S&P Capital IQ

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American International Group, Inc. NYSE:AIG

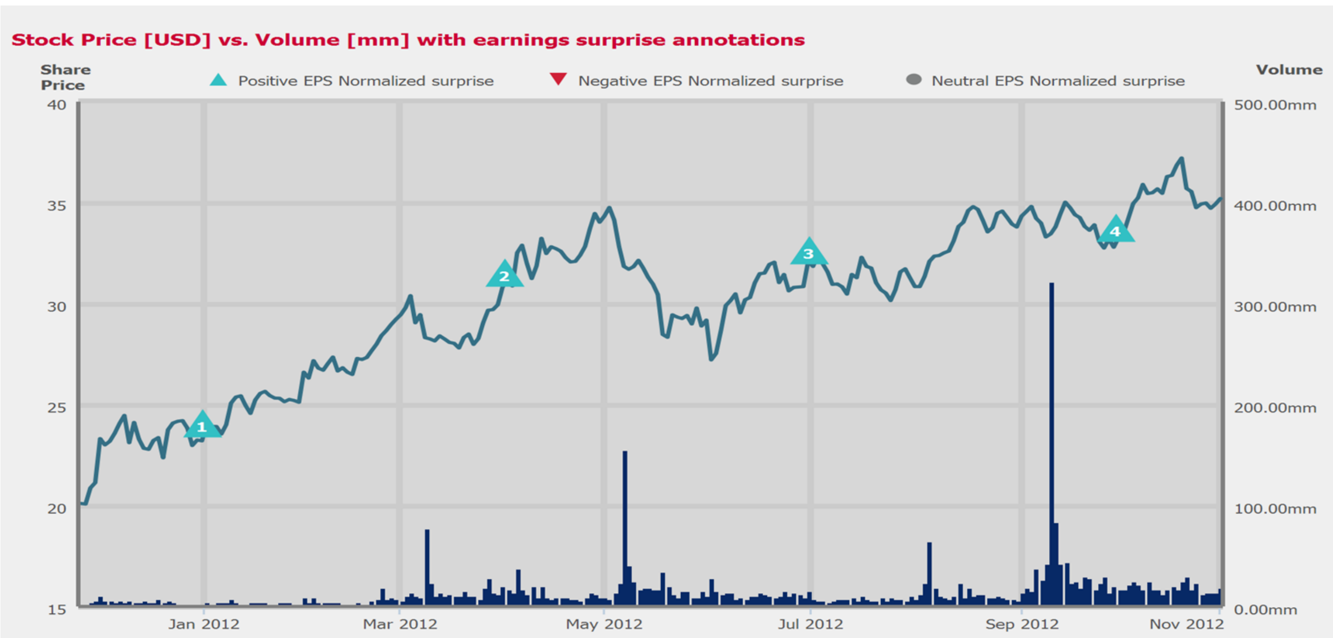
FQ4 2012 Earnings Call Transcripts

Friday, February 22, 2013 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ4 2012-			-FQ1 2013-	-FY 2012-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	(0.07)	0.20	NM	0.85	3.78	3.93
Revenue (mm)	8701.57	8613.00	▼(1.02 %)	8626.00	35359.75	34873.00

Currency: USD
Consensus as of Feb-22-2013 12:06 PM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ4 2011	0.65	0.82	▲1 26.15 %
FQ1 2012	1.39	1.65	▲2 18.70 %
FQ2 2012	0.60	1.06	▲3 76.67 %
FQ3 2012	0.89	1.00	▲4 12.36 %

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Presentation

Operator

Good day, and welcome to American International Group's Fourth Quarter Financial Results Conference Call. Today's conference is being recorded. At this time, I would 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. Welcome to AIG's discussion of their fourth quarter 2012 results. Speaking today will be Bob Benmosche, President and CEO; David Herzog, Chief Financial Officer; Peter Hancock, CEO of AIG Property Casualty; and Jay Wintrob, CEO of AIG Life and Retirement. Other members of senior management are also in the room and available for the question-and-answer period.

Before we get started this morning, I'd like to remind you that today's presentation may contain certain forward-looking statements, which are based on management's current expectations and are subject to uncertainty and changes in circumstances. Any forward-looking statements are not guarantees of future performance or events. Actual performance and events may differ, possibly materially, from such forward-looking statements. Factors that could cause this include the factors described in our 2012 Form 10-K under Management's Discussion and Analysis and 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 reconciliation of such measures to the most comparable GAAP figures is included in our financial supplement, which is available on AIG's website, www.aig.com.

Now I'd like to turn the call over to Bob.

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

Thanks very much, Liz, and good morning, everybody.

As I shared in May of '11 with all of you that -- I said the AIG crisis was over as we re-IPO-ed the company. As we look at the fourth quarter of 2012, we're just about to close the door completely on all of the issues that AIG faced during this period of time. You saw during the quarter, on our strategic activities, and I'm on Page 3 of the presentation, we sold the remaining shares of AIA for $6.5 billion. We entered into an agreement to sell approximately 90% of ILFC. That sale, by the way, is continuing. We're now just starting down the regulatory review process, so that's on its way. We would hope that we could close this in the second quarter of 2012. And at that time, we can say the door is completely closed and everything is behind us.

We also are building towards the future, and so we made a strategic investment in PICC. That investment, as you saw, is performing well as an investment, but it's more important in that it's strategic. It is allowing us to work with PICC to build a very big and strong life business in China. And of course, the Department of Treasury has now sold all of their shares, and they are completely gone.

As you look at our liquidity, we're sitting here with about $16.1 billion as a result of the AIA sale, and this is on top of very, very strong capital in all of our insurance companies. We're continuing to get strong dividend flows from our insurance companies, which is helping us deal with our strength, especially in this measure of liquidity.

When we talk about capital management, some of you keep asking. What we said last time is still in play today. Our highest priority is to make sure that we focus on getting high-cost debt out, reducing our expenses for interest and improving our coverage ratio. As the year progresses, we will then begin to look at things like could we add a dividend to the stock and also could we have some kind of a modest stock buyback. But we're going to wait until we're very, very sure we're in great shape, because what I've said, it's important we retain our ratings and improve those ratings. You saw some upticks here. We want those upticks to continue.

On the AIG Property Casualty business, Peter is going to talk to you this morning, but we see continued gradual progress in the loss ratio. The mix of business, you can see, is changing. So if you look at the major business on the commercial front, we continue to do well on the consumer front. And we're able to overcome the fact, on direct business, we can no longer amortize that over the life of the policies. We're also getting rate in the commercial arena. So, while Sandy took a big hit of $2 billion, which I believe actually reflects the size of AIG and how we do business and the kind of business we do, but with that kind of a hit in the quarter, you saw we actually made a profit, operating profit, in the fourth quarter for the company.

Life and retirement, again, continues to do well. Our variable annuity sales, which are very well designed, continue to grow at a time when many of our competitors feel the need to contract because of more aggressive features on their products versus what we're doing now. We continue to see less sales in fixed annuities, which you'd expect in a lower interest rate environment.

In our Mortgage Guaranty business, we did have to take a reserve charge to deal with the fact that, as some of the legacy book is now aging, we see less rescissions. So we made an adjustment in some of the future expected claims, but other than that, the underlying business continues to do extremely well.

So we're continuing to work hard to make sure that 2013 is a year where you see clearly that all the fundamental investment and hard work in this company is coming to fruition. And you'll see us continually work towards our aspirational goals in 2015.

What I'd like to do now is turn it over to David, who will take you through a little bit more detail on the financials. David?

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

Thank you, Bob, and good morning, everyone. As Bob mentioned, there was quite a bit of activity on the capital management and the operating fronts this quarter. We remained committed to our aspirational goals, including our $25 billion to $30 billion in capital management and a 10% ROE by 2015. That capital management is a current priority, as you've seen from our recent tender.

If you turn to Slide 4. Our fourth quarter net income included a $4.4 billion loss related to the agreement to sell ILFC, which reduced book value per share by $2.97. Book value per share, excluding AOCI, was $57.87, up 15.5% from 2011.

Operating results begin on Slide 5. And as you can see, Storm Sandy meaningfully affected Property Casualty results. Sandy losses are coming in, as expected, at about $2 billion. Life and retirement delivered another strong quarter, with operating income of $1.1 billion and strong investment returns. Both Peter and Jay will comment on these results in more detail.

The Direct Investment book and capital -- Global Capital Markets benefited from positive marks in the quarter, driven largely by tightening credit spreads. At the Direct Investment book, NAV came down by about $1.7 billion to $4.8 billion, which is primarily attributable to our ability to extract value and deploy it towards generating incremental parent liquidity. Subject to our stress-testing framework to ensure that the Direct Investment book can meet its liabilities, even under stress scenarios, we'll be regularly evaluated -- we will regularly evaluate the DIB for further opportunities to extract value from -- for our company and our shareholders.

As a reminder, the bulk of the hedges associated with the assets and liabilities of the Direct Investment book reside within Global Capital Markets. Over time, we expect to realize additional value from the DIB and its hedges in excess of what is required to service the liabilities, even under stress. However, it's important to note that approximately 60% of the Direct Investment book's debt is maturing in the next 5 years, so it's safe to assume that, for the near term, a significant portion of the DIB's maturing assets and their corresponding hedges will go towards satisfying these upcoming liability maturities.

Interest expense came in as expected. Corporate expenses, which were slightly elevated in the quarter, included the impact of costs incurred from continuing infrastructure buildout, our branding and advertising expenditures and some modest restructuring-related costs. The effective operating tax rate decreased during the quarter to just under 23% due to a impact from discrete items as well as some permanent items for the quarter. Looking to 2013, we continue to expect our operating tax rate to be roughly in the 30% range. As you may recall, we will not be paying any U.S. corporate income taxes for some time, given our NOLs.

Slide 6 shows the current status of our deferred tax assets. Despite losses from Storm Sandy, we will -- on a tax return basis, we will utilize about $4.4 billion of the gross NOLs in 2012, aided by the non-core asset monetizations. We also utilized a little over $4 billion of our gross capital loss carryforwards. Additional capital loss carryforwards may be realized in the future if and when other prudent and feasible tax planning strategies are identified.

Our capital position remains solid. And on Slide 7, you can see our debt levels reflect the $1.8 billion of senior debt issuances earlier in the year, and our shareholders' equity reflects the $13 billion in share repurchases. As we mentioned last quarter, our targeted improvement in the fixed charge coverage ratio is 1 to 2 turns over the next year or so through both capital management and earnings growth. Towards that end, we recently announced a tender offer targeting a number of our hybrids and legacy SunAmerica securities. We've been very clear about our intention to streamline our balance sheet and intend to execute on that plan in a very disciplined manner. Between this tender offer, scheduled maturities and the hybrid calls that are available to us, we believe that we will have made substantial progress towards our liability management goals in 2013. Anything else beyond this, for the remainder of the year, is likely to be opportunistic.

We continue to optimize our capital structure across the enterprise on an ongoing basis. During the fourth quarter, we invested $500 million in our Life and Retirement companies in a strategic cornerstone investment in PICC group that Bob earlier referenced. The Life and Retirement companies and our Property Casualty companies are teaming up to further develop our distribution and sales capabilities in China.

Our insurance subsidiaries remain well capitalized and above their CMA thresholds and they are well positioned to deliver dividends to the holding company going forward. The new CMA levels are effective in 2013 and reset based on our annual refresh of rating agency and regulatory capital models.

The Property Casualty CMA level declined due to the exclusion of the deferred tax asset from the computation. The Life and Retirement CMA level declined due to the reduction in rating agency minimum requirements and greater capital efficiency from the consolidation of several Life and Retirement legal entities.

Cash flow remained strong despite that of -- the effects of Storm Sandy. Slide 8 illustrates the pace of the quarterly distributions from the insurance subsidiaries, which was over $5 billion in 2012. In the fourth quarter, post-Sandy, we chose to make a $1 billion capital contribution to the Property Casualty companies.

We continue to expect $4 billion to $5 billion in annual dividends and distributions from our insurance subsidiaries. Parent company available liquidity is over $16 billion, reflecting the recent AIA sale proceeds. As we stated last quarter, the AIA sale generated about $2.5 billion in deployable capital.

And at this time, I'd like to turn the call over to Peter for greater detail of the Property Casualty results. Peter?

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

Thank you, David. Good morning, everyone.

The fourth quarter marked continued progress towards achieving our goals, increasing risk-adjusted profitability and implementing our main strategic initiatives. This morning, I'll comment on our quarterly performance while discussing our underwriting improvements, efforts to reduce risk and maximize capital efficiency, as well as several profitable growth opportunities.

Turning to Slide 9. Operating earnings exceeded $1 billion, excluding the $2 billion net Storm Sandy loss. This reflects healthier underlying underwriting results and strong investment performance, partially offset by higher expenses.

The fourth quarter accident year loss ratio, as adjusted, improved to 63.3%, reflecting the steps we've taken to refine business mix and enhance risk selection through predictive modeling, technical price and account management tools. The accident year loss ratio has improved approximately 3 points per annum over the last 8 quarters, and we expect that trend to continue in 2013.

Fourth quarter net premiums written were flat, excluding the impact of foreign exchange. We experienced growth in high-value products and geographies, offset by nonrenewals on underperforming businesses, primarily in U.S. casualty

The steps we're taking to improve business mix are producing more favorable underwriting results. We expect modest real net premium growth in 2013 as we pursue new profitable business and corrective underwriting actions begin to stabilize.

In the fourth quarter, net prior year adverse development was a modest $116 million or 0.2% of total reserves. This was primarily driven by adverse development in casualty, partially offset by favorable development in financial lines and property.

During the quarter, we completed our annual reserve study of workers' compensation and other long-tail lines, which supported current reserve levels. Despite the long-tail nature of workers' compensation, the work we've done to identify the structural drivers of losses has increased our confidence in our reserve adequacy.

We continue to actively manage our run-off lines of business. In the fourth quarter, certain pre-2004 environmental business was moved from the commercial segment to other to improve regulatory capital efficiency and claims handling. We've revised prior-period results to reflect the transfer of this business. This exposure is part of the same portfolio that was subjected to a claim-by-claim review, which we discussed in previous quarters.

Although Storm Sandy was most unusual in its nature and path, we do not consider it an outsized event for AIG. Total Sandy losses were 2.7% of AIG Property Casualty's shareholders' equity, which is in line with our risk appetite and PF [ph] comparisons.

Over the past 3 years, we took deliberate steps to reduce U.S. CAT exposure generally. We've also implemented flood sub limits on renewals, instituted changes to deductibles and terms and conditions and have pushed for rate increases, in particular following Hurricane Irene, which mitigated the extent of Sandy's impact. Our primary responsibility is to our customers, and I'm pleased to say that our claims service was recently recognized as best in class in response to Sandy by a major global broker.

This quarter, we provided additional disclosures on acquisition and general operating expenses to offer more transparency on their main drivers. Acquisition costs grew, as expected, as high-value business, including the direct marketing channel, accounted for a greater proportion of our overall portfolio. We're comfortable with higher acquisition expenses as we target business that will increase risk-adjusted profitability. Our investments in technology, talent and infrastructure impacted the general operating expense ratio, but we believe these initiatives will reduce losses through better claims handling and analytics. In addition, they will drive shared service efficiencies in mature markets and will also help us build scalable platforms to support our growth ambitions in emerging markets.

In the fourth quarter, we recorded approximately $100 million in severance charges. In 2013, we expect the GOE will approximate full year 2012 levels. We continue to expect a decline in GOE beginning in 2014.

Turning to Slide 10. Commercial Insurance net premiums written were flat excluding foreign exchange, a result of growth in high-value business offset by improved risk selection and rate discipline, particularly in U.S. casualty. In the fourth quarter, we entered into a new reinsurance program in U.S. excess casualty that reduced commercial's net premiums written by about 1%, but the agreement is expected to improve overall risk-adjusted profitability.

We reported positive rate change in many of the areas where it was most needed in the fourth quarter. U.S. Commercial Insurance rates increased 8.6%, and property and workers' compensation rates in the U.S. increased by 14.6% and 12.4%, respectively. However, we continue to observe more competitive conditions in Europe and some specialty lines.

Commercial's accident year loss ratio improved over 5 points on a full year basis, and we believe it should continue to improve compared to full year 2012 results. However, I would not expect its progression to be linear, given quarterly fluctuations, as evidenced in the fourth quarter comparisons.

Moving on to the consumer business. As most of you are aware, Jeff Hayman recently resigned as the leader of the business. I am working more closely with our experienced consumer management team to advance their business goals as I assume his role on an interim basis. Our broad product set and multiple distribution networks provide significant opportunities for expansion, and we remain very bullish on this business.

Turning to Slide 11. Consumer's premium growth, excluding foreign exchange, was approximately 1%, and we are pursuing growth strategies across its 2 major lines of business. Direct marketing remains a focus for us, and it represents 15% of the consumer business.

In total, we wrote $1 billion in premiums in growth economies in the fourth quarter. We experienced strong growth in Asia Pacific, excluding Japan, where premiums increased 15%; and Latin America, which had 13% growth over the prior year.

We pursued investments and joint venture agreements as part of our international expansion plans. A good example is AIG's investment in the PICC group, which strengthens our partnership with the PICC Property Casualty company. We've also achieved profitable growth through our long-term accident and health relationship with PICC, and we're excited about additional consumer opportunities in China.

We recently announced a bancassurance agreement with HSBC. AIG will act as the exclusive provider of nonlife insurance products to customers in Turkey and France through this agreement. We anticipate it will significantly enhance our ability to market A&H products in Turkey, one of our strategic business expansion countries. In Israel, we purchased our partner's 50% share in AIG Israel, a successful direct marketing business with strong in-country brand recognition.

Slide 12 demonstrates our investment portfolio mix. Fourth quarter net investment income increased 21%, reflecting strong alternative investment returns. We achieved greater diversification by further reducing our concentration in municipal bonds and investing in higher-yield securities while remaining aligned with AIG's overall risk appetite.

We made $902 million in dividend payments to AIG Parent in the fourth quarter, bringing our full year 2012 total to $2.5 billion before the $1 billion capital contribution that David referred to. Our capital efficiency efforts, which include legal entity simplification and restructuring of reinsurance arrangements, helped make 2012 our largest dividend-paying year in recent history.

2012 included a series of achievements that contributed to advancing AIG Property Casualty's intrinsic value. Our shift to high-value business and underwriting improvements produced better margins. We maintained our focus on capital efficiency and optimizing our risk profile. Finally, investments in our business, people and profitable growth opportunities provided us with a strong competitive advantage.

In closing, I'm satisfied with the progress we've made, and I'm confident that we'll build on our success in 2013

Now I'd like to turn it over to Jay.

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

Thank you, Peter, and good morning, everybody. I'll begin on Page 13.

AIG Life and Retirement delivered another strong quarter, with operating income growth of 20% for the quarter and 27% for the full year. Our results continue to benefit from actions on both the asset and liability sides of the balance sheet to manage spread income in the current interest rate environment from growth in assets under management and related fee income growth, aided by strong fixed income in equity markets, and from continued expense management.

The fourth quarter also benefited from strong alternative investment returns, a $57 million gain on our investment in PICC group and a net favorable DAC and reserve unlocking of $41 million. These items were partially offset by less-favorable individual life mortality results, though still in line with pricing assumptions, and a loss-recognition reserve strengthening of $61 million on legacy long-term care business written between 1997 and 2001. We no longer write long-term care insurance and have total runoff reserves of $245 million.

For the full year, operating income was $4.2 billion, up from $3.3 billion last year, due in large part to improved net investment spreads. While reported earnings growth will be challenging this year due to continued low interest rates and certain onetime positives this year in 2012, we will continue to proactively address the low-rate environment and actively manage net investment spreads.

As David mentioned, in the fourth quarter, AIG Life and Retirement was a significant contributor to capital management, providing $440 million of liquidity to the holding company through dividends and distributions from our operating life companies, thus bringing our full year 2012 total to $2.9 billion. Our year-end RBC ratio is estimated at approximately 510%, well above our capital maintenance agreement threshold of 385%.

In the fourth quarter, sales results once again reflect the value of our diversified business model. Variable annuity sales were strong at $1.2 billion in the quarter, just short of our high-water mark in the second quarter of 2012. For the full year, VA sales were an all-time record $4.6 billion, up 42% versus 2011.

As Bob mentioned, we benefited from some dislocation in the VA market this year, although we remain a relatively small percentage of industry sales. More importantly, our competitive product offerings, designed and priced with risk control as a primary goal, were embraced by the market. Longer term, we would expect product innovation and broadening distribution to continue to drive sales, and looking ahead to this year, VA sales growth should continue, although not at the same growth rate as in 2012.

Fixed annuity sales did improve sequentially in the quarter but do remain low relative to historical levels. Lower fixed annuity sales and an increase in large group surrenders of VALIC contributed to negative net flows for the fourth quarter. We also voluntarily waived certain surrender restrictions on VALIC contracts with high guaranteed minimum rates, which contributed to the higher surrender activity. While we're taking actions to improve our deposit growth in 2013 through expanded distribution and growth initiatives in all of our business lines, low interest rates, should they continue, are expected to restrain fixed annuity sales growth in particular.

We completed the merger of 6 life insurance operating legal entities into American General Life Insurance Company at year end 2012. Besides improving the capital efficiency of our remaining 3 life operating companies and providing expense savings, this merger, along with our reorganized and united distribution organization, will make it easier for distribution firms and producers to do business with us and better position us to sell multiple products across all of our distribution channels. We plan to modify our presentation of results to reflect our new organizational structure in the first quarter of this year.

We mentioned our investment in the PICC group earlier. And in close collaboration with our colleagues at AIG Property Casualty, we are currently negotiating a definitive agreement with PICC Life Insurance Company to establish a joint venture to distribute life insurance and other insurance products through a specialized agency force, with a focus on major cities in China such as Beijing, Shanghai and Tianjin.

We're also negotiating reinsurance and other economic sharing agreements with PICC Life for jointly developed products. We'll be providing more information on these activities once the final agreements are executed with PICC Life.

Moving on to Slide 14, we've provided additional information on our asset allocation and investment portfolio yields. While portfolio base yield for the full year increased to 5.43%, we continue to see modest pressure as we reinvest currently at lower rates. The fourth quarter base yield of 5.33% is down from the third quarter base yield of 5.38% and, of course, down from the 5.44% a year ago. As we mentioned in our press release, our total yield in the quarter benefited from strong alternative investment returns and the gain on our PICC stock investment.

Our total fourth quarter yield, as reported, of 6.09% is up from 5.86% in the third quarter and 5.33% a year ago. This quarter, alternative investment returns were higher than our expected trend, while the fourth quarter a year ago was below expected trend. And full year total yield, again, was 6.04% versus 5.63% a year ago.

Turning to Slide 15. We continue to proactively manage net investment spreads. Western National crediting rates declined both sequentially and year-over-year, contributing to the improvement in net investment spreads. VALIC's crediting rates have been relatively stable since the second quarter, and spreads have consequently declined due to slightly lower portfolio yields, both due to lower reinvestment yields and the fact that we have been repositioning the VALIC portfolio to improve credit quality.

Close to 2/3 of our fixed annuity and universal life account values are currently at guaranteed minimum crediting rates, up from 45% at the end of 2011.

In closing, with a very solid 2012 behind us, we remain focused on our strategic initiatives for 2013, increasing sales of profitable products, proactively managing interest spreads, growing our assets under management, increasing our life insurance in force and, of course, improving our return on equity.

And at this time, I'll turn it back to David.

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

Thank you, Jay.

On Slide 16, you'll see the growth and improving operating trends of our Mortgage Guaranty business. The loss in the quarter was due to a reserve strengthening, which was tied to more conservative assumptions for the cure rates, which I think Bob referenced earlier.

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

Elizabeth A. Werner
Head of Investor Relations and Vice President
Thank you, David. And operator, can we open it up for questions now?

Question and Answer

Operator

[Operator Instructions] And we'll take our first question from Mike Nannizzi with Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Peter, maybe one question on your comments on the 3-point loss ratio improvement. Is that in just U.S. commercial, is that overall commercial or across the entire book? And can you help us understand what is driving that? Is it mix? Or in the future, do you expect it to be less mix and more kind of a rate-driven margin? And just one follow-up.

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

It's -- to be precise, if you drew a trend line through the total P&C accident year loss ratio over 8 quarters, it's an annualized decline of about 2.6% per annum. It's a bit more of a rapid improvement in the fourth quarter, but it's -- that's slightly out of line of trend because you had an elevated number in Q4 '11 versus a depressed level in Q4 '12. So as you normalize that out, you can sort of think about an improving trend of about 2.6% per annum. It's a result of a number of initiatives that we've signaled very clearly: business mix shift as we re-underwrite out of business lines where we had clear unattractive economics; and managing the account relationships in multiline relationships in an intelligent way to shift to a better mix of business by customer, by geography, but also through greater use of analytics and technical pricing models and segmentation at a more granular level; and then finally, through a number of initiatives to reduce claims leakage, where we are seeing significant benefits from applying analytics to fraud management and other management of legal expense and another -- other factors. So we continue to see progress. No let-up in that trend, and we're making a conscious trade-off between expense and loss ratio as we improve the quality and repeatability of our business.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

So when you look ahead, it sounds like -- so you're going to have -- you expect to see continued improvement on the loss ratio. The expense ratio is higher as you make these investments, but that shouldn't be in the receipt in '14. So the net should be the overall combined continuing to fall once you get to '14 and beyond. Is that kind of how I should read that comment?

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

Correct, correct. So we stand by our aspirational goals that we laid out 18 months ago, which have an ROE of the business north of 10% and expense ratio -- I mean, a combined ratio between 90% and 95%. And the interplay between that combined ratio target and the ROE target is a function of interest rate environment. And so we feel that we're on the path and continuing to implement the initiatives I mentioned.

Operator

For our next question, we go to Josh Stirling with Sanford Bernstein.

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

So I'd love to start with Peter. And I'd love to ask a higher-level thing, though, which is related -- sort of a follow-up on Mike's commentary. When you add up a couple of points, it sounds like 3 is a reasonable target, of loss ratio improvement next year, and you assume that continues for perhaps into '14, and then you assume that expenses start to improve as well when we get to 2014, is it right to say that, sort of implicitly, you guys think you'll be running at a low-90s accident year, x CAT, combined ratio by 2014?

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

I think that we haven't provided a specific guidance on x CAT, so I wouldn't want to go beyond what we've indicated as our goal, which is 90% to 95% combined, which includes a normalized CAT number in it. I would also reemphasize what I've said many times before that I prefer to view the combined ratio and ROEs as outcomes of what we're really trying to optimize, which is growth in risk-adjusted profitability, which is -- may give rise to a slightly higher or lower combined than the numbers I mentioned, or ROE, because we're looking at the quantity and quality of earnings to really get that balance right between profitability, growth and risk, but I -- we believe that doing so is completely consistent with the guidance we've given to date on those aspirational goals.

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

David, I wanted to switch over and just talk about capital for briefly. Thank you for the clarification on sort of the debt tender. And generally I think I understood you to say was that you guys looking to only do opportunistic things once you sort of cover the 2 debt deleveraging initiatives that you've targeted. The question I'd love to talk a little bit more about, not the rating agency, but rather is the Fed. Your Chairman had a bunch of interesting comments in your letter around how closely the board has been working with the Fed. I'd love to -- if you guys can sort of bring us up to date broadly on what -- all the things you did to get Fed-ready and where you are now in terms of conversations with the Fed and, ultimately, sort of when you will, or perhaps you've already have had, the sort of the conversations around establishing what the level of capital a firm like AIG needs in the world that it now exists in?

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

Yes, sure. I'll start off, Josh, and welcome others to join in. I would characterize the conversations with the Fed really as constructive, open and frequent. I think it's the clearest way I can describe that for you. So with that as a backdrop, the -- we're not going to comment on specifics, but we -- again, we continue to work with the Fed to prepare ourselves for what we believe will ultimately be designated as a SIFI. And we've taken great steps to prepare ourselves, through mock exams, through enhanced documentation of procedures and the like, and processes and risk limits and the like, working hand-in-hand with Sid Sankaran, our Chief Risk Officer, and then our treasury group in terms of providing reporting and controls around liquidity and stress tests and forecasts. And so as we prepare ourselves for eventual SIFI designation, we'll put ourselves as best we can to carry on with the capital management objectives that we've laid out. But again, I would go back to my first characterization: constructive, open and frequent. So with that, Bob, do you want to add anything to that?

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

No, I think David covered it well. It's -- they're here. There's a lot to be looked at. We have -- some days you wish you could have a simple company, but then we wouldn't be AIG. So they're working through it, and they're doing it very effectively. And we have a good partnership, and I'm sure that they will be able to get a better sense of us in the months to come, but it's a long road because there's a lot to learn.

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

That's helpful. If I could just, very briefly, David, the debt tender that you guys have just announced. Those are for hybrids that, at least in the old days, would have been thought of as a sort of capital for purposes of the Fed. Did you have to sort of satisfy to them that you guys would be sufficiently well capitalized after you reduced your capital for that -- for the tender that's on track to be completed?

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

Yes, we're -- well, again, we're in the tender. I think -- but we're not going to comment on any specific conversations we've had with our colleagues at the Fed. And again, I think we're targeting those securities that are most efficient and effective for us in terms of our capital structure, the cost of them and the like. So I think we -- as we've done in the past, we've targeted our capital management activities to those securities that are most beneficial to our many stakeholders. Brian, do you want to add anything to that?

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

No. I think that sums it up. And again, these are securities that are generally viewed as having sort of low capital content. And certainly, looking forward into what we anticipate will be the regime in which these securities will be evaluated, they'll have even less capital credit in the future.

Operator

We now move to Randy Binner with FBR.

Randolph Binner
FBR Capital Markets & Co., Research Division

I wanted to ask a question about the reserves. In particular with the 10-K data, there was kind of continued drag from excess and primary casualty. So a couple of questions there. One is, was that drag mostly legacy? It kind of looks like it, meaning '02 and prior. And how should we think about the '02 and prior years? Because they obviously had significant drag before the last 2 years, but now it seems like it's a deficiency of maybe $0.5 billion a year. Can we get some color on kind of where that stuff is coming from, from an adverse perspective, and if we can kind of plan on $0.5 billion of drag there from the '02 and prior, going forward?

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

I'm going to ask -- this is Peter Hancock. I'm going to ask Charles Shamieh, Chief Actuary, to comment on that. But I would not in any way annualize any number that you just did in terms of deficiency. We look at our reserves on a quarterly basis with a clean slate every time to make sure that we are adequate at any given time. So any kind of correlation of adjustments up or down from quarter to quarter is entirely coincidental. So why don't we turn over to Charlie?

Charles S. Shamieh
Legacy Chief Executive Officer

I'll just respond to your question about the excess casualty line. And in terms of legacy versus current business, the vast majority of that was actually related to a run-off portfolio in our public entity business, general liability. And that is -- the number in the 10-K represents the latest quarter and also prior quarters where we saw a deteriorating experience. That portfolio has been in run-off since 2008. On the primary casualty side, the main driver of that was more general liability and especially on property damage. And it was much more of a severity issue, as we disclosed in the 10-K, and coming from more recent years. And we don't see any of that as an indicator of future adverse development. We believe the reserves are very adequately set to our best estimate today.

Randolph Binner
FBR Capital Markets & Co., Research Division

And then -- one, that's helpful. I mean, it just -- there's an above-average amount of legacy reserve drag from AIG versus other insurers, so it's helpful to have that color. The other question I had is the -- D&O had a favorable result in '12. And so just kind of some color on what accident years that came from and how that's trending?

Charles S. Shamieh

Legacy Chief Executive Officer

Well, the main year in D&O which was favorable in financial services was the 2010 year. And as we're emerging from the -- what we had referred to earlier as the credit crisis years, we have a lot more data and actual reported claims and paids on those claims, and they are coming in more favorably than we had anticipated. And that was the major driver of the $307 million favorable result in 2012.

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

John Doyle, do you want to elaborate on that?

John Doyle

I think we're -- we've done a lot of commentary on the financial lines business overall. I've heard from other markets, and we have a terrific book, a well-diversified book around the world, that continues to perform well. And we saw growth in the portfolio. We saw improved rate in the portfolio during the course of the year as well. So it -- financial lines is a mix of products. So there are certain segments, in the U.S. market primarily, that do need some improvement, and we're focused on that. But we continue to be very pleased with our business there overall.

Randolph Binner
FBR Capital Markets & Co., Research Division

So in layman's terms, though, the kind of concerns a lot of people had about D&O exposure from the financial crisis seem -- it seems that those are fading, and at the same time, you're getting rate going forward. And so that's the dynamic right now in D&O, broadly speaking.

John Doyle

I think that's right. I think we probably have a better-balanced book than some as well. But yes, our -- we continue to get improved pricing and terms in the book. And -- although most of that's in the U.S. It's a bit more competitive from a price point of view outside of the U.S. But yes, we continue to be pleased with that business overall.

Operator

And now we move to Josh Shanker with Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

Just quickly following up on Randy's question. I noticed there were some deficiencies in '05 and '07, which is somewhat irregular given what we've seen elsewhere. Can you talk about those years in particular?

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

I think you'll have to elaborate on your question, Josh.

Joshua David Shanker
Deutsche Bank AG, Research Division

If I break out the development for 2012 by accident year, I get very favorable results in '08, '09, '10, '11, deficiencies prior to '02, and then I get a mixed bag in the hard market years. Some are -- were redundant, but some were deficient. But I don't see too many companies out there reporting any deficiencies from the hard market years.

Charles S. Shamieh
Legacy Chief Executive Officer

A lot of the movements that you're observing, which as a percentage of reserves are very trivial, less than 1%, are really attributable to some large losses that we have reported in the 10-K that go back to those accident years, especially on our occurrence-based casualty lines of business, where that is not an unusual occurrence. So it's very hard to extract a trend from the numbers that you're looking at, as that's not at all the way that we look at it. I draw your attention, for example, Josh, to the disclosure and Page 94 for the health care business, which gives an indication of just that occurrence.

Joshua David Shanker
Deutsche Bank AG, Research Division

Okay, I'll pay close attention there. And then about the debt repurchase, can you contrast what you've currently reported to your thoughts about debt-refinancing some of the hybrids as opposed to repurchasing them? And if you're going to repurchase, why not start with the callable bonds that are trading at par rather than the ones trading at premiums?

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

The -- I think, Josh, the simple way to think about or the cleanest way to think about that is we maintain financial flexibility to the largest extent possible. And the callables are -- the calls are available to us, and it gives us the flexibility that we desire. Brian, do you want to comment further?

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

No. I think you summed it up well. We believe, by doing the tender first and having the calls available, we'll be able to most effectively meet our liability management goals for the year.

Joshua David Shanker
Deutsche Bank AG, Research Division

And any follow-up issuing some debt to give yourself greater flexibility for repurchasing some of the hybrids?

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

We haven't made any of those decisions yet, and we'll do so if and when appropriate.

Operator

And for our next question, we move to Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Couple of questions. Maybe the first one for Peter. Can you talk about what you're seeing from a pricing standpoint in 2013 in January? You must have some data already.

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

Well, I think we see -- I'll always have John elaborate on this. But I think that, for the most part, we continue to see continued improvement in rate in U.S. commercial lines, and that's good news because it was needed there. So we're getting closer to rate adequacy, but we're still not at rate adequacy in the longer-tail casualty lines. So it's got a ways to go. Europe is softer, but we're starting from a much more rate-adequate environment there. And in a couple of specialty lines, we're actually seeing a softer market, in particular in aviation. But John, if you want to elaborate on that? Perhaps you want to add to that.

John Doyle

Jay, I think Peter hit the theme. Casualty pricing in the fourth quarter in the U.S. for us was up just about 10%. Property pricing was up 14%. We expect continued casualty pricing improvement in 2013, and so far, it's met expectations. So there is a lot of capacity out there, so I do think the larger players in the market are being disciplined. And the reality is that the entire industry needs to drive a better underwriting result, given the current interest rate environment. So pricing is moving in the right direction there. And we're not just relying on pricing. We're focused, obviously, on a lot of other levers that Peter mentioned in terms of mix: better terms, better engineering, better underwriting tools, et cetera, claims tools that will drive further improvement. But price continues to move in the right direction there. 1/1 is a big Continental Europe renewal date. A little bit better than the fourth quarter, but again, lagging in the U.S., as Peter indicated. So we're optimistic about the environment. There are other geographies where property pricing has been improving, which is important to us. And so we think -- we don't see much to get in the way, in the near term, of some decent pricing improvements in the early part of 2013.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

The second question. If I look at the proceeds from AIA and the eventual proceeds from ILFC, it doesn't sound like you'll be using them either for buybacks, and you certainly won't be using all of that for debt repayment. What should we assume, in the near term, happens to those proceeds? They'll -- I guess, they'll generate some investment income. And where will that show up in your numbers?

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

Jay, it's David. Again, we haven't -- we've not given a projection about future capital actions, capital management actions, that we will take. As we've said, we remain committed to the $25 billion to $30 billion over the period through 2015. And I think a safe assumption would be that we'll put the money to work at the parent company level for a period of time until we assess our financial flexibility and our capital position, our liquidity position, and then carry on with the capital management. Bill?

William N. Dooley
Executive Vice President of Investments

Yes, Jay, we're in the process, because cash now is building up at the parent level. And we've already sat down between the risk group and the investment group and the capital management group to look at exactly what free cash will emerge over this period of time and into the future for the parent. The parent, over the last few years, has not had excess cash to any great degree to invest in longer-term securities. So we're in the process right now of putting together investment plans. We've already started to invest some of the money in very conservative investments at the moment to get additional yield and additional investment income. And that will...

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And does that show up in the capital markets earnings? Is -- where would it show up in your actual presentation?

William N. Dooley
Executive Vice President of Investments

In the parent.

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

It will show up in the parent.

Operator

And we'll move now to Jimmy Bhullar with JPMorgan.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

I had a couple of questions. First, for Peter, you mentioned you expect the loss ratio to improve over time. And if I look at the loss ratio x CATs and development in the fourth quarter, the 63.6%, it was one of the best levels you've had in a long, long time. So do you expect an improvement off of these levels as well? Or was this partly because of just unusually low non-CAT claims? And then maybe for Bob, on capital management, you mentioned several actions, debt reduction, buybacks, dividends. Do you expect to do these simultaneously? Or should we expect that you'd reduce the debt and improve your coverage by, like, the 1 to 2 turns you mentioned before paying dividends or resuming buybacks?

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

I would take you back to an earlier question where I tried to give as much guidance as to how to think about the trend in action year loss ratio. Look at the 8 quarters, the last 8 quarters. Do a regression line through them and see that the fourth quarter of last year is below that trend line. That trend line is declining at a rate of about 2.6% -- points per year, 2.6 points per year. That's not a bad estimate for what we think will happen going forward. So yes, there's a little bit of a fair wind in the fourth quarter, but I think that continued improvement is embedded in our expectations and our strategy. So I think that's a fair assumption to make.

Robert Herman Benmosche
Former Chief Executive Officer, President and Director

On the capital management side, that -- what we've said is we need to -- some of it's geography and some of it is reducing interest expense and some of it is which would be our debt reduction and improving profits. So all of that gets you a better coverage ratio covered by the operating companies. And so that's our highest priority. It continues to be our highest priority. We are working very closely with the rating agencies to make sure they are comfortable. Keep in mind that we came out of this crisis much more rapidly than anybody -- I won't say anybody, but I'm not sure there aren't more than 2 or 3 of you on the phone that was with us 3 years ago realizing we'd get to where we are today. And so the speed that this has occurred in, they just want more time to see us continue to evolve with the good, solid earnings that you've seen so far. Having said that, as they continue to be comfortable, as we continue to perform through the year, we continue to make progress on our coverage ratio, what I've said was, I would love to be able to put a dividend on the stock. I think that makes sense because it increases the number of potential shareholders for this company. And as we continue to progress through the year to the extent we could do a share buyback, we'd like to be able to do that as well. But we're going at a pace so that, clearly, we're looking for, as you saw with 2 rating agencies already, [indiscernible] pieces of our company starting to turn positive and potential upgrades. So an upgrade to AIG, over the next couple of years, I think, would be the important statement that says we have accomplished a strong comeback as an investor-grade company, and that's the goal we have. And 2015 is our aspirational date, and we're still marching pretty quickly towards that date and the things we need to achieve for it.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

Okay, got you. And then on the ILFC proceeds, lastly, if you think about the sales price, you're getting 90% of that, assuming that you end up selling 90%. You're putting back $1.1 billion into ILFC. If you were to get out completely from ILFC, would you get that $1 billion back? Or that's sort of a permanent contribution back to ILFC?

David Lawrence Herzog
Former Chief Financial Officer and Executive Vice President

Yes, Jimmy, it's David. The -- think of it as just a settlement of an intercompany pooling of cash, so it's going to go back to them when we close.

Robert Herman Benmosche

Former Chief Executive Officer, President and Director

Liz?

Elizabeth A. Werner
Head of Investor Relations and Vice President

So operator, at this time, we'd like to end the call at 9:00, but we do have a number of follow-up questions. So to anyone who's still in the queue, we will certainly be back -- getting back to you as soon as we get back to our desks. And thank you, everyone, for dialing in this morning.

Operator
Ladies and gentlemen, that concludes today's conference. Once again, we thank you for your participation.