![S&P Capital IQ]

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American International Group, Inc. NYSE:AIG

FQ3 2016 Earnings Call Transcripts

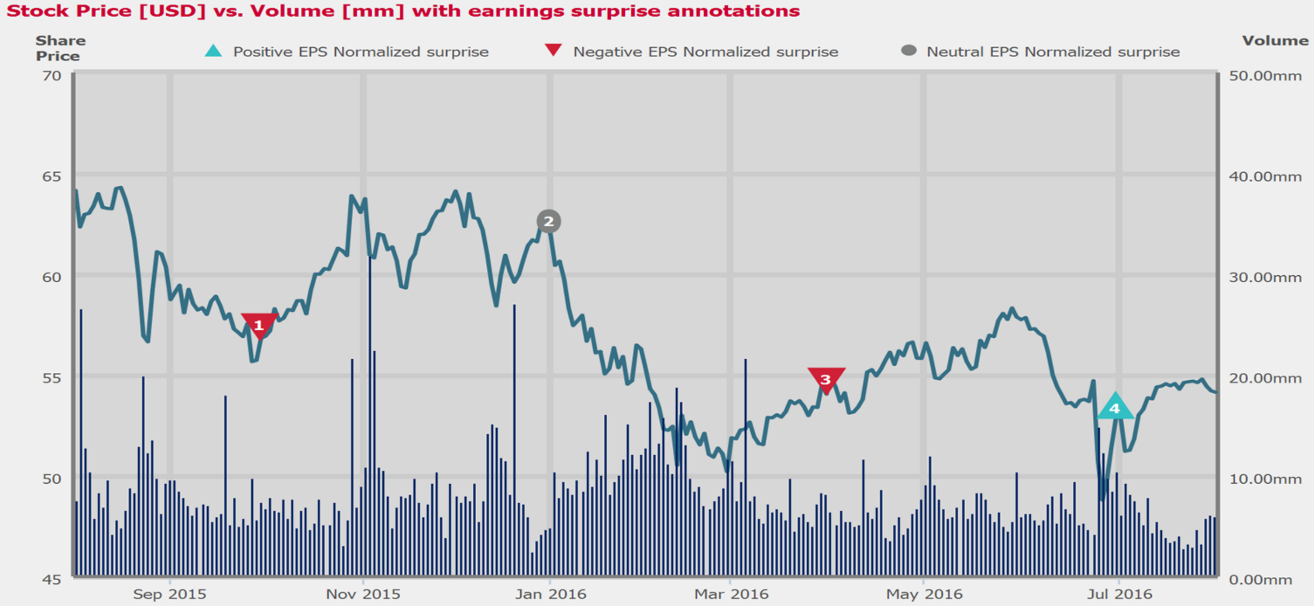
Thursday, November 03, 2016 12:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2016-			-FQ4 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.21	1.00	▼(17.36 %)	1.24	3.89	5.51
Revenue (mm)	13184.00	12854.00	▼(2.50 %)	12991.00	52841.50	52487.50

Currency: USD
Consensus as of Nov-03-2016 11:52 AM GMT

Stock Price [USD] vs. Volume [mm] with earnings surprise annotations



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2015	1.01	0.52	▼1 (48.51 %)
FQ4 2015	(0.93)	(1.10)	NM
FQ1 2016	1.00	0.65	▼2 (35.00 %)
FQ2 2016	0.94	0.98	▲3 4.26 %

Call Participants

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Presentation

Operator

Good day, and welcome to AIG's third quarter financial results conference call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Liz Werner. Please go ahead, ma'am.

Elizabeth A. Werner
Head of Investor Relations and Vice President

Thank you, operator, and good morning, everyone. Before we get started this morning, I'd like to remind you that today's presentation may contain forward-looking statements, which are based on management's current expectations that 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 first, second and third quarter Form 10-Q and our 2015 Form 10-K under Management's Discussion and Analysis of Financial Conditions and Results of Operations 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 the slides for today's presentation and our financial supplement, which are available on our website.

Nothing in today's presentation or any oral statements made in connection with this presentation is intended to constitute nor shall it be deemed to constitute any offer of any securities for sale or the solicitation of an offer to purchase any securities in any jurisdiction.

This morning, we will get to hear from our management team and -- which would include Peter Hancock, Sid Sankaran, Rob Schimek and Kevin Hogan, and we'll begin this morning's call with Peter.

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

Thank you, Liz, and good morning, everyone. I'm pleased with our progress this quarter and the continued execution of our strategic plan. We reported third quarter operating EPS of $1 a share, a solid result despite volatility from our review of our longevity assumptions and certain segments of our Commercial business.

I'm pleased that we maintained our strong position in our Life and Retirement segments and delivered another strong quarter in Personal Insurance. I remain highly focused on the continued improvement of our commercial underwriting and believe we're taking appropriate actions. Sid and Rob will speak to the specifics of our reserves and underwriting strategy in their remarks.

Since the second quarter, we announced or completed 5 strategic and complex transactions. These actions are increasing the sustainability of AIG's earnings and are reshaping the company. During our January strategy update, we discussed our focus on targeting geographies and segments with critical mass and expertise while improving our multinational capabilities. The Fairfax transaction is the most recent example of executing on this strategy. The transaction requires the extraordinary effort of our employees across 2 continents, 12 countries, and require the close and timely coordination with over 20 different regulators. The transaction is expected to consolidate our network partners and reinforce our commitment to servicing our multinational clients in over 200 countries and jurisdictions, without the need for bricks and mortar in every location.

As we committed to you in January, we are narrowing our focus on those countries where we have opportunities to improve our ROE. We're also highly focused on disruption in the market and our future growth opportunities. During the third quarter, we announced the launch of our technology driven solution to serve the USD 80 billion small to middle market. AIG, Hamilton Insurance and Two Sigma joined together to form Attune. Attune will partner with retail and wholesale intermediaries and offer small businesses a broader, a more flexible range of products through a technology-enabled platform. Through the combination of Hamilton's small business expertise, AIG's scale, extensive data and long-standing distribution network and Two Sigma's technology and data science capabilities, Attune can offer a powerful, disruptive solution to the small business market.

In addition to our actions to simplify AIG, our expense discipline continued this quarter. Through the 9 months, we are ahead of our 6% planned reduction with a 10% decline in operating GOE, excluding any foreign exchange affect and the impact of the sale of the AIG Advisor Group. We expect expense reductions to extend into 2017 and remain ahead of plan as a result of actions taken across the company.

The normalized return on equity was 7.1% for the quarter and 8.3% for the 9 months. Third quarter normalized return on equity reflects our seasonally high expected third quarter CAT losses. Our operating improvements and return of capital will continue to positively impact ROE, and we're on track to deliver full year normalized ROE in our targeted range of 8.4% to 8.9%. We will provide greater insights into our confidence in reaching our 2017 financial targets at our upcoming Investor Day.

We continue to shape the company to deliver more sustainable, higher-quality earnings and remain focused on meeting our 2-year strategic objectives. Our results and the strength of our relationships with customers and partners in the industry are positive indications of our progress and the foundation we're building for the long-term success of AIG.

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

Siddhartha Sankaran
Executive VP & CFO

Thank you, Peter, and good morning, everyone. This morning I'll speak to our quarterly financial results including noteworthy items, strategic transactions and capital management.

Turning to Slide 4, our core operating earnings improved from the same period last year, as the decline in the commercial accident year loss ratio is adjusted, expense discipline across AIG and improved alternative investment returns all meaningfully contributed to the improvement in performance. Looking ahead while we're only 1 month into the fourth quarter, our early estimate of losses from Hurricane Matthew is about $250 million, roughly 2/3 of which relates to Commercial and 1/3 relates to Consumer.

Operating results also reflected 2 adverse impacts of note. First, we took a loss recognition charge of $622 million related to longevity experience studies, which indicated increased longevity, particularly on disabled lives on a legacy block of structured settlements underwritten pre-2010. This legacy block accounted for over 80% of the $622 million charge. As we told you on our January 26 strategy update, these assets and liabilities will be reported in the Legacy Portfolio when we release our fourth quarter recaps and results.

Shifting to our Operating Portfolio actuarial updates, we recorded net charges totaling $24 million. We recorded a benefit of $238 million for our operating consumer life and retirement businesses due largely to Fixed Annuity surrender assumptions, partially offset by increasing reserves for universal life and secondary guarantees. Offsetting this, we recorded $262 million of total prior-year adverse reserve development net of premium adjustments, which largely related to our U.S. program business within Specialty. Rob will comment further on this review and the underwriting actions we've taken on our U.S. program book.

During the quarter, we announced the sale of UGC to Arch Capital Group and have included an overview of the transaction on Slide 6. AIG will retain the attractive economics associated with our 50% quota share reinsurance agreement on business written by UGC and are reporting earnings in Commercial Insurance. This quota share covers business written during the 2014 to 2016 accident years, and we expect average annual pretax earnings from the quota share will be approximately $150 million for 2017 and '18 and will decline thereafter. The remaining operating results of UGC, which is held for sale on the balance sheet, are being reported in corporate and other up to the closing date. We anticipate closing the transaction in the fourth quarter ideally or early in the first quarter.

We expect to receive $2.2 billion in cash proceeds at closing, an additional $250 million pre-closing dividend as well as approximately 9% of Arch's common shares. In addition as part of the transaction, UGC's tax attribute deferred tax assets remain with AIG. Note, this quarter we also began reporting Institutional Markets results in corporate and other as the vast majority of this business will be reported in Legacy beginning in the fourth quarter.

Slide 7 shows recent strategic transactions and their estimated impact on our 2017 results. While there's some modest earnings impact from these transactions, each transaction is accretive to our overall ROE. Rob and Kevin will speak to the strategic rationale for the Commercial and Consumer transactions.

Consistent with our capital plan, we completed a life reinsurance transaction late in the third quarter that resulted in the distribution of approximately $1 billion of excess statutory capital from our U.S. life companies to AIG parent. This is our first completed life reinsurance transaction towards our goal of freeing up $4 billion to $5 billion of capital by the end of 2017. We remain focused and confident on executing on the additional life reinsurance transactions. The earnings impact from this transaction will be reported in next quarter's new Legacy module as it's largely related to Legacy whole life and universal life business.

Turning to Slide 8, as Peter stated, we're ahead of plan on expenses and continue to expect to exceed the 6% targeted GOE decline for the full year. Our expense reduction targets are carefully aligned against our projections of new business volumes to meet our objective of improving operating leverage. We took additional pretax restructuring charges of $210 million during the quarter relating to our ongoing efficiency program, which we expect will generate an additional $400 million of run rate expense savings. We expect to exceed our 2-year expense reduction target.

Slide 9 details the 120 basis point expansion in normalized ROE for the quarter. This improvement reflected the active return of capital to shareholders as well as continued improvement in normalized operating results and reflects our seasonally high CAT loss expectation in the quarter, which is greater than reported 3Q CAT losses. Our year-to-date normalized ROE is 8.3% and we continue to expect to achieve our full year normalized ROE target of at least 8.4%.

Slide 10 shows the drivers of book value per share x AOCI and DTA and including dividend growth, which grew 1% during the quarter and 5% year-to-date, reflecting operating earnings and accretive share repurchases.

Turning to capital on Slide 11. We continue to execute against our capital return target and we are confident we are on track to meet our target. We returned $9.8 million of capital to shareholders in the first 9 months of the year. During the quarter, we deployed about $2.3 billion towards the repurchase of almost 40 million common shares. Since quarter end and through November 2, we repurchased an additional $946 million of common shares, leaving about $1.4 billion unused under the current authorization plus an additional $3 billion from the new authorization that we just announced.

Our balance sheet and free cash flow remains very strong, and as you can see on the Slide 12, parent liquidity at quarter end was $8.6 billion, above our targeted range of $6 billion to $8 billion and reflects the timing of insurance company dividends received late in the quarter.

In addition to the life reinsurance transactions, we also monetized $900 million of Legacy assets during the quarter for $5.2 billion over the last 4 quarters. These proceeds are partially funded capital return to shareholders. And when considering announced but not closed transactions, we expect to well exceed the $5 billion to $7 billion funding target from divestitures that we have lined in our January 26 strategic update.

We also announced that we reduced our hedge fund allocation by about half which we expect would free up $2 billion of capital towards our capital return target by the end of 2017. We have reduced our hedge fund portfolio by $2.7 billion for the first 9 months of the year, which has freed up approximately $800 million of capital in our life companies, which has come up to the holding company in the form of dividend payments.

As Peter stated, we're focused on the continued execution of our strategic plan and providing you with additional disclosure as we progress at our upcoming Investor Day.

Now with that, I'd like to turn the call over to Rob.

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

Thank you, Sid, and good morning, everyone. During the third quarter, we remain focused on our strategy to improve underwriting results and create a stronger, more valuable Commercial Insurance business. Our strategy recognizes the importance of managing both the adjusted accident year loss ratio and expense ratio and this quarter, we saw improvement in both. We will have quarterly variability in each component of the adjusted accident year combined ratio but we expect the net result will continue to improve.

Turning to Slide 14. The adjusted accident year loss ratio declined 1.9 points during the third quarter, reflecting continued improvement in U.S. Casualty. The UGC quota share agreement contributed to the improvement over prior year by 0.4 points in the third quarter or 0.3 points year-to-date.

Moving to expenses, the 1.9. Expense ratio improvement exceeded the prior year quarter despite lower net premiums earned. We expect expenses to continue to decline, but similar to the loss ratio, the expense ratio will fluctuate around a downward trend lining. Globally, rates were down less than 1 point, with a marginal increase in the U.S. and more aggressive competition internationally. In the U.S., Casualty rates increased 3.5 points, representing the fourth consecutive quarter with rate increases in excess of 3 points and Specialty rates increased 2.5 points. Partially offsetting those increases was continued pressure in Property of approximately 4 points, driven primarily by excess and surplus lines. In certain segments, we're seeing fewer high-quality new business opportunities and therefore have maintained our discipline as we deploy our capital where we will meet or exceed our targeted rate of return. We're pleased that we continue to grow in our focused growth segments year-to-date despite competitive market conditions.

In prioritizing our valued multiline client relationships, retention from major clients has remained consistent with prior levels at 94%. As an example, multinational global policies grew 8%, reflecting our multiyear investment to provide world-class solutions for clients across the globe. As Peter mentioned, an important part of the Fairfax transaction is Fairfax will act as our strategic network partner to serve multinational clients in all 12 countries included in the deal. This follows a similar transaction completed with Grupo ASSA in Central America last year, and signifies an enhanced strategy to better serve our multinational clients in over 200 countries and jurisdictions through what we consider to be the best combination of owned operations and strong strategic partners in the industry.

Turning to third quarter calendar year results. CAT losses were better than our average annual loss expectation but higher than prior year. And as Sid mentioned, the U.S. programs business resulted in a Commercial net reserves strengthening of $306 million. Our U.S. programs business consists of $1.1 billion of annual net premiums written spanning across 108 program segments and 41 program administrators. This business is written via managing general agents for predominantly small and medium-sized enterprises, and third-party administrators handle over half of the claims activity. Prior year development was driven by higher-than-expected loss emergence in the most recent calendar year from a subset of these programs.

We've now completed a detailed segmentation of the entire programs book as part of a broader, more holistic assessment of the business we transact with managing general agents. Through the review, we identified the programs we're seeking to grow, improve, remediate or terminate based on our profitability criteria, and we terminated 16 program segments with net premiums written totaling approximately $200 million as a result.

We estimate approximately 80% of the programs business reserve charge relates to programs where we've initiated termination or we're in the process of remediating. The purpose of evaluating our managing general agent relationships has been to determine where we wish to focus our resources, reposition relationships and better align incentives. The sale of our interest in Ascot and NSM, which we announced earlier this quarter, are examples of ROE-accretive repositioning where we will opportunistically partner with these franchises that bring highly specialized expertise and diversification benefits to create a greater long-term value for AIG.

Now turning to Slide 15. The year-to-date adjusted accident year loss ratio of 64.1 improved 2.1 points from the full year 2015, excluding the UGC quota share benefit. The remainder of my comments will exclude the benefit to provide an apples-to-apples comparison of our performance to the strategic targets we set in January. While the chart at the top right side of the page demonstrates the quarter-to-quarter variability of losses, I'm pleased with the overall improvement in the adjusted accident year loss ratio trend line. Our ability to manage expenses, combined with the loss ratio improvement, resulted in an adjusted accident year combined ratio improvement of 3.1 points.

This quarter, we experienced more pronounced volatility in our short-tail lines, which adversely impacted Commercial's adjusted accident year loss ratio by approximately 2 points. 1 point was attributable to increase in the current accident year loss picks following our review of the U.S. programs business, and the other point was related to higher property attritional losses. Although third quarter severe losses were significantly lower than prior year, Property's attritional loss ratio was the second highest result over the past 12 quarters due to the claims frequency that was greater than the norm. During the past several years, we've made several significant changes to structurally improve the quality of our Property portfolio, including our shift from excess and surplus lines to highly engineered risks and the expansion of our use reinsurance. However, as we've said in the past, we do not expect our path to be linear.

We believe accepting a reasonable degree of variability in quarterly results is the right business decision, and we have the ability to course-correct as business and market conditions change. Given our actions in the first 9 months of the year, we're continuing to target a run rate adjusted accident year loss ratio reduction of 4 points, recognizing as we saw this quarter with respect to short tail property losses, our results are subject of volatility. We remain committed to our target of a 6-point run rate reduction in the adjusted accident year loss ratio by the end of 2017.

As shown on Slide 16, we continue to make significant progress in optimizing our portfolio to reduce the adjusted accident year loss ratio. Overall, we're pleased with the pace of improvement in our mix of business written through the first 9 months of the year which will earn-in over future periods.

In closing, although we faced some headwinds this quarter, I'm proud of the progress our team has made, improving our portfolio, managing expenses and proactively seeking out value-enhancing opportunities. Reflecting our work -- reflected on our work over the past 10 months, I am confident in this team's ability to execute our strategy.

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

Kevin T. Hogan
Executive Vice President and Chief Executive Officer of Global Consumer Insurance

Thank you, Rob, and good morning, everyone. Despite a challenging economic and regulatory environment, I'm pleased to report that each of our Consumer Insurance businesses performed well during the quarter, reflecting the benefits of our diversified portfolio of Retirement, Life and Personal Insurance businesses. Importantly, each of our businesses is executing on our strategic priorities and are focused on value creation as I will discuss.

First, let me make a few introductory comments. In Retirement, I am proud to say that our strong diversification has made AIG the largest provider of annuities in the U.S. in the first half of the year. While we hold a top 5 sales ranking in each of variable index and Fixed Annuities, and we are the only company to hold a top 5 sales ranking in more than any one of these lines, our focus is on value over volume, and we continue to maintain vigorous pricing discipline facilitated by our lack of dependence on any one product.

In Personal Insurance, we continue to execute on our focused strategy. We are on track to meet our target state of 15 individual and 35 group countries by the end of 2017. And the most recent announcement with

Fairfax Financial is a further key step to achieving our goal. The benefits from these actions are beginning to emerge and will continue to evolve over the coming years. Most importantly, we are preserving our ability to serve are multinational customers and covered individuals through our strategic network partners.

In U.S. Personal Insurance, our Private Client Group is implementing a market competitive end-to-end platform to build on the double-digit growth that we've been generating, which will further improve the customer and distributor experience and create operational efficiencies through automation and self-servicing.

In Japan, we remain focused on transforming the business, delivering improved results, executing on our customer value proposition, all while we are preparing for the successful execution of the legal merger. During the quarter, J.D. Power Auto Consumer Satisfaction Survey awarded Fuji Fire and Marine with the #1 ranking in shopping satisfaction and AIU with the #1 ranking in relationship satisfaction in the market. We also now average over 20,000 independent Japanese agents using our new technology front-end platform on a daily basis.

Now I will briefly discuss the results for the quarter. Turning to retirement on Slide 18, in the quarter, we saw lower retirement sales from a year ago, reflecting an industry-wide slowdown in variable annuity sales from the uncertainty caused by the DOL fiduciary rule and market volatility. These challenges validate our strategy of offering a broad portfolio of product solutions to meet our clients' needs. We have been proactive in updating our variable annuity product features and taking pricing actions to maintain our returns in the continuing low interest rate environment. With respect to the DOL rule, we remain in active discussions with our distribution partners and are confident that we will be prepared to support them on their broad spectrum of chosen paths for implementation.

Fixed Annuity sales and net flows declined reflecting our ongoing Fixed Annuity pricing discipline in the current investment rate and credit spread environment. Maintaining our Fixed Annuity pricing and asset quality focus remains a priority as we seek value over volume.

Group Retirement benefited from strong deposits and lower surrenders, resulting in improved net flows. While these results reflect the investments we've made in the business, including our client-focused technology platform, competition in this space remains robust. We do expect to see more plan conversions in the fourth quarter, which is standard for the defined contribution market, including both large plan acquisitions and large case group surrenders.

As you can see on Slide 19, we continued to maintain our discipline in managing crediting rates and net spreads. Trends in the quarterly reported base yields and spreads are impacted by volatility associated with bond accretion and commercial loan prepayment income. Looking forward, absent significant changes in the overall rate environment, we continue to expect our net spreads will decline by approximately 2 to 4 basis points per quarter.

Turning to Slide 20. Growth in International Life sales drove an increase in premiums and deposits of 10% from the same period last year on a constant dollar basis. Growth in U.S. life sales reflects our focus on term Life, where we are again a top 5 term writer and also #1 in direct term sales in the first 6 months of the year. Change in our product mix demonstrates our commitment to the value of new business as we have increased our focus on products without long duration interest rate guarantees. Our positive sales trends at Life also reflect the evolution of our distribution strategy and further development of our independent distribution network. Operating comparisons for Life benefited from continuing favorable mortality experience, expense management and improved investment returns. We also continued to make progress in the transactions supporting our previously announced plans to reinsure our remaining redundant reserves.

As Sid mentioned, we completed our first Life reinsurance transaction during the quarter. This was an extremely large and complex transaction and I would like to thank Charlie Shamieh and the whole Legacy team for their discipline and focus throughout the transaction process. I am confident that supported by this team, we will continue to meet our targets for the remaining Life reinsurance transactions.

Turning to Slide 21, Personal Insurance reported another strong quarter of operating performance. The operating improvements reflected our strategic actions to reduce expenses, including direct marketing costs as well as early emergence of operating benefits from investments in Japan and other select markets. We did see a higher number of large but not severe losses in the quarter than a year ago. However, the accident year loss ratio as adjusted was only slightly above our expectation. Expenses continue to be a key lever to future margin expansion in Personal Insurance. But as I have said, progress will not be linear quarter-to-quarter due to the nature of our ongoing investments, including in Japan.

To close, I'm pleased with the progress we are making against our strategic priorities across all of our Consumer businesses, and we remain focused on continuing to execute on our plan.

Now I would like to turn it back to Liz to open up to Q&A.

Elizabeth A. Werner
Head of Investor Relations and Vice President
Thank you. [Operator Instructions] We would like to open our lines up at this time operator for Q&A.

Question and Answer

Operator

[Operator Instructions] And we'll take our first question from Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Just wanted to ask about the reserve charge in the program business. You talked about doing sort of a deeper dive into that business this quarter. And I guess the assumption that we had was that you had done a pretty deep dive into everything at year-end 2015. So my question is, are there still other businesses that you need to dive in a little deeper to?

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

Jay, it's Rob. From an underwriting perspective, as you know, so I'll comment on underwriting and let Sid comment about reserves. But from an underwriting perspective, the way we'll drive our 6-point improvement in the adjusted accident year loss ratio is by digging deeper into all elements of the commercial portfolio focused on the value over volume exercise. And so in the -- in 2016, this is one of the areas where we focused. And consistent with the actions you've already seen us take this year, the fact that we terminated 16 programs is very consistent with the actions we took with respect to our environmental pollution and legal liability business in the U.S. and Canada earlier this year and the buffer, trucking, where we believe that a business is not a business that will add value to AIG, we have proved that we're willing to just step away from it. I'll let Sid comment about the reserves.

Siddhartha Sankaran
Executive VP & CFO

Yes, Jay, I think as we said before, we review all of our reserve segments annually. So actually in 2015, programs was reviewed midway through the year and we did not observe any significant adverse client activity, which is important to note. Now during the first half of 2016, as Rob noted, and I think the team did an excellent job on a deep dive underwriting review, we noted calendar year loss emergence for the most recent accident years that indicated the need to strengthen the program reserve. So that's really the backdrop on programs.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Got it. The other question was on the direct marketing expense, which came down quite a bit. Did you see those reductions have any impact on revenue production?

Kevin T. Hogan
Executive Vice President and Chief Executive Officer of Global Consumer Insurance

Yes, Jay, our change in strategy in direct marketing primarily focused on Japan, where you may recall we made an announcement about a year ago that we were ceasing direct marketing in the American Home business and focusing that activity in our life insurance platform, Fuji Life, in Japan. So we have seen a reduction in the production in the supplemental health business in American Home and Japan, concomitant with that reduction in direct marketing expenses. And we are focusing on independent distribution channels in terms of new business in Japan.

Operator

And the next question is from Michael Nannizzi with Goldman Sachs.

Michael Steven Nannizzi

Goldman Sachs Group Inc., Research Division

So with those reserve points addressed, I guess one question I had is on the underlying combined underlying profitability in your 4 sort of subsegments. So 70% of your business, International Consumer and North America Commercial, did okay this quarter, where the other 30%, which is International Commercial and North America Consumer did really poorly, at least versus our estimates. And this isn't of the first those 2 areas have shown difficulties. So what is adequate profitability in those segments? What are you doing to get there? And how long is it going to take? And would you consider selling pieces or all of those businesses if parts of them that remain challenged aren't able to remediate?

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

Mike, I'll take that. I think that the way you're segmenting the business is not the way we run the business. And so we tried to make very clear in our January strategy update our forward-looking segmentation to help you sort of think about valuation an adequate profitability, as you put it, in 2 broad segments, Legacy and Operating. And within the Operating, that helps you estimate what our sustainable ROE will be and hence, what kind of multiple on earnings you think we might deserve. And in the Legacy, I think it's very clear that sizable chunk of equity is -- about 1/4 of the company's equity at the beginning of this year had a very suboptimal return, about 3% return on equity. And therefore, as you get to understand the legacy better, you figure out what kind of discount to the current book value you need to sort of anchor your valuation from. So I'm feeling really good right now about the returns on the aggregate of all of our operating businesses on a forward-looking basis. And I think the big question mark is how quickly and how big a discount to book value we can divest or reinsure the Legacy book. And I think getting into the subsegments, as you have, I don't think is a practical way -- when we're looking at divestitures, it's very focused on the Legacy and focused on the most efficient way to cleanse the earnings picture with those substandard returns so that we can focus our energy on a sustainable return on the operating business. So I think that's the way we look at it. And I don't know whether any detailed comments on the segments that either Rob or Kevin would like to make.

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

So Mike, it's Rob. I'll just make a couple of quick thoughts. First of all, as it relates to the adjusted accident year loss ratio in Commercial, I'll just restate, I'm absolutely confident that we're making the important changes that we've got to make to deliver on our commitment to improve the loss ratio by 6 points. And I probably would point to 4 quick observations. First, we've absolutely demonstrated the willingness to reduce our premium writings as we retain the business that we think is important for us to remain focused on our valued client segment. We've been doing this very consistently throughout the year. You can see that our premium volume in the first 9 months of the year is down 16%, including of course the effect of reinsurance. The second point that I'd make is that as we show on Page 16 of the presentation, the accident year loss ratio dispersion chart showed that we're driving improvements in the mix of business in a very material way. And to put this in context for you, the remediate and improve portions of our portfolio have declined by 1/3 on a dollar basis, from $7.5 billion of premiums in the first 9 months of 2015 to $5.1 billion of premium in the first 9 months of 2016, showing that we're -- where we're reducing premium is in the remediate and improve portions of the portfolio. Actually as they grow and maintain portions of the portfolio, product set 1 and product set 2a, our premium volume is approximately flat. It's down just about 2%. I'm going to turn to Kevin for anything, sort of.

Kevin T. Hogan
Executive Vice President and Chief Executive Officer of Global Consumer Insurance

Yes, absolutely. I think across the board in Personal Insurance, we've actually enjoyed quite strong margin expansion, including in North America. And in fact, our adjusted combined ratio has improved, from 95.9 last year, it's 92.4 this year. What you may be seeing, however, in the loss ratio is that in the third quarter, once we have quite a bit of consistency quarter-to-quarter, there is a little bit of volatility. We did have a number of losses that were large, over $2 million, but not quite at the severe level, in the third quarter. Whereas in the first 2 quarters, there were really an absence of those. So year-to-date, frankly, we are pretty much where we had expected to be in terms of the loss ratio. Consistent with what we've done in the rest of Personal Insurance in the North American portfolio, we have worked hard on remediating certain areas of the business, including particularly the warranty, which process is now complete. And we're seeing quite a strong growth in our Private Client Group business, which is one of our leading businesses. So we're quite comfortable with the direction we're going in PI, including the very strong North American franchise.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Okay. And then maybe, Sid, if I could follow up on your capital management comments. You said that -- and we're seeing the disposition dollars are adding up but you've said, or at least the presentation imply that further confidence in the $25 billion. Sort of adding out all the pieces, that would seem to get above that number. Can you just sort of help us reconcile those 2 points?

Siddhartha Sankaran
Executive VP & CFO

Well, I think if you go back to the funding page that we shared with you back in January, we see ourselves as on track on each of those buckets in the funding page. Clearly from a divestiture standpoint, you can see what we've done, both on Legacy sales where I think the team -- Charlie and the team have done a great job. And then we have a slew of transactions that are in the process of closing. Once we get to our process of closing transactions, we do our capital plan and proceed at that point. But right now, I think the best way we could put it is we remain confident in our targets.

Operator

And we'll take the next question from Kai Pan with Morgan Stanley.

Kai Pan
Morgan Stanley, Research Division

The first question on the Commercial loss ratio reduction. If you -- on the Page 16, you see the mix shifting towards the grow and to maintain buckets. But if you look at underlying loss ratio for these 2 buckets you are trying to maintain and grow is actually increasing year-over-year. I just wonder what's the dynamics there. I just wonder, would that -- basically, you increased that, but the loss ratio increasing will offset the improvements. You offset some the improvements you're making in the other 2 buckets?

Kevin T. Hogan
Executive Vice President and Chief Executive Officer of Global Consumer Insurance

So Kai, a couple of things. First of all, I think the main message on Page 16 is that we're driving our improvement by improving the mix of business. So if you look at product set 1 and 2, while I would love to retain my loss ratio as low as possible, overall, the loss ratio has increased by 3 points, overall for product set 1 and 2, from 54% in 2015 to 57% for the first 9 months of 2016. So you've got to actual market conditions, which will be whatever the rate changes are in the market. So it's a pretty -- as you might imagine, it would be pretty competitive in that space. And second, whenever we do an update to our reserves, we don't wait to make changes to our loss picks. And so to the extent that we have updated our reserve reviews, we've already reflected an increase in our loss picks for product set 1 and 2 where those reserve reviews have been completed. I would note that in product set 2b and 3, where the loss ratio has come down from 79% down to 73% over the first 9 months of the year, the main observation I'd drive for you there is that's not because anybody gave me lower loss picks. That's being driven by the fact that we've really fundamentally changed the mix of business and been able to cut out some very poor performing parts of the portfolio.

Kai Pan
Morgan Stanley, Research Division

That's great. My follow-up question is on the divestiture of UGC. It looks like given the current run rate of earnings for that book, you're probably going to lose more than $500 million pretax earnings next year. And how do you plan to offset that including maybe increasing buybacks to offset the EPS impact?

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

Well, I think we've disclosed to you that one of the important elements of the transaction is in retaining the quota share, which we view as very valuable and has about $150 million of net income to us. So we view that as critical to looking at how we're managing the overall portfolio.

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

I would just frame this as we've got the Legacy Portfolio with very low ROE businesses, which we are focused on divesting going forward. This was a business with a very high ROE that we felt would be more valuable in somebody else's hands than ours and improved our risk profile. So we're very much focused on value. The aggregate of the sales price and the reinsurance and the DTA makes this a very attractive net price to us based on any future outlook for that industry. And so the offsetting aspects of earnings dilution through buybacks and redeployment of that capital into other lines of business is also, in our view, going to improve the quality of earnings to a less cyclical mix. There are many other ways we can obtain exposure to the U.S. housing market on the left-hand side of our balance sheet, which can more than make up for any kind of risk-adjusted earnings that we give up by the sale of UGC.

Operator

The next question is from Josh Shanker with Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

I guess this is for David. In the past, kind of mature, you said that you saw 1.9% loss ratio improvement...

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

I'm sorry, Joshua, who are you directing the question to?

Joshua David Shanker
Deutsche Bank AG, Research Division

Sorry, to Rob. I'm sorry, to Rob. You saw 1.9% loss ratio improvement in the Commercial segment based on better underwriting. Although it seems a while that was Q2 lower severe losses. Although at the same time there were a lot of severe losses in 3Q. So my question's, a, if you think about all the losses that occurred in 3Q last year, would you have had exposure? And b, do you feel that the -- that there's more of a run rate -- that the severe loss exposure of AIG has gone down in this reunderwriting process?

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

Josh, thanks for your question. So let me maybe break this into 2 components for you. As I think about our longer tail lines, Casualty and Financial lines, absolutely, the 2016 third quarter was better performing than the 2015 third quarter, and even if you remove the fact that we had some increases in the loss picks for Healthcare, for example, in the third quarter of last year. So we are simply improving the underwriting performance of the longer tail lines of business. With respect to the shorter tail lines of business, as you commented, there was a better result in severe losses. I also want to point you to the fact that we did announce earlier this year that we purchased a reinsurance program designed to limit some of that volatility in severe losses. And had you applied that treating, that reinsurance program to 2015, you would have a lower level of severe losses even in 2015 using the reinsurance program that we've put in place this year. So I think that, for sure, there are improvements in the underwriting in the long-tail lines. And while there are some volatility in the short-tail lines, we have in fact made improvements in underwriting and have purchased reinsurance in a different way.

Joshua David Shanker
Deutsche Bank AG, Research Division

So you've never told us what the budgeted number of severe loss you anticipate in the new budget would be. But we should assume that going forward, AIG's exposure to those severe man-made losses is lower than it was in '15 or '14?

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

The way it works, Josh, is that the reinsurance that we purchased has an attachment point. So if there were severe losses -- a high frequency of severe losses below the attachment of our reinsurance, then yes, we could have an elevated level of severe losses. But generally speaking, our expectation is that our purchase of reinsurance will in fact reduce the level of severe losses moving forward.

Operator

At the next question is from Brian Meredith with UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

First question. I'm just curious, Rob, in the adjusted loss ratio for Commercial lines this quarter, how much of -- how much was current year development in that loss ratio? You said that you adjusted loss picks in the program business?

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

Yes, I gave that number in my prepared remarks. That was 1 point...

Brian Robert Meredith
UBS Investment Bank, Research Division

Sorry, it was 1 point in the loss ratios.

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

That's correct.

Brian Robert Meredith
UBS Investment Bank, Research Division

And then second question. Peter, I'm just curious, if I look at your financial targets for 2016, as you commented, all of them pretty much getting closer there, except for that book value growth. Maybe you can talk a little bit about why you're not achieving it? Is there anything that you've kind of learned this year that may make it challenging to meet that type of a target in '17 as well?

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

Well, I mean I think that this year, we had some somewhat unusual accounting asymmetries which have given us a bit of a headwind in addition to some of the other dynamics. But in particular, one that was sizable was the asymmetry of the treatment of the significant change in the Sterling exchange rate, which impacted the adjusted book value that we're targeting but had an equal, an offsetting gain in AOCI. So on a net basis, that's a -- it was $1.2 billion, I think, is that right? It is.

Kevin T. Hogan
Executive Vice President and Chief Executive Officer of Global Consumer Insurance

Yes. So Brian, actually we've included an exhibit on Page 25 of the conference call presentation, which really shows that on the book value per share side, we view our kind of growth year-to-date as a -- in the ballpark of 8%, excluding the impact of kind of market volatility. We talked about loss recognition today on legacy structured settlements. The change in reserve discount, which also impacts, as Peter -- as well as some of the nonoperating items that Peter mentioned like the Brexit FX issues.

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

So we think we're on a solid trajectory on book value per share growth at this point in time.

Operator

The next question is from Ryan Tunis with Crédit Suisse.

Ryan James Tunis
Crédit Suisse AG, Research Division

I just had a follow-up. On the 6 points of targeted accident year loss ratio improvement out to the end of '17, is that exclusive of the help that the loss ratio is currently getting from the UGC quota share?

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

Yes.

Ryan James Tunis
Crédit Suisse AG, Research Division

Okay, understood. And then my follow-up was actually on the reserve release in annuities. And I guess intuitively, I would have thought that lower surrenders in an annuities business would be a bad thing just given where interest rates are. Can you just help us understand why that results in a favorable item?

Siddhartha Sankaran
Executive VP & CFO

Yes, Ryan, it's Sid. I assume you're asking about the DAC unlocking on Fixed Annuities. Think about it as lower lapses mean people persist longer, which means there's more absolute dollars of income over time which then creates the DAC unlocking.

Ryan James Tunis
Crédit Suisse AG, Research Division

Okay. And then I guess my last one just quickly was I noticed you moved some new lines into runoff. So I -- I mean, I guess I asked the question on the quota share. What's the impact of some of the lines that you moved in the runoff on the loss ratio this quarter? In other words, how would it have looked if you didn't move some of those lines into the runoff segment?

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

Yes. So Ryan, it's Rob. We do not move -- we did not move business into runoff out of Commercial. And to be clear, for example, when we exited business-light programs, that business that we've exited will continue to run off through my results and not help me until it has been fully earned in the Commercial loss ratio. So that creates a headwind for me. With that headwind, we still reaffirmed the fact that because we've been able to terminate that business, that by the end of 2017, we do expect we'll deliver all 6 points of the loss ratio. Let me ask Sid to comment further.

Siddhartha Sankaran

Executive VP & CFO

Yes, Ryan, it's Sid. I think the last time we had a move of items into runoff was in Q1, so you can look back to Q1. The only item of note, I believe, in this quarter is if you look at our financial supplement, we split out the UGC quota share that Rob has talked about to be fully transparent.

Operator

The next question is from Elyse Greenspan with Wells Fargo.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

I just wanted to talk a little bit more about the Commercial line's underlying margin. You did point out about 2 points from Property losses and also from the program adverse development of the current year. As we -- and so that drove -- as we think about the Casualty and the Specialty books, I guess, within Commercial, how did those books do sequentially on an underlying loss ratio basis when we compare it to the Q2?

Kevin T. Hogan
Executive Vice President and Chief Executive Officer of Global Consumer Insurance

Yes. So Specialty excluding programs had a higher loss ratio in the third quarter of 2016 relative to Q2, and also relative to the third quarter of the prior year. The areas of Specialty that would have been higher loss ratios were -- the single biggest one for the quarter was actually aerospace, and that's a short-tail line. But I'll point to aerospace and then as it relates to -- relative to prior year, of course, its environmental as we've exited some business that will continue to runoff. As it relates to Casualty, we've had much better results. The Casualty result is more than 3 points better in the third quarter of 2016 than it was in the third quarter of 2015. And in part, because we've got the reinsurance in place that will continue to earn in with increasing momentum across the course of the year. The benefit of that is better in Q3 than it was in Q2, and it will be better in Q4 than it was in Q3.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

Okay, great. And then in terms of the capital return plan, we did see a little bit of a sequential slowdown in the Q3 but the -- it seems like the liquidity at the holding company did go up in the quarter. So as you think about Q4, I guess we should see a view towards an uptick there, given when some of the divestitures and cash came in to the company. And then also if you can comment on the expected cash dividend from the operating companies in the Q4, if possible?

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

So Elyse, I'll start with the first point, which is yes, you're right, we did slow buybacks in the third quarter because we had 2 factors in the back of our minds. One, it's CAT season and so we wanted to make sure that we were very well-prepared for any uncertainty on catastrophes. And secondly, there were a number of transactions, as I talked about, over 5 sizable transactions that's signed in the quarter, and we wanted to make sure that we got them over the finish line before we redialed it up. In the fourth quarter, I think it's good assumption to assume that there'll be a higher piece of buybacks, somewhat constrained by daily trading volumes. And as we look forward, while liquidity is one dimension that calibrates the pace of buybacks, it's only one. We also look at capital, we look at fixed charge coverage ratio. And we are very committed to maintaining an extremely strong balance sheet because that is a core part of our promise to our clients. So I don't know, Sid, if you want to comment further on that?

Siddhartha Sankaran
Executive VP & CFO

Yes, on the final question, Elyse, on dividends and tax-sharing payments, we never comment on specific quarters, but if you go back to my earlier comments, we look very much on track over our windows here in terms of the free cash flow generated from our subsidiaries. We have, I think, one of the strongest track records here in terms of free cash flow generation across our operating subs.

Operator

The next question is from Larry Greenberg with Janney.

Lawrence David Greenberg
Janney Montgomery Scott LLC, Research Division

I just have a general question on service levels and how you maintain those service levels in the Property Casualty business while taking out so much cost. Competitors, and I think this is self-serving on their part, have talked about this and say they're capitalizing on some of your challenges. So given how important it is for the long-term sustainability of the franchise, I'm just wondering if you could talk about that topic.

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

I'll start by my observations when I meet with clients, especially large groups of clients, in our client advisory councils, where they give us very candid feedback, many of them have been clients of ours for 20, 30 years. In some cases, they have seen a change in the person who is their account representative. And I'd say that in the first 2 quarters of this year, they were pretty grumpy and they would complain about the changes. In the third quarter, a number of notable clients came to me and said that the changes we've made have been a net improvement in the service quality. We have a hungrier, more focused set of leaders that are more empowered to respond to clients' needs, and they are equipped with better technology than they have before to be responsive. And so I'm very pleased with the -- as the overall -- obviously in a company that services 1 million claims a month, there will always be some that go awry, and they obviously get more attention than others. But in overall terms, I'm actually very pleased on this particular point, and that's a core part of our strategy going forward, where we can focus our energy on service levels on the clients that need us most and so that we can be -- we can be all things to all people in all countries, and that's a core part of our strategy.

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

And I'll just add one quick thing, Larry, it's Rob. I would just say that we are absolutely relentlessly focused on providing the best service possible to our clients. I would look at multinational as a great example of where we're doing things differently but I think we're doing things dramatically better. So the feedback that we get from our multinational clients, and the key performance indicators that we monitor regarding our speed, the accuracy, the capability that we're bringing to that space are better than they've ever been before. And I credit Carol Barton and her multinational team for some excellent leadership for us in this space.

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

I think multinational is one of the most complex to service businesses there is. And I believe year-on-year, the numbers, we're up about 8%, 8.5%. So I think that we're pretty pleased with the way our service level is translating into growth of client business.

Siddhartha Sankaran
Executive VP & CFO

And I'd just add one more thing. I mean, as we are narrowing our focus, particularly in the consumer business, we really are focused on value over volume, and we are currently participating in fewer products, fewer distribution channels and fewer geographies, which are allowing us to ensure that the places that we are focusing on, we're well-positioned to win. And so we're doing business in approximately 19 fewer territories than a few years ago, and it's allowing us to focus our energies on those places that are our highest priorities.

Operator

And the final question is from Adam Klauber with William Blair.

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

A bit of a follow-on on some of the other but directionally, you've done a lot of heavy lifting in North America P&C. So when we think about premium growth next year directionally, is it going to be more flattish, up or down?

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

Adam, it's Rob. I guess what I'd say is you have to put in the transactions that Sid talked about earlier in his comments. So there's a couple of transactions that will impact the Commercial business. They include the Ascot transaction, the NSM transaction and the Fairfax transaction that we described. And those transactions will reduce our net written premiums in the vicinity of $700 million in 2017. And then I'd say the other thing that would be sort of an environmental factor for us with premium growth is that when we announced our plan last year in the first quarter, on January 26, we were not able to impact the very important January 1 renewals, in Europe in particular, and many of the renewals that we would have had in the first quarter here in the U.S., in North America, where we really do our heavy negotiation of that well in advance of the renewal date. So I'd say after we get past the first quarter, I expect our premiums, absent the 3 transactions that I described, to be relatively flat, maybe modest growth. But in the first quarter, especially thinking about the January 1 renewals and the fact that we're continuing to make sure we're using our risk selection tools to the best of our ability, we will have some reduction in premium in the first quarter. I think it's fairly -- in total, it's probably accurate to say something like, including the 3 transactions, about a $1 billion reduction in premium in 2017 is probably about a fair benchmark for you.

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

Adam, and consistent with our commitment to value versus volume, we have been proactive in getting our expenses down and returning excess capital to shareholders so that we are less concerned about that top line number than perhaps others, because we really want to improve the quality and sustainability of our earnings rather than just the volume. And I think that the team has done an excellent job of getting ahead of the curve on expenses so that we won't see a retreat on the expense ratio as the top line is impacted by some of these tough decisions to exit either lines of business, locations or customer segments where we don't feel we're getting adequate returns on capital.

Elizabeth A. Werner
Head of Investor Relations and Vice President

So I'd like to thank everyone for joining us this morning on our earnings call. I would like to answer all your questions. So if we didn't get you this morning, please don't hesitate to reach out to us directly and we will be sure to follow up. Operator?

Operator
And this concludes today's call. Thank you for your participation. You may now disconnect.