S&P Global
Market Intelligence

American International Group, Inc. NYSE:AIG

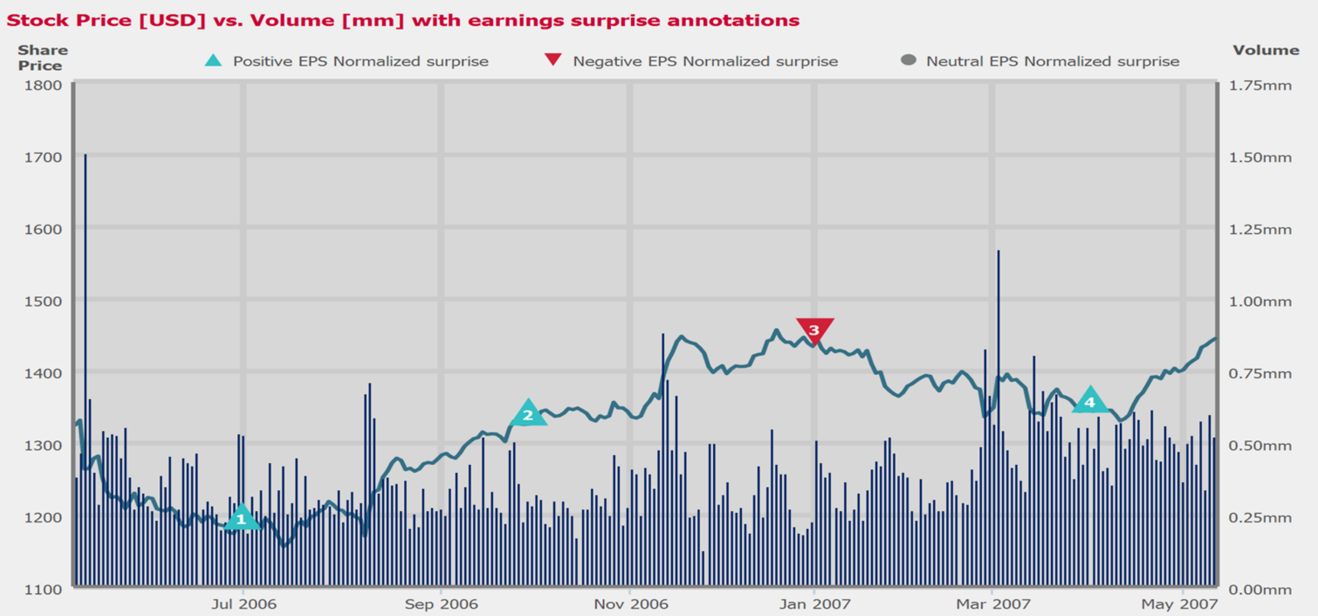
FQ2 2007 Earnings Call Transcripts

Thursday, August 09, 2007 12:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2007-			-FQ3 2007-	-FY 2007-	-FY 2008-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	32.34	35.40	▲9.46	31.79	131.15	140.53
Revenue	-	-	▲3.26	-	-	-
Revenue (mm)	30166.88	31150.00	-	30210.11	123584.00	132627.67

Currency: USD
Consensus as of Aug-09-2007 7:57 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2006	27.75	28.80	▲1 3.78 %
FQ3 2006	28.54	30.60	▲2 7.22 %
FQ4 2006	29.96	29.40	▼3 (1.87 %)
FQ1 2007	30.91	33.60	▲4 8.70 %

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Call Participants

EXECUTIVES

Andy Foster

Billy Nutt

Bob Clyde

Bob Lewis

Charlene Hamrah

Chris Swift

Edmund Tse

Frank Douglas

Jay Wintrob

Joe Cassano

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Martin Sullivan

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Presentation

Operator

(Operator Instructions) I will turn today's conference over to Charlene Hamrah, Vice President and Director of Investor Relations. Thank you, you may begin.

Charlene Hamrah

Good morning and thank you for joining us this morning for our second quarter earnings conference call. Before we begin, I would like to point out that the remarks made today may contain projections concerning financial information and statements concerning future economic performance and events, plans, and objectives relating to management's operations, products, and services, and assumptions underlying these projections and statements.

Please refer to AIG's quarterly report on Form 10-Q for the period ended June 30, 2007, filed yesterday with the Securities and Exchange Commission, and AIG's past and future filings with the SEC for a description of the business environment in which AIG operates and the factors that may affect its business. AIG is not under any obligation and expressly disclaims any such obligation to update or alter its projections and other statements, whether as a result of new information, future events, or otherwise.

The information provided today may also contains certain non-GAAP financial measures. The reconciliation of such measures to the comparable GAAP figures are included in the second quarter 2007 financial supplement, available in the investor information section of AIG's corporate website.

Now, I would like to turn this conference call over to Martin Sullivan.

Martin Sullivan

Thank you, Charlene and good morning, ladies and gentlemen. As usual, I'm joined this morning by a number of my senior management colleagues. Because of the uncertainty in the financial markets in recent weeks, we are going to change our normal format for this call. I will first give you a brief summary of our results and an overview of our operations, followed by a presentation on AIG's exposure to the US residential mortgage market.

As you have seen from our results, AIG had a strong second quarter, owing to our diversified global business portfolio. Major contributions to our results came from General Insurance, Life Insurance and Retirement Services, Asset Management, and Capital Markets. Partnership returns remained strong, positively affecting investment income.

Net income was $4.28 billion, a 34.1% increase over the second quarter of 2006. Second quarter adjusted net income, which excludes realized capital gains and losses and the effect of hedging activities that did not qualify for hedge accounting treatment under FAS 133, was a record $4.63 billion, or $1.77 per diluted share, a 12% increase compared to $1.58 per diluted share in the second quarter of 2006.

Return on equity using adjusted net income as the measure was 19.8% for the second quarter. Total assets now exceed $1 trillion. Shareholders equity at June 30 stood at just over $104 billion, including retained earnings of some $92.3 billion. Book value per share increased to $14.44. Excluding $2.34 billion in payments advanced to purchase shares, book value was $41.34. We purchased over 22 million shares in the second quarter and an additional 24.5 million shares through August 6. That puts our year-to-date share repurchases at approximately 49 million shares or 67% of the $5 billion in repurchases planned for 2007.

Looking towards the second half of the year, we have good reason to be confident about AIG's growth prospects. Our diverse worldwide operations are well positioned to respond to opportunities that will arise from major global economic trends. At the same time, we're undertaking organizational and financial initiatives that will enhance future returns. We continue to develop our economic capital model; and last evening we posted a progress update on our website. Our businesses remain focused on their objectives, and they continue to bring new products and services to market through multiple distribution channels.

Quickly looking at our major business segments, General Insurance results were led by the Domestic Brokerage Group, which posted improved underwriting results due to favorable loss trends and higher net investment income. To offset the continued pressure on rates in certain lines and regions, our General Insurance operations are capitalizing on the opportunities offered by our broad product mix, ability to deliver unique products to market, our geographic footprint, and expanding distribution platform, while maintaining underwriting discipline.

Foreign General, which also had an excellent quarter, is accelerating growth by investing in India, Russia, the Middle East and China. Following the close of the quarter, AIU was granted a subsidiary license in China that will allow us to expand our capabilities, achieve operational and capital efficiencies, and with regulatory approval, provide a platform to establish new branches in other areas of China over time.

Domestic Personal Lines remain focused on achieving underwriting profits and extending the strong competitive position of the Private Client Group. Domestic Life Insurance impaired annuities operating income increased largely as a result of solid growth in reserves and higher net investment income. These businesses expect to see continued top-line growth through further enhancement of the product portfolio, expanded distribution, and increased demand from the institutional marketplace.

In Domestic Retirement Services, all three major product lines reported improved deposits, with operating income increasing largely as the result of higher net investment income from partnerships and other yield enhancements. Our Group Retirement division remains focused on targeted asset retention strategies. The variable annuity business continues to improve as we roll out products that provide guaranteed income for life. Despite the challenging sales environment, our long-term commitment to the fixed annuity product line and strong bank relationships has AIG Annuity well positioned to take advantage of any change in the yield curve and/or interest rate environment that favors long-term guaranteed fixed-rate savings. Foreign Life and Retirement Services results in the second quarter reflect the continued demand for investment-orientated products and sales of risk-based accident and health products throughout our global operations.

In Southeast Asia, AIA remains the leading market player, distributing our products through approximately 140,000 Thai insurance agents, while also developing alternative distribution such as our recent agreement with the Bank of Investment and Development of Vietnam. In China, we're making good progress in expanding our geographical footprint, increasing the number of sales offices by seven this quarter, giving us a total of 90, and strengthening our distribution capabilities, especially in Bancassurance where production has increased significantly. Additionally, we wrote more than 2,100 group cases in the quarter, bringing total cases written since we received our license in May 2006 to more than 5,600.

Market conditions remain challenging in Japan as a result of increased competition, the effect of additional regulatory oversight, changes to the tax deductibility of insurance premiums, and the weak yen. However, life insurance products, which have substantially higher profit margins, continue to sell well. Medical production is anticipated to improve due to the recent launch of a new product targeting a younger generation of clients.

Financial Services operating income declined compared to the second quarter of 2006 as growth at Capital Markets was offset by the decline in consumer finance results. Aircraft leasing results were up slightly as ILFC did not sell any aircraft in the second quarter of 2007 compared to three sold in the second quarter of 2006. However, the sales environment is improving. We see the current sub-prime environment as an opportunity for American General Finance despite the short-term pressures. AGF's conservative, disciplined approach to lending will position the company well for the new order in the mortgage market. Overseas, we continue to expand our consumer finance operations, with recent efforts focused on India, Mexico, and Thailand.

In Asset Management, Guaranteed Investment Contracts benefited from an increase in partnership income and the Matched Investment Program contributed to the growth in income. Despite the decline in operating income, our institutional asset management business continues to make significant strides, attracting new client assets and expanding the breadth of its product offerings. AIG Investments has successfully launched several new private equity and real estate funds in the first half of the year, which generate both a base management fee and the opportunity for future performance fees.

Now as I mentioned at the outset, I'm intentionally limiting my discussion of the quarter's operating performance and our strategic growth initiatives in order to fully address the concerns that have been raised by many in the investment community about our exposure to the U.S. residential mortgage market. This morning, we provided a document in the investor section of the AIG corporate website that summarizes the areas within AIG that include this exposure; namely United Guaranty, American General Finance, and AIG Financial Products, as well as our investment portfolio.

Bob Lewis, AIG's Senior Vice President and Chief Risk Officer, will walk you through the information in that document. With these details, we hope that you will have a better understanding of the respective businesses and portfolios and what we believe is a well-managed risk profile. AIG's investment and credit offices monitor developments in this area very closely. We believe we are well positioned, even in the event of further deterioration in this market.

During the Q&A, Bob and my other colleagues will be available for follow-up questions. However, by addressing this issue upfront, we hope we can use the majority of the time allocated for Q&A to answer your questions on the quarter's results.

Bob Lewis

Thank you, Martin. Over the past several weeks, the US mortgage market has been the subject of a considerable amount of press and stress, as a consequence of an increase in delinquencies in the private mortgage market, a tightening in credit availability, and the difficulties some funds have experienced in situations where high leverage and strained liquidity have forced them to realize large losses and, in some cases, cease operations. Although there are clear signs that this stress will continue for some time, much of the dialogue has suggested that there is a considerable amount of confusion about the market in general, its participants, how it functions, and where the potential for future stress is greatest.

In order to provide information to investors about our activities in the US residential mortgage market, we have prepared a slide presentation which was posted to our website earlier this morning. I would now like to walk you through that presentation; and afterwards, we will take your questions.

Referring to slide 3 of the presentation, AIG is active in many segments of the residential mortgage market from lending to mortgage insurance to investments to super senior portfolio protections. Certain segments of the market have experienced credit deterioration, which is affecting the current results in AIG's mortgage insurance business. AIG also holds residential mortgage-related securities and recognizes that the current market dislocation has caused quoted prices in many of them to decline. AIG views such declines as temporary, as the robust cash flow characteristics combined with the reasonably short maturity structure of most of these securities will exert a very strong pull to par even if markets remain unfavorable.

AIG views recent pricing as indicative of market turmoil unrelated to the fundamental financial characteristics of these securities. In addition, we believe that it would take declines in housing values to reach depression proportions, along with default frequencies never experienced, before our AAA and AA investments would be impaired. AIG does not need to liquidate any investment securities in a chaotic market due to its strong liquidity and cash flow as well as its superior financial strength.

I am confident in our people and our risk management processes. Our exposures to this market are prudent, given the nature of our business and our financial strength. AIG has the financial wherewithal and expertise to take advantage of opportunities as they arise in the future.

In all the areas where we are active, we have strong risk management processes undertaken by experienced professionals. The risks we take are analyzed based upon our own independent analyses, modeling, and monitoring. Risk tolerances and appetites are formulated and implemented within authorities allocated by senior management; and ongoing review and analysis is undertaken both in the businesses as well as at the corporate enterprise risk management level. Although the market may continue to experience a period of adjustment and volatility, our exposures are understood and well managed within an appropriate risk tolerance for a strong world leader in Insurance and Financial Services.

Turning to slide 4 of the presentation, AIG is active in several segments of the US mortgage market. Through American General Finance, we originate mortgages by extending first and second lien mortgages to borrowers. United Guaranty provides mortgage guaranty insurance for first and second lien mortgages that protects lenders against credit losses. Our insurance companies invest in residential mortgage-backed securities, or RMBS, in which the underlying collateral are pools of mortgages that are repaid from the underlying mortgage payments. We, including AIG Financial Products, invest also in collateralized debt obligations, or CDOs, and asset-backed securities, or ABS, some of which also include RMBS as collateral. Also, AIG Financial Products provides credit protection through credit default swaps on the super senior AAA-plus tranche of CDOs.

Slide 5 describes how the residential market mortgage market functions. Starting on the left-hand side of the slide, lenders provide mortgage loans to borrowers to enable them to purchase or refinance a home. The borrower provides the lender with a security interest in the home and pays mortgage principal and interest on the loan to the lender. Mortgage insurers provide mortgage insurance on certain mortgages to lenders, to protect them from certain credit losses on the mortgages. Lenders either hold the mortgages on their balance sheets or sell the mortgages for securitization. Mortgages are then placed in collateral pools with thousands of other mortgages. Dealers create special-purpose vehicles which issue residential mortgage-backed securities to the market, which may have different risk levels. The rating agencies analyze the relative priority of the risk levels in the structures and assign various credit ratings to the levels, based upon the credit quality of the underlying mortgages in the pool, the value of the collateral, and the order of priority to receive interest and principal payments.

Monoline insurers, like MBIA, Ambac et cetera, may guarantee or wrap certain tranches of RMBS and elevate their credit ratings to AAA. Dealers always create other collateralized debt obligations with various collateral pools, sometimes with a combination of asset types such as bank loans, corporate debt, RMBS, commercial mortgage-backed securities, and other asset-backed securities. Investors then invest in these securities and are repaid from the payments made by the underlying borrowers in the pools, after securitization services distribute the cash flows according to the priority of cash flows to the various risk layers.

Other credit protection providers may provide protection above the AAA tranche, known as super senior or AAA-plus protection. As mentioned earlier and shown on slide 6, American General Finance participates as a mortgage lender. United Guaranty provides mortgage insurance to many lenders. AIG Insurance companies and AIGFP invest in securitization vehicles such as RMBS, CMOs, CDOs, and ABS. And AIGFP provides super senior credit protection by writing credit default swaps on the most senior risk layers in these structures.

Turning to slide 8, American General Finance, AGF, is AIG's domestic consumer finance division. AGF is a portfolio-based lender whose products include real estate, non-real estate, and retail sales finance loans. It originates real estate loans through its 1,500 branches in 45 states, Puerto Rico, and the US Virgin Islands. AGF also originates and acquires loans through a centralized real estate operation. AGF underwrites and prices its products to perform within target ranges for delinquency and net charge-offs. Their disciplined lending approach includes a state-of-the-art credit risk management system that allows them to track more than 350 individual real estate markets. This credit-focused approach enabled AGF to anticipate and mitigate much of the risk inherent in today's mortgage market.

Unlike many industry players, AGF did not relax underwriting standards when the market overheated in late 2005 and 2006. During that time, AGF continued its disciplined underwriting, which has resulted higher-quality loans, strong first lien and fixed-rate mortgages, and no negative amortization products.

As demonstrated on slide 9, the trend in AGF's real estate receivable growth significantly slowed beginning in the third quarter of '05. This shows that AGF anticipated some of the real estate market issues and sacrificed short-term growth for long-term credit quality and earnings stability. On slide 10, although delinquency and losses are somewhat higher than last year's all-time lows, AGF's credit quality remains strong and is substantially better than its target ranges. Since the market downturn in 2005, real estate

60-plus day delinquency has risen only 43 basis points to 1.95%; and net charge-offs remain extremely low at 37 basis points, less than half of our target range.

On slide 11, we present detailed data on AGF's real estate portfolio, showing a breakdown by FICO score range, vintage, and other factors. Of the total $19.2 billion portfolio, over 50% of the mortgage borrowers have a FICO score greater than or equal to 660 at origination. Borrowers with a FICO score of 620 to 659 represent 17% of the portfolio. Borrowers with a FICO of less than 620 represent 31% of the portfolio. Further delineation of the portfolio shows that the loan-to-value is more conservative as the FICO score declines, strengthening to 75% at the below-620 range.

As the real estate market softened in late '05, AGF made a conscious decision to slow growth and maintain its consistent underwriting standards, as shown by the tracking of loans produced in '05 to early '07. AGF's loans with LTVs greater than 95.5% represents 19% of the portfolio, but they have performed well, with a low 60-plus day delinquency of 1.53%; and only $548 million of these loans have a FICO below 660. Low documentation loans, which make up 2.6% of the portfolio, have also performed well, with a delinquency of just 2.3%. AGF's interest-only loans have a low delinquency of only 1.7%. They include just $299 million of loans with a FICO below 660 or 1.6% of the total real estate portfolio.

As previously highlighted and outlined on slide 12, AGF's conservative lending approach has differentiated them from many of the mortgage players. AGF has mitigated risk by requiring full income verification on almost its entire real estate book, in addition to having 85% of the portfolio as fixed-rate mortgages. Only 11% of the overall real estate loan portfolio is due to reset by year-end 2008. Furthermore, AGF does not delegate underwriting on purchased loans to unrelated parties; has not made option adjustable-rate mortgages or ARMs; and has not made loans to LTVs above 100%. AGF tracks and adjusts underwriting standards monthly or quarterly.

In summary, AGF has a history of strong risk management and successfully anticipated the risk in today's mortgage market by adhering to disciplined underwriting standards. Although the credit quality of AGF's mortgages can be affected by general economic conditions, AGF has a dedicated focus on performing within charge-off and delinquency ranges, and will continue to exercise prudent risk management.

Moving on to AIG's mortgage insurance subsidiary, United Guaranty, on slide 14, UGC has been insuring high credit quality, high LTV loans since 1963. Products include mortgage guaranty insurance on first and second lien mortgages which protect lenders against credit losses. AGF sources its business from major US lenders and, as a key component of its diversification strategy, currently provides first loss credit protection in 13 international markets.

In order to maintain these long-standing relationships, UGC insures a wide variety of mortgage products. UGC has experienced an average 10-year loss ratio through 2006 of 27% in its first lien business, but recent exposure to some higher risk products has negatively affected short-term results. UGC's sophisticated default and pricing models and predictive real estate scoring systems enable UGC to manage its risk and product mix over the long-term cycles of the business.

The graph on slide 15 shows that UGC's primary first lien delinquency rate is consistently below that of the mortgage insurance industry. This first lien business constitutes 90% of UGC's net domestic mortgage risk in-force. Although the difference has varied over time and has narrowed to 70 basis points in recent months, UGC has historically outperformed the industry. This performance is driven in part by UGC's decision not to participate in significant volumes of bulk mortgage insurance, most of which was in the high-risk segment of the market.

As shown on the portfolio mix slide on page 16, 90% of UGC's $25.9 billion of domestic mortgage risk in-force consisted of first mortgage risk, while the second mortgage business represents 10%. Total delinquency on the first mortgage book is 3.8%. Loans with FICO scores less than 620 constitute 8.5% of UGC's domestic mortgage risk. Almost 70% of their net risk in-force has FICO scores greater than 660.

Given the recent growth in US mortgage originations and the rapid runoff of older books fueled by historically low interest rates, 62% of UGC's risk in-force is from book years 2005 through early 2007. UGC has slightly over 16% of its risk in low documentation loans. You can see from the chart that as the credit risk increases, measured by FICO score, the concentration in limited documentation decreases, with only $100 million of risk in loans to borrowers with FICO scores less than 620. The same can be said for option ARMs and interest-only products. The $2.3 billion of risk in these two products represent 9% of UGC's total risk in-force. Exposure to borrowers with FICO scores less than 620 represent a mere $61 million or 0.2% or UGC's total risk.

The chart on slide 17 shows that second liens comprise only 10% of UGC's domestic mortgage risk in-force. Nonetheless, they are producing 58% of the second quarter 2007 losses incurred, and are disproportionate to the total domestic mortgage insurance book. Although the softening of the housing market has affected all segments of the business, high LTV second lien product is particularly sensitive to home price declines. Second liens default earlier due to the lack of a foreclosure requirement for claims to be paid, as compared to first lien mortgages that may take 12 to 18 months to go from delinquency to claim. As a result of this accelerated claim paying process, these losses are expected to work through the portfolio much faster. Significant tightening of product and program eligibility in 2006 for second lien business is resulting in improved credit quality and new business production.

There are a number of risk-mitigating factors described on slide 18. In light of the cyclical nature of the mortgage insurance business, UGC employs risk-sharing arrangements via captive reinsurance with most of its major lending customers. It purchases quota share reinsurance on portions of its sub-prime first lien business and segments of its second lien product. It has an aggregate stop-loss provision of generally 10% on its second mortgage product. UGC maintains an exclusion for fraud on both its first and second lien business.

Insuring primarily prime, high FICO score loans within a highly diverse book geographically, UGC's largest business remains its first lien fixed-rate mortgage insurance for single-family, owner-occupied residences. Financial performance of UGC may remain under pressure because of current market conditions but tighter underwriting standards by lenders as well as elimination of certain of risk factors by UGC will improve credit quality of new business production. Moreover, current market conditions have reinforced the benefit of mortgage insurance, resulting in higher volume and improved pricing for UGC.

Turning on to AIG's Insurance investment portfolios on slide 20, our Insurance companies invest in the residential mortgage market across most security types, including agency pass-through and collateralized mortgage obligations issuances, prime jumbo non-agency CMOs, Alt-A and sub-prime RMBS, and other housing-related paper. Total Insurance company holdings aggregate approximately $94.6 billion at June 30, 2007, or about 11.4% of AIG's cash and invested assets, which is considerably underweight the overall bond market concentration in mortgage-related securities of about 28%. About 83% or $78.5 billion represents non-agency securities and are concentrated in the highest rate tranches, with about 89% AAA rated and an additional 8% rated AA. Holdings related BBB or below total approximately $400 million, well under 1% of the portfolio and less than 0.1% of cash and invested assets. About 10% of the $78.5 billion is also wrapped by monoline insurance.

Non-agency RMBS is issued in tranche structures such that the lower rated tranches absorb any losses on the underlying collateral and insulate the higher rated tranches from loss. The sizing of the different tranches varies somewhat depending on the nature of the collateral and rating agency models and analysis. As a general rule, AAA and AA securities can withstand very significant default losses within the collateral.

Slide 21 presents a schematic showing the breakdown of our Insurance companies' $28.7 billion in investments in sub-prime RMBS. Residential mortgage-backed securities are structured with a pool of collateral of thousands of mortgages. The securities are divided into tranches, with different claims on the waterfall of cash flows emanating from the borrowers' principal and interest payments on the underlying mortgages. The AAA tranche has the first priority claim on these cash flows; followed by the AA tranche; the A tranche; down to the lowest equity-related tranche. AIG's investments are made up primarily of AAA and AA tranches, representing together over 97% of our exposure. Virtually all of our exposure is investment grade, with a further 2.4% in single-A and BBB tranches.

Slide 22 shows the breakdown of our exposure by issuance year or vintage and by credit rating. As mentioned on the previous slide, AIG focuses almost exclusively on AAA and AA rated investments. The large portion of exposure to the '05, '06, and '07 vintages, 98.3% including 45.7% in the '06 vintage, is the result of our investing primarily in the shorter maturities of this asset class. The weighted average life of the portfolio is 3.35 years. Therefore, earlier vintages have already substantially paid down. Our decision to purchase the shorter maturity tranches is a result of both the need to match the duration of our liabilities in the book and our conservative credit risk appetite.

Turning to slide 23, from a credit prospectus AIG views the AAA and AA RMBS market as a very safe asset class with minimal risk of ultimate loss. First, the underlying mortgages have to be of high quality, with LTVs averaging around 80%. AIG's underwriting approach is to avoid the higher risk 80/20 or so-called piggyback loans and option adjustable-rate mortgages.

Second, the securities are structured in a way as to provide significant subordination cushion to absorb a certain amount of losses at the lower-level, higher-risk tranches. For example, the loss cushion between the AAA tranche is generally 20% to 25% at inception and for the AA tranche the cushion is approximately 18%. In addition, the majority AIG's RMBS holdings are structured to pay down early as the underlying mortgages amortize. As a result, the subordination cushion generally increases over time.

An additional structural enhancement is the amount of excess interest held that could be used to absorb losses. In a typical sub-prime capital structure, this excess interest is approximately 2% per annum.

Finally, in some cases, AIG uses third-party mortgage insurance to provide additional capital recovery and obtains monoline insurance wraps on approximately $2 billion of its sub-prime portfolio.

As described on slide 24, clearly the strength in our portfolio is also an indicator of the organizations with which we do business. The originator and servicers of the mortgage pools are generally those organizations with strong financial discipline. AIG generally targets shorter-term sub-prime securities. In addition to the structural enhancements contained in our RMBS holdings, AIG receives additional comfort from a number of other key factors:

AIG's RMBS portfolio is highly diversified in terms of location, tenor, and size, as reflected in the thousands of underlying mortgages in the pools. The underlying collateral is closely monitored by AIG, by the respective collateral managers, as well as by the rating agencies. Over the past few months, a number of institutions have faltered because of their problems with their residential mortgage portfolios. The rating agencies have indicated that the 2006 vintage might incur losses of between 11% and 14%, approximately twice the high of 6.5% incurred in the year 2000. Assuming the high end of the range, this would still be substantially below the cushions afforded to the AAA and AA tranches of approximately 25% and 18% respectively.

To put these subordination cushions into context, assuming a Depression scenario, when housing prices could decline dramatically, say in the 30% to 40% range, there would have to be defaults by the borrowers in these pools approaching 45% to 60% to start to affect the AAA and AA tranches. In the 2000 vintage, defaults reached 20%, resulting in the 6.5% loss experience.

Our insurance companies also invest in collateralized debt obligations containing sub-prime mortgage collateral. Slide 25 shows that the holdings of sub-prime-related CDO paper in AIG insurance portfolios are modest at $253 million. They are secured by AAA and AA underlying collateral and are currently performing in accordance with AIG's underwriting expectations. AIG does not anticipate losses on its CDO holdings.

Turning to slide 26, within alternative investments AIG has no direct private equity investments exposed to the residential mortgage market, nor do we have any knowledge of any indirect exposures through our private equity investments. Finally, we do not have any investments in hedge funds focused on the residential mortgage market.

On slide 28, we begin our discussion of the activities of AIG Financial Products and the residential mortgage industry. AIGFP's exposure to the market is derived through two sources. First, they write extremely risk-remote super senior or AAA-plus credit protection on highly-diversified pools of assets, some of which include residential mortgages. Second, they are cash investors in highly-rated securities where some portion of the underlying collateral, which may include collateral from many sectors, includes residential mortgages. While both of these activities involve significant notional exposure, the risk actually undertaken is very modest and remote, and has been structured and managed effectively.

AIGFP has been running a successful business of writing super senior credit default swap, or CDS protection, since 1998. As of June 30 this year, they had a total net CDS exposure across all asset classes of $465 billion. The super senior portion is the least likely to incur any losses in these deals, since losses are allocated on a sequential basis from lowest to highest quality. Before AIGFP would be at risk for its first dollar of loss, these structures would have to experience exceptional losses that eroded all of the tranches below the super senior level, including a very significant AAA layer of protection.

AIGFP's entire super senior book covers many different classes, with the bulk of it in corporate loans totaling $258 billion. It also includes $128 billion of exposure to prime mortgages, none of which represent US residential exposure. The balance of $79 billion relates to multi-sector CDOs that FP helped to structure. These multi-sector CDOs consist of very diverse pools of reference securities, some of which are exposed to US sub-prime RMBS collateral. Of this $79 billion, $15 billion has no US sub-prime RMBS exposure, and $64 billion has some collateral that represents US sub-prime RMBS exposure. We're going to focus on this segment of the portfolio in this section of the presentation.

The multi-sector CDOs on which FP provides super senior protection are extremely granular, with typically 175 to 200 different underlying rated obligations in the collateral pool. In those deals that do have some sub-prime RMBS exposure, the percentage is typically 50% or less. The collateral pool is usually made up of other collateral such as auto loans, credit card receivables, CMBS, or other assets. In all cases, every transaction AIGFP has conducted has been carefully structured and screened as to collateral, manager, and structure to ensure that AIG continues to receive the maximum protection to its position.

Continuing on slide 29, the $64 billion of super senior CDO exposure that has some degree of US sub-prime collateral is split among 103 different deals. 45 of these deals, totaling $45 billion of net exposure, consist of multi-sector collateral defined as high grade and being predominantly AAA and AA by virtue of a subordination embedded in each individual underlying security. The average attachment point in these deals is well in excess of the regular AAA attachment point. On average, it is around 16%, with a large part of the subordination, 44% on average, being itself AAA. Our notional net exposure to all of the highly-rated sub-prime collateral after deductible subordination is $17.5 billion.

The remaining $19.4 billion of net super senior exposure is spread across 58 deals where the multi-sector collateral is predominantly mezzanine, such as BBB securities, again by virtue of its subordination in each and every individual obligation. The attachment point on these deals is structured to be significantly out of the money, at an average of 36%. Again, a large percentage of the total subordination, 30% on average, is itself AAA. Our notional net exposure to all of the sub-prime collateral in these deals, after accounting for the high amounts of subordination, is $8.8 billion.

Given the diligence employed in selecting and structuring these deals, none of the AIGFP deals have experienced any significant collateral deterioration. There are only three deals out of the entire 103 multi-sector CDOs transactions that have experienced any negative rating actions on any tranches subordinate to AIGFP's position. These three deals are rapidly amortizing and make up less than 0.5% of our CDO exposure, totaling just $296 million.

Turning to slide 30, with super senior protection we're talking about a very remote risk, which is defined and calculated not just by rating agency models, but also by our own very rigorous internal models used on each deal AIGFP structures. FP underwrites protection on super senior tranches of portfolios based on simulating the loss distribution of the underlying securities over the life of the transaction. The simulation is conducted on a security-by-security basis, with different security types treated differently with respect to, for example, recovery rates. The determination of the attachment point for the most senior layer, the super senior tranche, is based on the assumption that the exposure to the portfolio will occur during a severe recession until the maturity of the transaction. A super senior tranche must show zero losses 99.85% of the time in this severe recession scenario.

Prior to the simulation, a portfolio must pass several layers of scrutiny. First, we conduct due diligence on the originator of the portfolio, focusing on the underwriting process. Second, the transaction must be structured so as to afford AIG the maximum protections to be acceptable. Third, the portfolio must meet various diversification criteria. For example, different asset categories in a portfolio cannot exceed certain concentration limits. Geographical diversification is also important. Fourth, each underlying security is subject to scrutiny by AIGFP credit officers and treated as stressed or less creditworthy in the simulation. Finally, the risk analysis and underwriting for each individual transaction must be approved by the credit trading team, the AIGFP credit officers, and then finally by AIG's credit risk committee.

All of AIGFP's deals are subjected to an exceptional degree of due diligence both at the inception of the deal and on a daily basis going forward. It is this due diligence that led FP to dramatically scale back their operations in this sector at the end of 2005, due to growing concerns about both the increasing percentages of US sub-prime RMBS exposure in the CDOs and the quality of some of the underlying collateral. As a result, they withdrew from making any further commitments to providing super senior protection on any deals that had US sub-prime RMBS collateral, as they felt the new production was of a significantly poorer quality. Accordingly, their exposure to the more risky vintages of '06 and '07 are minimal. It is also the case that because AIGFP's exposure is always at the very top of the payment waterfall, over half their transactions have started to amortize; and hence, the exposure is currently being reduced.

As outlined on slide 31, the $3.6 billion of multi-sector cash CDO securities, the second source of US residential mortgage exposure at AIGFP, is virtually all AAA rated. Further, the total exposure to all sub-prime collateral originated in '06 and '07 is only $10 million.

Turning to slide 34, AIG has a strong enterprise risk management process where risks to the mortgage market are identified, assessed, analyzed, monitored, and managed at all levels of its organization. All business units involved in the mortgage markets have credit functions and carry out underwriting practices that utilize their own analysis and conclusions prior to inception of risk exposures, as well as on an ongoing basis. The foundation of AIG's decision-making process is based on this independent analysis. The fundamental analysis by the rating agencies is an important component of our analysis.

However, their ratings do not drive our decisions. Decisions are made under credit authorities granted by AIG's corporate level credit risk committee or CRC. The CRC also reviews and governs credit risk tolerances for the business units. AIG's corporate credit risk management department and the credit risk committee conduct regular reviews of the portfolios and provide independent assessments to senior management. AIG establishes prudent credit reserves for all its exposures through a process that includes recommendations from the business units and approval by AIG actuaries, controllers and AIG's chief credit officers.

In conclusion, I will repeat what I said earlier. As Chief Risk Officer of AIG, I am confident in our people and our risk assessment processes. Our exposures to this market are prudent given the nature of our businesses and our financial strength.

Martin Sullivan

Thank you very much, Bob. Ladies and gentlemen, Bob has described in detail for you AIG's presence in the US residential mortgage industry and our exposures to the sub-prime segment of the market. As he has discussed, AGF's businesses are performing better than delinquency and net charge-off target ranges. Disciplined underwriting based on over 50 years of experience in the sub-prime market is serving the company well. As a broad player in this cyclical market, in a cyclical market UGC has experienced a low domestic mortgage loss ratio over the past ten years.

UGC is currently experiencing a significant decline in operating income due primarily to unfavorable loss experience in its domestic second and first lien mortgage businesses as a result of the continued softening in the US housing market. However, UGC is beginning to observe tighter underwriting standards on new business production within the mortgage market.

Exposures to the residential mortgage-backed securities market within AIG's insurance investment portfolios are of a high quality and enjoy substantial protection through collateral subordination. AIG does not need to trade mortgage-related securities and does not depend on them for its liquidity needs.

Temporary market disruptions may have some non-economic effect on AIG through unrealized losses. However, the sound credit quality of the portfolios should result in collection of substantially all principal and interest under any reasonable scenario.

AIG's Financial Products portfolio of super senior credit default swaps is well structured; undergoes ongoing monitoring, modeling, and analysis; and enjoy significant protection from collateral subordination. Certainly, we will be following this market closely during this period of volatility and correction, and we will continue to manage these risks carefully. However, in every period of uncertainty there is also opportunity. Given the high quality of our investments and our superior financial strength, AIG is poised to take advantage of these opportunities as they arise.

As I said, with all the uncertainty, recent volatility, and on some occasions even panic in the market, hopefully we have demonstrated that with our superior financial strength, liquidity, and cash flow, why we believe AIG is a very safe haven in stormy times, and while I remain extremely confident about our future. Now, ladies and gentlemen, we will be happy to take your questions.

Question and Answer

Operator

Your first question comes from Josh Shanker - Citigroup.

Josh Shanker
Citigroup

I hate to start off with a question on the mortgage space, but I'm sure I'm not the only one. My first question regards AIG Financial Products. I am trying to understand if there has been any slowing of business generation, as there might be less buyers for the less subordinated tranches?

Has AIG corporate been a purchaser of any of the less subordinated tranches from AIG Financial Products?

The third question is, given some of the ratios that we have seen for 2Q '07, which actually have looked pretty good in American General, should we be concerned about what 3Q '07's ratios are going to be looking like?

Martin Sullivan

Josh, we have Joe Cassano on the line. So Joe, would you like to respond to the first part?

Joe Cassano

Actually Josh, I've also got Andy Foster with me, who trades our credit business here in the UK. Why don't we answer it together? Andy, why don't you give Josh a response to what we see going on in the market now?

Andy Foster

Well in terms of whether we are going to be slowing down our business, as Bob outlined, the CDOs and writing protection on those, that basically stopped completely back at the end of 2005, when we stopped taking sub-prime as collateral, given the increasing percentage in all the CDOs, that meant that we actually were effectively ruled out of that market. So yes, that part of our business is effectively stopped.

Joe Cassano

Josh, just to add further to that, obviously with the last four weeks of market volatility here, we are not seeing new portfolios of other assets to write, right now. So there has been a bit of a slowdown in the flow within the credit business. As you know, the Financial Products platform is fairly diverse, and we still see good flows in our equity business, our commodities business, our currencies and rates businesses.

Josh Shanker
Citigroup

In terms of the past pre-2005, was AIG corporate a buyer of any of the less subordinated tranches?

Joe Cassano

If it did happen, it happened coincidentally and it may have been very small. We don’t work in a coordinated fashion with the parent in terms of the super senior portfolios that we have been writing protection on. If it happened, it has to be a de minimus one-off kind of thing. I can't imagine that there is much of it that has gone on.

Josh Shanker
Citigroup

The American General question about ratios in 3Q '07?

Martin Sullivan

Rick Geissinger is here, so he can answer that.

Rick Geissinger

Our credit quality statistics for the end of the second quarter are strong, as Bob mentioned. We set target ranges back in 1996, and we are well below those for delinquency. The target range was 3% to 4%. Charge-off range was 0.75% to 1.25%. But we are well below those target ranges within which we can operate the business at a 15% after-tax ROE or better.

If you look at historical seasonality, delinquency and charge-offs get a little worse every year in the third and fourth quarter. So you can expect to see those numbers be a little bit higher. We do have July results, and the change in delinquency and charge-offs is slightly up, but de minimus.

Operator

Your next question comes from Andrew Kligerman - UBS.

Andrew Kligerman
UBS

Good morning. First question, partnership income, it was phenomenally strong this quarter. Could you give a little color on, at this point in time, how the performance would be if the quarter stopped right now?

Rick Geissinger

I think it would be a little difficult to tell you exactly what it would look like if the quarter stopped right now. I think we have said repeatedly that we expect our partnership portfolio, including our hedge fund portfolio, to yield somewhere between 10% and 15% a quarter on a long-term basis. We have been significantly north of that for, I believe, the last six quarters. The last five quarters anyway.

Andrew Kligerman
UBS

Do you think they would be down materially from that target range?

Rick Geissinger

No, I really can't give you a number at this point.

Martin Sullivan

We have said, Andrew, at many times, that our anticipated range is between 10% and 15%.

Andrew Kligerman
UBS

I know that, I am just kind of curious because it has been a rocky quarter. But I will move on. Japan, could I get an update on the regulatory environment that was mentioned in the press release, and how that might affect the Japan sales going forward?

Martin Sullivan

Absolutely. In fact, Bob Clyde is on the line from Tokyo. So, Bob, could you respond to Andrew?

Bob Clyde

The regulatory environment is still pretty strict, as you know. The claims reviews that we have been going through have been public information and that has put a little bit of pressure, I think, on sales for the industry. This is an industrywide issue. In first quarter, the FSA undertook an industrywide claims review covering claims for the periods of 2001 to 2005; and required us to submit our results to the FSA on April 13. At the first quarter, we reserved for our best estimate exposure for additional claims resulting from this review and subsequent follow-up with our claimants. We have had charges, as you know, for additional claims and reserves in the second quarter.

Andrew Kligerman
UBS

The Japan sales, are they going to tick up again now? Are they ready to move north? Or do you still think there will still be pressure for a while?

Bob Clyde

We expect the second half to be better than the first half by a few percentage points, frankly. We anticipate that on June 25 ALICO Japan launched a new premium medical product called Returns which has been well received by our agency force and also direct marketing. Direct marketing premiums will take some time to be realized, but the initial response rate to our TV advertising has been good. In addition, ALICO has launched a revitalization plan for agency with renewed emphasis on medical sales. Edison Life has seen increased interest in its cancer products. Star Life continues to produce strong medical sales, as it expands its agency and branch channels.

Furthermore, while we continue to rationalize our marketing spend in ALICO Japan over this past year and that has had a dampening effect on sales. It is clearly improving our profitability, which will help drive the bottom line, I think, going forward.

Andrew Kligerman
UBS

Lastly, you mentioned that you had strong commercial property, commercial liability rates or results. It was a little weaker in excess casualty and D&O. Could you give us just a sense of the rates, where they are going, and some kind of a range right now?

Martin Sullivan

Sure, I will give you an overview, Andrew, and then I will ask Kris and Nick to respond between Domestic and International. As we mentioned on our first-quarter call, we saw an uptick in competition in April. That continued somewhat through the quarter. Rates domestically were down 7% to 10%; internationally in the 10% range. But I would say that, again, we saw a further uptick in competition in the month of July.

Overall, terms and conditions are still holding reasonably well, particularly outside of the US. But we are seeing some pressure on deductibles. It is not a significant change, but it is a little difference in scenario. But let me just hand over to Kris to add some more color there.

Kris Moor

Yes, further on the D&O rates, they were down for the quarter about 10% to 15% and on excess liability down about 8% to 10%. As Martin said, July was a little tougher month. It was the first time our overall portfolio in property actually went to negative rates, down a few points. So I think the third quarter is heating up a little bit more than the second quarter.

Nick Walsh

On the foreign side, our plan called for about a 5% decline, and we're running about 10%, as Martin said. But remember that half of foreign gen is consumer business rather than commercial, so the effect of the cycle is different. The effect is different across product and region. In general, property pricing is probably under the most competitive pressure; and terms are being negotiated but the principal markets are withstanding those. On the casualty side, pricing is reasonably flat but there is pressure on terms as far as deductibles are concerned. In financial lines, particularly management liability or D&O, the effect on major cap in Australia and the UK is quite competitive. There is broadening of coverage in Europe. That is much more a function of the sophistication of the development of the market rather than effect on capacity.

Martin Sullivan

I would just add, Andrew, that the one market that is very competitive at the moment is the aviation market. It just seems to get more competitive every single day.

Operator

Your next question comes from Jay Gelb - Lehman Brothers.

Jay Gelb
Lehman Brothers

First, on an overall basis on the investment portfolio, can you walk us through the accounting treatment of when AIG may need to take mark-to-market adjustments in the investment portfolio because of the sub-prime issue? If you could sort of quantify that quarter-to-date, that would be helpful.

Bob Lewis

Normally, we would take a mark-to-market if one of two things were true. One, obviously, if we sold the securities; actually there are three things. Two, if we had an intention to sell the securities. Or three, there is a technical provision of the accounting rules called EITF 9920, which generally would apply to only the lower-rated tranches, but which might require a mark-to-market in effect if the anticipated cash flows on a given security were to change in a manner that was deemed to be adverse to the holder. At this point, it is really either sale or intent to sell, and we don't see either of those being a likelihood on this portfolio.

Jay Gelb
Lehman Brothers

So just to follow-up on that, since there is no expected material deterioration on the cash flow trends in the residential mortgage-backed or the rest of the portfolio, you would not anticipate a downward mark-to-market in the investment portfolio at this point?

Bob Lewis

Not on any general basis, I mean, we do have small pieces of the lower-rated pieces, and some of those might need to be looked at.

Jay Gelb
Lehman Brothers

But nothing for the AA or AAA which is the vast majority of the portfolio?

Bob Lewis

No.

Jay Gelb
Lehman Brothers

On page 67 of the supplement, you disclosed in the mortgage-backed securities the non-agency Alt-A and the second liens. Can you give the vintage years for those, or just the '06 and '07?

Bob Lewis

Yes. I might mention the second lien is almost all wrapped by monolines as well.

Jay Gelb
Lehman Brothers

So that is all wrapped with the AAA?

Bob Lewis

Almost all, not all; essentially all. On the second lien is about half 2007 and half earlier. That is all very short paper. On the Alt-A by vintage, the total 2007 is about 14%; 2006 is about 43%; 2005 is 31%; earlier is about 12%.

Jay Gelb

Lehman Brothers

Then on the property casualty side, there continued to be some adverse development in the 2000 year and prior. I was just wondering if you could give us a little more color on that and when perhaps you see that trend easing.

Frank Douglas

Yes, we highlighted that again this quarter. It was a little bit heavier than the first quarter, the development, from actually years 2002 and prior. I believe you said 2000 and prior. Excess casualty was about $140 million of that this quarter and about $110 million came from Transatlantic. Most of that, by the way, was also excess casualty.

What it largely relates to are latent type of claims, a lot of which wouldn't really hit us today given the changes that have occurred since the soft market. For example, some of the large losses relate to pharmaceuticals, or construction defects, or product aggregates where we're dropping down from an excess attachment to pick up primary claims that have exceeded an underlying aggregate. Our current policy forms and underwriting guidelines would actually eliminate a lot of those claims. So we do think the exposure we have for accident years after 2002 to those kinds of claims is going to be dramatically less.

As to when they may stop, these claims are not going to go away next quarter. They are latent. The nature of claims such as product aggregates are very hard to predict. They don't follow a normal loss development pattern, because you don't have any claim at all until the underlying aggregate is eroded. So it's hard to say exactly when they are going to disappear. But we are many years now removed from the soft cycle and we do expect them to diminish each year as we go forward. This was an adverse quarter. I don't think this quarter should be regarded as the ongoing expectation.

Operator

Your next question comes from Tom Cholnoky - Goldman Sachs.

Tom Cholnoky
Goldman Sachs

Bob, in your presentation, you describe some disaster scenarios for your mortgage portfolio. However, on the CDOs, you are wrapping in financial products. Can you give us a sensitivity analysis or perhaps go into a little bit more detail of what could really cause losses to emerge on some of these CDOs? What kind of economic conditions would we have to have?

Bob Lewis

Well, I guess the short answer, Tom, is an extreme economic event. As I mentioned in my presentation, AIGFP does a considerable amount of modeling on stress scenarios to first determine where the attachment point would be on the writing of a super senior cover. So that modeling that is undertaken is intended to stress the underlying values of the collateral pool, which is a diversified portfolio of CDOs, and distress that under extreme economic conditions and after that, to determine that their attachment point would be above that of an extreme condition in the marketplace. Joe Cassano, you might want to add some color on that.

Joe Cassano

One of the other things you have to look at in those CDO pools, along with what Bob said, the way we model it is we're looking at a continuous recessionary cycle that lasts for what we anticipate to be the life of the underlying CDO security that we are wrapping. So there is a fairly extensive severe recession that needs to go on. But the other thing is the granularity and the diversity within the underlying CDOs; and then the collateralization that takes effect within those CDOs. Maybe, Andy, you want to talk a little bit to that.

Andy Foster

Absolutely. Obviously, all the pools are extremely diverse. I think in terms of the direct answer to your question as to what could they sustain, I think if you look back a few slides earlier, when Bob was outlining sort of the loss scenarios and the stresses that the underlying securities can take when we were looking at the AIG investment portfolio. Don't forget, obviously, within the CDOs, you've got subordination upon subordination. So you need the scenario where you're eating through into the sort of AA, AAA type underlying securities. Then even if you did manage to have that scenario, obviously all our CDOs then have additional subordination on top of that. So you would have to eat through that, and then eat through the additional subordination.

So what we are modeling is the sort of disastrous type scenario. And even in those cases, our CDOs are not blowing up for the reason that we are modeling these and our VARs at this 99.85 percentile.

Joe Cassano

It is hard to get this message across but these are very much handpicked. We are very much involved in the process of developing the portfolios in which we are going to wrap, and then picking the attachment points. People have been willing to work with us in order to do that, to create the value that they do in these underlying. So the combination of the diversity, the combination of the underlying credit quality, and then the stresses that we put it through to make sure that we can hit these marks it is hard for us with, and without being flippant, to even see a scenario within any kind of realm of reason that would see us losing $1 in any of those transactions.

Tom Cholnoky
Goldman Sachs

No, I agree with you, I tend to think that this market is overreacting; anyway, that is a separate point.

Martin Sullivan

That's why I am sleeping a little bit easier at night, Tom.

Tom Cholnoky
Goldman Sachs

Joe, did you get involved with any CDO squared at all?

Joe Cassano

It is one of those markets that we never got comfortable with, Tom. It has been around for a long time and it is just something that doesn't; you know, there are people that do and I don't want to criticize it too much. It is just a place where we couldn't get comfortable with the risk involved.

Andy Foster

Exactly, we have always had this desire and need to be able to look through to all of the underlying obligors and be able to stress those and pick and very selectively choose the obligors that are going to go into our CDOs. So when you get into the CDO squared product, that is actually much harder to do. So we shied away from that and didn't do any deals where it was CDO squared.

Tom Cholnoky
Goldman Sachs

Okay. Then on the BBBs, I guess that it has been an area that has been of concern, and that maybe 60% coverage might not be enough on these. How should we look at that? Is there something there that we need to worry about? Or are you really comfortable that you have handpicked through these as well?

Andy Foster

Absolutely, we handpick them. So we are extremely comfortable. The diligence that we did in all of our portfolios was across all of them. Perhaps to give you an illustration, if you look at the rash of downgrades that you have seen across all the different collateral in all the different sectors, of our existing CDOs, it is less than 0.5% of all the underlying collateral that is currently on review for a downgrade. You think how many of these have had that sort of negative watch listing.

Also, I think one of the key points to take away is definitely that we stopped this business at the end of 2005. Most of the stresses that people are sort of really concerned about, I think, are very heavily concentrated in '06 and '07. We have almost zero exposure to that. Again, as Bob outlined in the slide, there is almost zero exposure, net exposure after our subordination, to all of that collateral, assuming it was all wiped out tomorrow with zero recovery. We have an extremely small amount of that. Again, it is not just the portfolio construction; it is the structure of the CDOs; and then it is the vintage that we have decided to invest in.

Tom Cholnoky
Goldman Sachs

I understand that ALICO recently won a partnership with the Japan Post. I was just wondering how we should look at on a go-forward basis on what that may do for Japan production.

Martin Sullivan

We are in ongoing dialogue with Japan Post on a number of opportunities. We would be in advance of ourselves in giving any color at this moment in time because, as you know, it is going to take a period of time for the post office to privatize in its current form. We are working with them in a number of initiatives. So actually, when something more concrete is available, we would be happy to disclose that.

Tom Cholnoky
Goldman Sachs

I assume that would be more of an '08 event, as opposed to '07?

Martin Sullivan

Well, I think the privatization is going to take a number of years, so it is certainly forward-looking.

Operator

Your next question comes from William Wilt - Morgan Stanley.

William Wilt
Morgan Stanley

Good morning. I will stick with the same theme, Foreign Life. Looking at Asia, Foreign Life in Asia, operating income down about 4%. It looked like it all came or most of that came from Life Insurance down about 8% operating income. Deposits under considerations was up nicely, was moderately positive, so I wanted to see if there was some color that could be provided there.

Martin Sullivan

Certainly. We have got Edmund with us this morning, so Edmund?

Edmund Tse

Good morning, William. Those numbers, really they are somewhat misleading, certainly based on the second quarter. Because this is comparing to last year the same quarter, last year there was a one-off item or adjustment of certain investment income which was $144 million. If you normalize that, the current quarter's operating income for Foreign Life, it's from 3.7% up to 14.3%. Same applies then if you take the Life itself because applying this income more applying just to the life insurance. If you normalize it then we would have a double-digit operating income increase.

William Wilt
Morgan Stanley

On the second lien mortgage insurance at United Guaranty, there was a reference in the presentation to stop loss reinsurance. Maybe a quick recap of how that works. I thought it was 10% of the notional exposure. Is that $2.5 billion, or $250 million aggregate stop loss? I wondered how close you were to hitting that aggregate stop loss? Thanks.

Martin Sullivan

We have got Billy Nutt with us here. So, Billy?

Billy Nutt

We do implement stop loss limits on all of our second lien policies. As you see on the chart in the presentation that Bob Lewis presented, chart 16, of our domestic mortgage net risk in-force, 10% of that is related to second liens, which is $2.5 million. With an average stop loss limit on that of about 10%, you're looking at about $250 million of total stop loss, which is rather modest. Some of our policies are close to their stop loss limits. But a number of them are not even close to their stop loss limits, and that is due to the diversification of the portfolio.

William Wilt
Morgan Stanley

So it would be too simple looking at, I guess, page 17, the domestic second lien losses of $159 million in the second quarter, it's too simple to just take that number, add losses in the first quarter, and presume that you are close to being able to benefit from the stop loss?

Billy Nutt

That would be too simple. But we will benefit from the aggregate stop loss limits in some of our policies.

Operator

Your next question comes from Dan Johnson - Citadel Investment Group.

Dan Johnson
Citadel Investment Group

Good morning. I think it will be afternoon by the time we are done. Within the Life and Retirement segment, a couple questions please. We used to have disclosure on the runoff block. Honestly, maybe I have missed it. It was running around $15 billion or so. Can you give us an update on where that is at?

Martin Sullivan

Chris Swift will respond to that.

Chris Swift

Dan, are you referring to the domestic fixed and variable annuities that we put into runoff?

Dan Johnson
Citadel Investment Group

I believe that was what was in there, although I can't entirely be sure. But yes, it was about $15 million or billion for the last couple quarters, coming down, and then it looks like it disappeared from the supplement. Or moved, possibly.

Chris Swift

We did make a supplement change, broke out Life and Retirement Services differently. If you look at the fixed annuity line for Domestic Life, we also combined that with the old I will call it Domestic Life runoff. Within the Retirement Services, there is a, I will call it runoff category also where we just provide reserves. It is running off as expected. I don't think there's anything abnormal in there. But it is declining. I think reserves are closer to the $12 billion level than $15 billion.

Dan Johnson
Citadel Investment Group

Within the Retirement Services business, there was some commentary in the Q, but maybe you could give a little more discussion around it, about what the flows look like in light of redemption profiles and new business efforts.

Martin Sullivan

Absolutely. Jay is on the line from California, so Jay, can you respond to that?

Jay Wintrob

First of all, in the supplement I think the flows are pretty clearly laid out. Mainly that is going to be driven prospectively by PDOC sales. That is because, as we have disclosed, we continue to expect surrenders at these kind of levels or higher in the fixed annuity business due to the shape of the curve and the fact that we are five years out from our record sales years.

We are seeing some improvement in the ALIC group business and also in the variable annuity business. Again, on the sales side, with sales momentum I think we can improve on the flow side. It will be harder with fixed annuities because it is so subject to the two factors I mentioned, the shape of the curve and the fact that we are five years out on our two record sales years, starting at the end of this year.

Dan Johnson
Citadel Investment Group

So that is on the Life side. On the P&C side, the workers comp discount rate change, I am certainly not an expert on this one. Can you give us a little color around what drove that? I think, if I read right, it is a $155 million adjustment? Then since I think we all look at the different accident years between say the good years and the bad years, can you help us rethink about your disclosure of the accident years, excluding that $155 million positive?

Frank Douglas

The work comp discount, which we adjust quarterly, was previously subjected to really a full actuarial analysis only in the fourth quarters. What we changed this quarter, which we do disclose in the Q, is that we are now updating the analysis quarterly. That did result in an increase in the discount of $155 million for workers comp, $125 million of overall discount, including discount in other line.

I think that is not a one-time aberration. This is a process that we're going to continue going forward. As our work comp reserves increase, the discount in those reserves is going to increase. It is spread across all accident years, as we have a significant volume of workers comp reserves in all accident years. You would see in the disclosure we have on accretion of discount, you would see that number was $12 million this quarter. That would tell you what the prior accident year impact was of the unwinding of the discount in prior accident years.

The balance of the discount is being put up in the current accident year against our workers comp reserves. So the prior accident year reserves discount will continue to accrete or unwind every quarter. But as we do an updated evaluation each quarter of our workers comp losses and their payout pattern and interest rate, the amount of discount in any one quarter could vary from what the change was in the prior quarter. But as our work comp reserves increase, our discount will increase proportionately with it.

If you look at our 10-K, you will get a picture of how it has changed over the longer-term period, how much discount is remaining by accident year. We don’t show that every quarter, but if you look at it in the 10-K I think you will be able to see the general pattern by which it amortizes or unwinds.

Dan Johnson
Citadel Investment Group

Maybe my better question, just to get to the point, was that 155 in the 120?

Frank Douglas

No.

Dan Johnson
Citadel Investment Group

That is the answer to the question. Thank you very much.

Frank Douglas

We do not include discounting in the loss development. All of the loss development tables are based on undiscounted losses.

Operator

Your next question comes from Tamara Kravec - Banc of America Securities.

Tamara Kravec
Banc of America Securities

First, just going back to the mortgage insurance business, the first lien business, which you had put in your release is 77% of the total there, and it generated about 42% of the losses. I guess I just wanted to get more granular on specifically where that business is underperforming in terms of the losses rising? Is it in particular vintages, particular FICO scores, LTVs? You have broken it down, but if you can just give a little bit more details that.

You are well on your way with the buyback, and you have articulated before that you're looking for $5 billion this year. Given the pace that you're on right now, would you consider exceeding that and doing the full $8 billion this year? Or are you sticking with what you originally laid out? Thanks.

Billy Nutt

First of all, a correction in your statement. The domestic mortgage net risk in-force, 90% of that is in the domestic first lien business; and 10% is in the domestic second lien business. The first lien business represented 58% of our losses incurred. That is generally occurring along all segments of the business in terms of FICO scores. But in particular, we are seeing stress in those states that have experienced an economic recession : the upper Midwest, Indiana, Ohio, Michigan, West Virginia. Those markets that have been in a manufacturing recession. We're also beginning to see some deterioration in incidence and severity in California and Florida now.

Martin Sullivan

On the second part of your question, on the stock repurchase, obviously we have authorization up to $8 billion. We said we would do $5 billion in 2007. Obviously, we would keep our options open. If there was any change in that timing, obviously we would disclose that to the market.

Operator

Your next question comes from Mark Lane - William Blair.

Mark Lane
William Blair

Frank, on the commercial side can you talk about loss cost trends, any changes? What is your thought about how loss cost trends will develop over the next year on the commercial side?

Frank Douglas

Well, I can tell you how they have developed up until now. Obviously, it is an extrapolation what will happen over the next year. But certainly what we have seen and reported each quarter for the last several years has been favorable loss trends for primarily accident years 2003 and forward. We are still seeing those favorable trends in accident year 2006, which is the newer phenomenon that we have seen in the last two quarters. Obviously, one can't say that because we have seen that for these two quarters it is going to automatically continue for the next four quarters, but that might be an assumption one might want to make. I am not saying we make that. We assume our reserves are adequate based on an assumption that loss costs are going to continue to rise from one accident year to the next.

After each quarter's data comes in we reevaluate with the updated data. We have been able to avoid having to raise some of our loss ratios, frankly, because the prior accident years and the more recent years continue to develop better than expected. So as the accident year loss ratios go down for 2003 through 2006, it alleviates the pressure to increase the loss ratio for the current accident year.

Whether that will continue is obviously unknown, but that has obviously been the pattern we have seen for the last couple of years.

Mark Lane
William Blair

So basically going forward, you're saying you are just kind of watching? There is really nothing that you can do to anticipate anything? It is just you are watching and you're using historic trend, and you will adjust it if it is not a trend, basically?

Frank Douglas

Yes and as Kris noted earlier, if rates are going down and if they accelerate in a negative way, that obviously puts upward pressure on the current-year loss ratio. However, that could be mitigated or offset completely in some cases, or recently in almost all cases, by the favorable emergence from prior years. So it's a quarterly analysis we do for every profit center, for every product.

We look at what losses came in from all accident years, including the most recent years. We put into the equation what the rate changes earning in the quarter are and come up with an indicated current-year loss ratio.

Mark Lane
William Blair

Do you have the developed accident year loss ratio as of June 30 from '06?

Frank Douglas

For many classes we are developing the accident year 2006 losses. For other classes, we are using expected loss ratio methods, as you are probably familiar with.

Mark Lane
William Blair

But do you have as of June 30, the developed accident year '06?

Frank Douglas

The number at the AIG is currently 62.9. That is our current AIG all property casualty segments combined loss ratio.

Mark Lane
William Blair

'06 developed as of June 30?

Frank Douglas

Right, yes. That compares with 64.4 currently for accident year 2007.

Mark Lane
William Blair

Foreign Life, I know you answered this question. It is a business that is very difficult to analyze even with the increased disclosure. Earnings have been under pressure for a number of quarters, particularly in Japan. Premium production on the single premium side, has been extremely robust for the last several quarters. So when are we going to start to see that hit the bottom line? Can you talk about profit emergence within Foreign Life over the next six to 12 months? It is just very difficult to figure out any trend there.

Edmund Tse

How soon are those robust single premiums to hit the bottom line is a little bit more difficult to answer. It depends a lot on rates of persistency. But over time, and definitely, the increase in AUM because of the single premium products will contribute a lot more to our bottom line consistently over the years. As you can see, we have a very consistent growth either in top line or, in many countries, even in bottom line over the last few quarters. Maybe, Chris, you could add some color to it?

Chris Swift

Sure, Edmund. Profit emergence is a little slower with our single paid business compared to regular premium business, as Edmund was referring to. But where we price it, in essence, the net spreads that we get in it are attractive; and it will emerge over time. As Edmund said in his opening comments, we have some comparability issues this quarter. If you really take that away, Foreign Life is up 14%-ish, which is probably on a high end of a long-term expected growth rate, but probably not too far from where we will see the total Foreign Life business going.

We have commented in the past in Japan on Star and Edison being year end in the inflection point where we think they could start to grow faster. We still see that and believe that as we head into the '08 planning cycle.

Operator

Your next question comes from Jay Cohen - Merrill Lynch.

Jay Cohen
Merrill Lynch

Shifting back to the portfolio, it seems like the folks within Financial Products and American General Finance really saw the writing on the wall to some extent with the whole mortgage issue on the sub-prime side and pulled back. Was there any communication between those folks and the investment folks? Because it seems like the buying of this stuff on the portfolio side continued pretty aggressively in '06, although it is hard to tell. What is the communication lines like between these different areas?

Bob Lewis

I think it is fair to note that there are some structural differences in the business that I think Billy might comment on. There are some structural reasons in the business why the timing of an effect of a change is slower in UGC's business to take effect than it can be on the investment side or the FP side. Billy, you might want to just mention that reason.

Billy Nutt

UGC and American General Finance really have different business models. We are a broad market mortgage insurer. AGF is a niche mortgage lender. We must participate in the broad market with all of our major lenders, which includes insuring some segments of the higher risk products, as well as insuring a large market share of their A paper business.

We basically follow the fortunes of the market. We follow the fortunes of the lender, where AGF can pull in and out of markets depending upon the dynamics that are going on in those markets. Also what is important to note is UGC is in first-dollar loss position, where AGF has equity or other credit protection before they incur a loss. We do communicate across units. We understand each other's respective businesses, but we have distinct business models.

Bob Lewis

Coming over to the investment side, I would like to mention that there are some structural reasons for the investment that has to do with matching our liabilities. Richard, do you want to explain?

Richard

There's so many different facts that one might put out there; but one thing you should understand is we did change our basic underwriting in '06 and '07 particularly with regard to Alt-A, where we switched to almost exclusively super senior structured AAAs which have subordination under them more akin to sub-prime deals than a typical Alt-A deal would have. So we do have good communication across groups. We do talk to FP. We do talk to AG Finance. We do talk amongst ourselves.

I do think that everyone should understand that since this is primarily a AAA portfolio we are not overly concerned about modest or even fairly aggressive deterioration in these markets. But the switch in the Alt-A portfolio, in particular, to the much more highly protected tranches was certainly directly related to our perception of the underwriting standards in the market.

Jay Cohen
Merrill Lynch

That's helpful. Then just one quick follow-up. Just to understand the mark effect, you had said initially that the quoted prices for many of these securities has gone down. But it sounds like that would not necessitate a mark-to-market on your behalf. Is that right?

Richard

All of our assets get marked through the balance sheet, with a difference in fair value going through other comprehensive income whether we intend to sell them or not. But whether or not it goes through reported realized gains and losses is a question, i.e., is marked to market through the income statement, is a function of either deciding to sell it or selling it.

Bob Lewis

Jay, virtually all of the RMBS securities that we hold are unavailable for sale. So they do, as Richard just said, they get marked to market on a quarterly basis through accumulated other comprehensive income. Only to the extent that there was any determination that there was an other than temporary impairment in those securities would there be an income statement effect. I think we have talked through this presentation on why we don't believe that is going to occur.

Jay Cohen
Merrill Lynch

Right, that is what I thought initially. Okay, great. Thanks.

Martin Sullivan

Jay, I would also just draw your attention on page 14 of the presentation, where we obviously lay out that the average domestic mortgage loss ratio for UGC over the last ten years is some 27%. As Billy has mentioned before, I guess you could define the environment he is trading in at the moment as the mortgage insurance definition of a cat loss.

Jay Cohen
Merrill Lynch

No doubt, thank you.

Martin Sullivan

Ladies and gentlemen, unfortunately we only have time for one more question.

Operator

Your final question comes from Charlie Gates - Credit Suisse.

Charlie Gates
Credit Suisse

Good morning. This was an awesome conference call. Congratulations. Haven't the two recent Supreme Court decisions, the one June 18 concerning securities underwriters and the one June 21 concerning [inaudible] weren't they very important, arguably, positives for your business in loss cost trends?

Martin Sullivan

Kris is going to respond.

Kris Moor

Charlie, obviously, on the surface they are positive, but you have to be very cautious as we have seen in the past, when you get big decisions that are favorable, that things tend to change in the marketplace and the plaintiffs' bar figures ways to get around it. So on the surface and right now, though we think they're positive, but we haven't taken any account of those decisions into our loss ratios.

Charlie Gates
Credit Suisse

With regard to all these concerns about marking assets to market, I don't think I can recall a day when the yield on the ten-year was down 10 basis points before, to 4.76%. Isn't that a very important positive from the standpoint of marking securities to market?

Kris Moor

In general, I would say yes it is since we tend to have a modestly, I would say, an intermediate duration portfolio.

Charlie Gates
Credit Suisse

I guess the only other question, on page 29 of the mortgage presentation you show this year credit default swap of $19.4 billion where the collateral was predominantly BBB. To what extent is that a source of worry?

Martin Sullivan

Maybe Joe or Andy, you could respond to that.

Joe Cassano

That is the same question that Tom Cholnoky was asking too when he looked at that. I think maybe to put that further in perspective, that underlying pool are pools of BBB assets. But when you pool those up they created other AAA, AA assets. Then we have attached above that AAA group, when they got pooled. As we were saying to Tom in the previous answer, going through the stress tests that we have, and having hand selected the underlying assets that are involved in these portfolios, and then stressing the underlying CDOs or the BBBs that are in there, we're quite comfortable that there is no issue with those portfolios.

We wanted to make sure in this presentation, we broke out exactly what everything looked like in order to give everybody the full disclosure. But we see no issues at all emerging. We see no dollar of loss associated with any of that business. Any reasonable scenario that anyone can draw, and when I say reasonable, I mean a severe recession scenario that you can draw out for the life of those securities.

Charlie Gates
Credit Suisse

That was an awesome conference call. Thank you.

Martin Sullivan

Thank you, Charlie. Ladies and gentlemen, thank you very much indeed for your patience and your attention today. Thank you.