, but that's just an extra safety belt down the road. But the cash coming in, Treasury wants first priority on that cash. Because that's the deal. So as we monetize the assets we don't get to leave them with Maiden Lane II, and then SPV taking it by 1% percent. They want their cash, and that's what we're negotiating when the time comes, as to how we exit from that SPV.

Operator

That's all the time we have for questions. I'll turn the call back to our speakers for any closing or additional remarks.

Elizabeth A. Werner
Head of Investor Relations and Vice President

I'd like to thank everyone for joining us this morning and let you know that we are available to follow up with you on all questions, so please feel free to give us a call. We will get back to you, if you were still in queue. Thank you.

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

Thank you, all, very much.

Operator
And again, that does conclude our conference. Thank you, all, for your participation.