S&P Capital IQ

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American International Group, Inc. NYSE:AIG

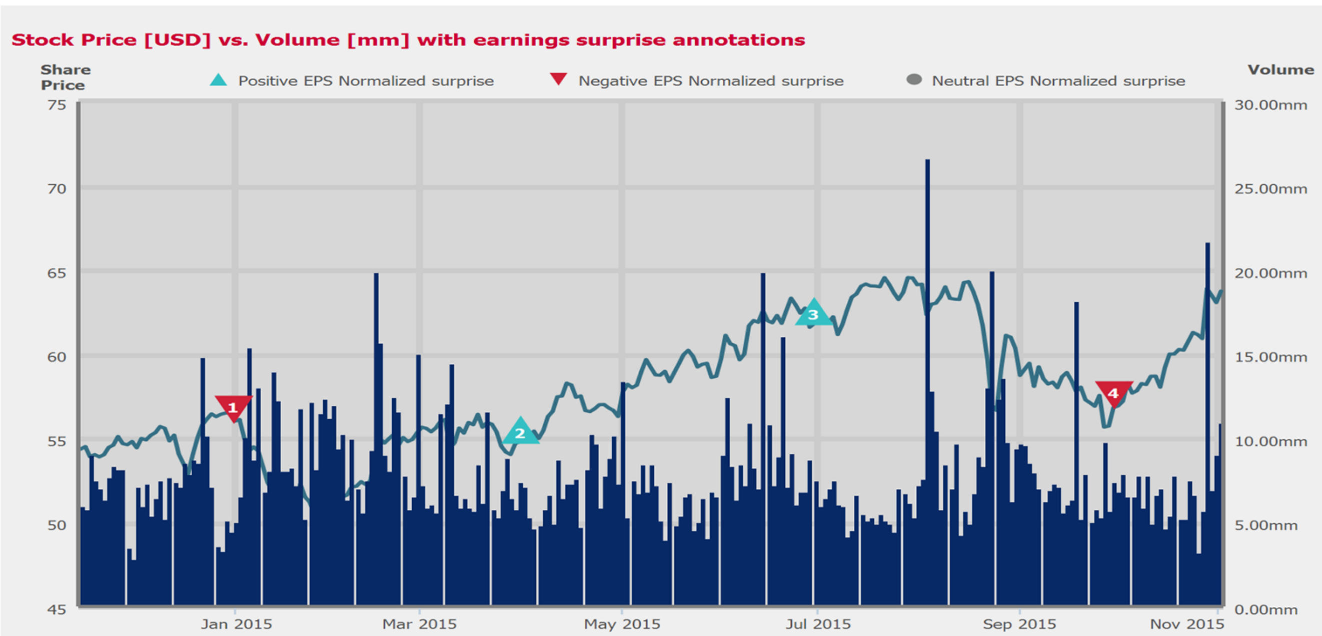
FQ4 2015 Earnings Call Transcripts

Friday, February 12, 2016 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ4 2015-			-FQ1 2016-	-FY 2015-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	(0.93)	(1.10)	NM	1.12	2.33	2.19
Revenue (mm)	14151.50	13831.00	▼(2.26 %)	14424.00	58487.00	58327.00

Currency: USD
Consensus as of Feb-12-2016 12:57 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2014	1.05	0.97	▼1 (7.62 %)
FQ1 2015	1.19	1.22	▲2 2.52 %
FQ2 2015	1.22	1.39	▲3 13.93 %
FQ3 2015	1.01	0.52	▼4 (48.51 %)

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Presentation

Operator

Good day, everyone, and welcome to AIG's Fourth Quarter Financial Results Conference Call. Today's call is being recorded. At this time, I would like to turn the conference over to Liz Werner, please go ahead.

Elizabeth A. Werner
Head of Investor Relations and Vice President

Thank you, Anthony. Before we begin, I'd like to address the format of today's call. [Operator Instructions]

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 first, second and third quarter Form 10-Q and our 2014 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 comments and 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 our website.

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

This morning's prepared remarks will begin with our CEO, Peter Hancock; followed by our incoming CFO, Sid Sankaran; the Head of our Commercial Business, Rob Schimek; and the Head of Consumer, Kevin Hogan. Our Chief Investment Officer, Doug Dachille is also joining us this morning in the room.

So at this time, I would like to turn the call over to Peter Hancock.

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

Thank you, Liz. Good morning, everybody. Thanks for joining our fourth quarter call. In today's call, I'll highlight unusual items in the quarter and importantly, I'll provide an update on our progress in executing on our strategic plan, which we presented on January 26.

We and the board feel that our plan maximizes franchise value for all stakeholders and is based on achievable goals. This quarter is a further step in providing additional transparency to assess our progress towards our goals.

Before I comment on the quarter, I want to mention yesterday's news that our Board of Directors agreed to expand the size of AIG's board from 14 to 16 seats. We believe this resolution is in the best interest of all our stakeholders and most importantly, allows us to focus on executing our strategic plan.

Our fourth quarter results were impacted by our actions to strengthen reserves and the lower returns on alternative investments. As we have previously disclosed, we completed a number of in-depth reserve reviews of our long-tail lines and we responded quickly to new information.

As part of our strategic plan, we announced our intentions to reduce and narrow our hedge fund allocation, which we believe will lead to greater risk-adjusted returns and contribute to our $25 billion return of capital through 2017.

During the fourth quarter, we took a number of actions towards our goal of being a more streamlined, focused insurer. Importantly, I announced a smaller executive leadership team, a management structure that has already resulted in increased accountability across our businesses and accelerated our decision-making. This team is already executing on our strategic plan and today, you'll hear from some of them directly.

Core to our strategic plan are the organizational changes, strategic actions and operating improvements, which we presented on January 26.

On the organizational front, the adoption of a modular approach to our business and the creation of our Legacy Portfolio are important steps to improving transparency into the performance of our Operating Portfolio. In the quarter, we announced the sale of PICC shares and took additional actions to monetize Legacy Portfolio assets, which Sid will speak to. We're well on our way to achieving the targeted $9 billion in legacy capital released by 2017.

The fourth quarter strategic actions are the foundations of the $25 billion of capital return that we expect over the next 2 years. For the full year 2015, we returned approximately $12 billion to shareholders, and we expect a similar pace to continue.

Yesterday's announced additional $5 billion share repurchase authorization and 14% increase in our dividend is consistent with the path towards returning the $25 billion over 2 years, or over 1/3 of our market capitalization.

We also announced the sale of our Advisor Group, which we expect to close in the second quarter; and plans for an IPO of a portion of our interest in UGC. UGC is the market leader in the mortgage insurance industry.

Finally, we are aggressively pursuing operating performance improvements, and you'll see that our progress on operating expense reduction supports our conviction in achieving $1.6 billion in gross operating expense reductions through the end of 2017. Today, we will also provide additional insight into our actions to improve our Commercial Property and Casualty accident year loss ratio.

On Slide 4, we reaffirm the targets that we discussed in January and a year ago. We stand by our plan and look forward to sharing our progress with you on an ongoing basis.

Before Sid begins his remarks on the quarter, I'd like to take a moment to recognize the great contribution that David Herzog has made to AIG. David has devoted the last 16 years to the company, and was essential to our emerging through the financial crisis and positions the company for its continued future success. His guidance and stewardship of our financials continues to be highly valued, and he'll be missed by many here at the company.

Sid will now provide you with the financial highlights of the quarter.

Siddhartha Sankaran
Executive VP & CFO

Thank you, Peter, and good morning, everyone. This morning, I'll speak to our quarterly financial results, progress made on our expense initiatives, our continued active capital management and certain strategic actions impacting 2016 results.

Turning to Slide 5. As Peter stated, the fourth quarter operating loss per share of $1.10 was primarily due to the reserve strengthening and weaker alternative returns in both the Commercial and Consumer segments.

As I stated on the January 26 call, we believe our reserving actions this quarter will help mitigate the risk of future volatility around our best estimate.

The reserve strengthening in accident years 2011 through '14 was driven by greater actual versus expected loss emergence for primary and excess auto liability, Healthcare and Financial Lines. The impact of revised tail factors based on emergence in earlier accident years also contributed to the adverse development for excess Casualty and Financial Lines. Of note, Financial Lines remains well above our current profitability targets.

Our reported operating tax rate for the quarter was just shy of 39% due to the pretax operating loss and the impact of other discrete tax items reducing our tax expense. We expect our operating effective tax rate for 2016 to be approximately 32%.

Turning to Slide 6. Total general operating expenses declined 6% in the quarter and 3% for the full year on a constant dollar basis, a rate that is expected to accelerate under our current strategic plan.

Included in our 2015 results are approximately $145 million of expenses related to the acquisition of 4 companies in the calendar year, offset by approximately $125 million representing the nonrecurring portion of the pension curtailment gain.

In addition, we recognized another $222 million in pretax nonoperating restructuring charges in the quarter, $123 million of which relates to the restructuring charge we announced in the third quarter of this year. The remaining $99 million relates to new actions, primarily for additional staff reductions that will result in at least another $200 million reduction in our annual expense run rate.

Taken together, the actions announced in the third and fourth quarters of this year will reduce our annual expense run rate by approximately $700 million to $800 million. We anticipate that we will achieve the majority of these savings by the second half of 2016. These actions, along with other initiatives we are undertaking, give us confidence we will achieve our $1.4 billion net reduction by 2017.

Slide 7 shows our continued execution against our capital management targets. During the quarter, we deployed over $3.2 billion towards the purchase of approximately 53 million common shares. This year, we have purchased an additional $2.5 billion of common shares through February 11. This leaves about $800 million unused against -- under the $3 billion authorization that we announced in December, plus an additional $5 billion from the new authorization that Peter referenced. We also announced an increase in our dividend of 14%, which is consistent with our positive view of sustainable profitability.

From the standpoint of total capital return to shareholders, our annual dividend payment is approximately $1.5 billion based on our current outstanding shares, and that amount is included in the $25 billion in capital return we discussed in our strategic update.

At year-end, we had $9.2 billion of parent liquidity, as you can see on Slide 8. While we manage our liquidity within a target range of $6 billion to $8 billion, we may be slightly higher or lower from this range from time to time.

Cash inflows from the insurance subsidiaries during the quarter were approximately $400 million, reflecting our annual fourth quarter true-up of tax-sharing payments.

As we said at the strategy update call, we expect $7 billion to $10 billion in dividends and tax-sharing payments over the next 2 years, which are net of parent and interest expense and the $2.9 billion capital contribution made to the PC subsidiaries in January.

Slide 9 depicts the composition of our Legacy Portfolio. As we said in our strategic update call, we are creating a Legacy Portfolio, which contains roughly 1/4 of the company's total equity. Legacy will consist of actively managed run-off businesses or noncore assets and liabilities that we are targeting for maximum value. Our actions as they pertain to the Legacy Portfolio focus on how quickly we can extract capital by either divestitures, reinsurance or other efficient run-off methods, without giving away too much value.

In the fourth quarter, we monetized $2.1 billion of Legacy Portfolio assets, including a portion of our stake in PICC, which we've previously disclosed, and certain DIB assets as well as some internal sales of assets to our Insurance businesses. Legacy Portfolio capital declined $5 billion in the quarter to approximately $17 billion, driven by the $3.6 billion of buybacks and dividends in the quarter, which were partially funded by the monetization of legacy assets. The reduction in Legacy Portfolio capital was also impacted by the additional NOLs created during the quarter, largely as a result of the reserve strengthening we previously announced.

Slide 10 presents the composition of our deferred tax assets. During the year, we utilized about $600 million of foreign tax credits. NOLs increased by roughly $1 billion, also primarily as a result of the reserve strengthening we mentioned before.

Finally, I would like to cover 2 of the strategic actions that will impact our earnings in 2016. The first is our planned life reinsurance transactions, which are intended to address the approximately 40% of redundant reserves in our U.S. Life companies that have not already been financed. We expect these transactions will optimize our capital and generate $4 billion to $5 billion of additional liquidity to the parent through a combination of dividends and tax-sharing payments. This will also result in annual reduction in net investment income of approximately $200 million to $250 million beginning in 2017. There will be only a modest impact to net investment income in 2016, as transactions are being finalized.

Secondly, we are reallocating roughly 50% of our hedge fund portfolio, as Peter mentioned, primarily into investment-grade bonds and commercial mortgage loans, which we believe will free up about $2 billion in additional capital from the allocation to lower capital-charge assets. If we assumed a 9% normalized return, this would result in approximately $200 million decline in annual net investment income in 2016, net of our reinvestments. This would occur over the course of several quarters.

The net investment income reductions from both of these transactions were reflected in the Commercial and Consumer PTOI targets that we provided in our January 26 strategy update presentation.

We look forward to delivering on our strategic plan that we outlined in January and providing you with additional disclosure by 2016 year-end. We remain confident in our plan to deliver $25 billion to shareholders over the next 2 years and our continued operating improvement.

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. Today, I will discuss the Commercial Insurance segment's quarterly results, our strategic priorities and the actions we're taking to improve operating performance.

On Slide 12. The fourth quarter Commercial Property Casualty accident year loss ratio, as adjusted, was 66.4%, an increase of 0.5 point from the prior-year quarter, driven by higher severe losses in Property. Increased loss, particularly in the U.S., including in E&S trucking and other segments of commercial auto, also contributed to the higher adjusted accident year loss ratio.

The fourth quarter expense ratio of 28.6% reflected an increase in commission rates in Property, partially offset by net improvements in general operating expenses. Net premiums written grew 1.5% after adjusting for foreign exchange. We continued to improve our portfolio mix and grow in areas that meet our targeted ROE.

In the quarter, large-limit and middle-market property and segments of our program business continued to grow. We also benefited from fee incomes from NSM, a leading U.S. managing general agent acquired by AIG in April of 2015.

Overall rate change declined by nearly 1 point in the quarter, driven by continued pressure in Property, particularly in the U.S. E&S business. U.S. Casualty rates increased by 3%, reflecting margin improvement in lines subject to remediation. Rates were essentially flat in Specialty and Financial Lines.

We see profitable growth opportunities in multinational, Financial Lines, Property upper middle market and major account segments that utilize our risk engineering capabilities, international Casualty, and areas of emerging risks, such as cyber and M&A insurance. We're also excited about providing clients with best-in-class claims expertise, risk services and analytic capabilities that will strengthen our relationships. These include expanded teams of engineers to analyze and mitigate risk, innovations from our partnership with Clemson University and investments in companies like Human Condition Safety, whose wearable devices can help workers avoid serious injuries. The breadth of the AIG franchise and the strength of our client relationships position us well to capitalize on new opportunities and current market disruption from some of our competitors.

With respect to UGC, our CEO, Donna DeMaio, and her team delivered another quarter of increasing profitability. The strength of UGC's business is evident in the default rate that was last seen in 2006.

For the full year, UGC had a record first-lien new insurance written of over $50 billion and pretax operating income of $644 million. The Private Mortgage Insurer Eligibility rules asset test came into effect in December 2015, and I'm pleased to report that UGC will exceed the requirement by approximately 20%.

During our January 26 strategy update call, we announced specific actions to improve Commercial's performance that will reduce the accident year loss ratio as adjusted by 6 points.

On Slide 13, the green line shows an accident year loss ratio improvement of almost 11 points since 2011, including the effective prior-year development for all of those accident years.

Following significant progress between 2011 and 2013, our trend rate slowed in 2014 and 2015, but during that time, we made some important advancements in our underwriting tools and analytics.

The bars in the chart highlight the change in business mix, as we reduced writings in poorer-performing areas of U.S. Casualty from 39% of our portfolio in 2011 to 27% in 2015. In 2016 and 2017, we will continue to focus on improving the portfolio mix and we will accelerate the use of underwriting tools and analytics capabilities developed over the past few years. One of the benefits of AIG's recent organizational changes will be to increase agility and speed the adoption of these tools.

Slide 14 shows the dispersion of the adjusted accident year loss ratio, excluding catastrophes, of each sub-segment that comprises our $20 billion of net premiums earned in 2015. The loss ratio has ranged from as low as 30% to above 100% for a handful of subsegments. This illustrates a very important point, we do not need to improve each and every subsegment of our $20 billion portfolio by 6 points in order to achieve our target, rather focusing on our best- and worst-performing areas will significantly contribute to improved performance. We intent to grow the 15% of the Commercial portfolio included within product set 1. It includes the lowest loss ratio businesses, which ran at an average of approximately 41%. We will focus our resources on expanding our presence in the many products and geographies within this product set, where we have strong competitive advantages and offer a compelling value proposition. We'll maintain or improve the business captured in product set 2, which represents 70% of total premiums, with an average accident year loss ratio of approximately 66%.

This is the product set that will benefit the most from the underwriting tools and data analytics I mentioned earlier. For the highest loss ratio subsegments, which are predominantly in U.S. Casualty, we intend to expand our use of quota share reinsurance. The effect will be an improved Commercial loss ratio, release of statutory capital and a higher return on equity. We will remediate product set 3, where the remaining 15% of the Commercial portfolio ran at an average accident year loss ratio of approximately 91%. This is where we will narrow our focus through strategic exits and remediation.

We already began taking actions on some of these subsegments in the second half of 2015 and expect to be seeing benefits from these actions in the first half of 2016. Earlier this month, we announced and communicated to our distribution partners the exit of 4 specific high loss ratio areas within U.S. Casualty, which include certain subsegments of Healthcare and commercial auto that Sid mentioned earlier, following our fourth quarter reserve study. We expect to see these benefits beginning in the second half of 2016 and extending through 2017.

I would note that the majority of the businesses we're remediating in the U.S. will renew relatively evenly throughout the remainder of the year. We will, of course, provide proper notice in compliance with the relevant regulatory rules, and communicate with our clients well in advance of these actions.

We believe these levers provide a clear path for achieving the targeted accident year loss ratio by year-end 2017. Our strategy is to be targeted using micro-segmentation tools, narrowing our focus to significantly differentiate between products, geographies, clients and distribution channels based on value.

With respect to underperforming 1 or 2 product accounts, you can expect to see dramatic reductions as we move forward. Our goal is to be our clients' most valued insurer, and we're focused on clients where we can deliver the most value and grow profitably.

In closing, Commercial's strategy is clear, focused and on pace. While there's a lot of work to do, I'm confident in our strategic plan and our ability to execute it.

Finally, the Commercial leadership team and I are 100% committed to achieving the plan we've outlined.

Thank you. Now 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. This morning, I will discuss our Consumer businesses' operating performance, provide an update on the DOL's proposed regulations and provide an update on Japan.

Beginning with Retirement on Slide 17. As Sid highlighted earlier, lower alternative investment returns, combined with lower base portfolio income, contributed to the decline in pretax operating income. We continue to expect base yields to decline 2 to 4 basis points per quarter on a normalized basis in 2016 based on the current interest rate environment.

Sales growth was strong from a year ago, particularly in Index Annuities and Fixed Annuities. We are seeing Index Annuity growth through all of our channels, particularly with independent agents, and expanded wholesaling in banks, broker-dealers and advisers.

Fixed Annuities growth was driven by higher interest rates and credit spreads in the latter portion of 2015.

Retirement net flows improved both sequentially and versus a year ago, due largely to continued positive flows for Retirement Income Solutions and a decline in Fixed Annuity and Group Retirement surrenders.

Despite a challenging environment, we believe our product and distribution diversity allow for continued positive net flows overall.

I would like to provide an update on the Department of Labor's fiduciary regulations with respect to ERISA plans and IRAs. The version of the proposed regulations, which was advanced to the Office of Management and Budget at the end of January, has not been made public. The final regulations could be issued as early as March or April. We remain focused on preparing for its implementation with respect to product development, distribution support, compliance, service and administration. We are in active discussions with our distribution partners to be in the best position possible to meet the evolving needs of retirement savers. Through Group Retirement, Fixed Annuities, Index Annuities and variable annuities, we will offer a broad product portfolio to meet the growing needs of consumers for guaranteed lifetime income and other savings solutions.

Slide 19 presents results for our global Life business. In Life, our new business is already priced to achieve our targeted returns. As Sid mentioned, we are executing on plans to finance our remaining redundant reserves with a series of reinsurance transactions that will improve the returns in that portfolio and allow for increased distributions to parent.

We are also executing on a plan for our Life business to narrow our distribution and product focus, including greater specialization, which will result in reduced distribution expenses. Examples of this enhanced emphasis include a greater focus on independent distribution channels with a significant reduction we made in January to our Life career agency force, and a narrowing of our product focus on our group benefits business to profitable lines where we have a competitive advantage.

Turning to Slide 20. Personal Insurance delivered strong growth in new business in the Private Client Group, in Japan Property, and automobile across all regions. However, there were a number of items that resulted in an increase in accident year losses.

During the fourth quarter, we strengthened reserves for Accident and Health as a result of our normal annual review. We saw unsatisfactory performance in some European warranty service programs leading to remedial actions, including contract cancellations. And we realized higher auto losses in a number of European countries that are already targeted for exit.

We continue to move forward with our work in Japan, and are preparing for the merger of Fuji Fire and Marine and AIU legal entities. At the same time, we have successfully grown our personal auto business, which grew year-over-year for the first time in over 10 years. Our onetime merger-related expenses were roughly $100 million this year, largely comparable to last year, and we further expect onetime expenses to peak in 2016 at a slightly higher level as we prepare to enter premerger status. The subsequent legal merger, when approved by the authorities, will bring to a close the integration of Fuji Fire and Marine, which we acquired in 2011.

I would like to briefly comment as well on our plan to deliver $800 million of pretax operating income improvement by 2017. We expect that much of this improvement will be achieved through significant expense reductions for each of the Consumer businesses, which are part of AIG's firm-wide GOE targets. The largest reductions will be in the Personal Insurance business and U.S. distribution. We expect that these benefits will be partially offset by lower net investment income from hedge fund reallocations, as well as from a lower invested asset base resulting from the distributions to the parent company.

To close, we remain focused on achieving profitable growth across our Consumer businesses and effectively managing risks by executing on our customer-focused strategies, maintaining a prudent risk profile and targeting capital-efficient growth opportunities.

Now I'd like to turn it back to Liz to open up for Q&A.

Elizabeth A. Werner
Head of Investor Relations and Vice President
Anthony, could we start our Q&A session, please?

Question and Answer

Operator

[Operator Instructions] And it appears our first question comes from Tom Gallagher with Crédit Suisse.

Thomas George Gallagher
Crédit Suisse AG, Research Division

Sid, I just wanted to ask you a question on your comment on the impact from the Life reinsurance deals. So the $5 billion you're going to free up, you said you would lose $250 million of NII. If you look at that from an after-tax standpoint, you're only giving up a 3% to 4% return on that capital. Are there any other lost earnings associated with that? Or is that it? And is that a third-party reinsurance deal?

Siddhartha Sankaran
Executive VP & CFO

Yes, no, there -- obviously, we are reinsuring the Life reserves with external parties, but there also are internal parties and internal reinsurance in the structure. What I would say is your estimates on the ROE give-up are roughly accurate. And just a reminder is that the additional liquidity to the parent comes both from freed-up capital as well as from the acceleration of tax-sharing payments from the subsidiaries.

Thomas George Gallagher
Crédit Suisse AG, Research Division

Okay. So it's not full the $5 billion capital release. There's some tax benefits in addition to that.

Siddhartha Sankaran
Executive VP & CFO

Yes, that's correct. And so the costs on the transaction are economically attractive for us when we look at the additional liquidity.

Operator

Our next question comes from Larry Greenberg with Janney.

Lawrence David Greenberg
Janney Montgomery Scott LLC, Research Division

I guess this would be for Rob. Rob, it just seems very challenging to take 4 points off the loss ratio for 2016, particularly given that probably 1/3 of the earned premiums for the year had already been written last year. So on the reinsurance fees, which appears that it probably plays a pretty significant role here, you mentioned the quota share for, I guess, the worst-performing part of product set 2. Will that -- will reinsurance also be used for product set 3? And then I guess the quota share is mostly designed to just change the mix and get more high-loss-ratio business out of the portfolio. Is that correct? And then finally...

Elizabeth A. Werner
Head of Investor Relations and Vice President

Larry, I think you kind of went over the 1 question, 1 follow-up. So let's just start with your first 2, and I actually think we'll be able to get to the rest of them if you just get back in queue.

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

All right. Larry, thanks for your question. The first thing I want to say to you is we're not starting flat-footed on any of our actions here. So actions were being taken in 2015, which we'll see beginning in the first part of 2016. The second thing I want to say is regarding use of reinsurance -- I know there's a lot of questions about that. The first thing I want to say is we don't think it's a long-term sustainable strategy to be looking to arbitrage our reinsurers. That's not the strategy here. We're partners with our reinsurers and we see many opportunities for our reinsurance strategy to benefit AIG as well as the reinsurers. I think there's 3 key points I'd like to make regarding how this works with the reinsurers. First, you should know, I think the reinsurers have an increasingly favorable view about the quality of the data and the quality of our underwriting. Second, the reinsurers themselves receive significant diversification benefits in their capital models, which makes business like our U.S. Casualty business more attractive for them. And third, the long-tail nature of our U.S. Casualty business, for example, gives the reinsurers a significant deal of flexibility in their investment allocation decisions, which might differ from the way AIG might choose to structure its investment portfolio. I would say, most of our actions will be with the reinsurers in product set 2, and it will be on the higher end of the loss ratios in product set 2, which is where the U.S. Casualty business sits. The reinsurance will change, of course, our mix of business because if you reduce the amount of business in product set 2 that is U.S. Casualty, the range in loss ratios in product set 2 is pretty wide. It ranges from as low as the low-50s to as high as the 80s. And so therefore, you'll get a lot of benefit from reinsuring the U.S. Casualty business, which is higher loss ratio business in product set 2.

Operator

Our next question comes from Meyer Shields with KBW.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Peter, on the January 26 call, you're pretty explicit that the 6 points of accident year improvement were actually for all of 2017. Can you talk about what's changed from then until now so that it's a run rate at the end of the year?

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

Well, I just want to be clear, obviously, it is our intention to drive all 6 points of the improvement in the accident year loss ratio by the end of 2017.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Right, I understand that. So what is the goal for the 2017 accident year loss ratio?

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

Close to 60% on an adjusted basis.

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

Ex CAT.

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

Ex CAT. That's what the adjustment is.

Operator

Our next question comes from Josh Stirling with Sanford Bernstein.

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

Listen, I want to applaud you for taking shareholders in the board. I think it's refreshing that you -- and it's great to see you guys are still willing to take shareholders' views into consideration, and I appreciate you putting shareholders first. But everybody here at home today is trying to figure out what the impact actually is likely to be from, like, your expansion of the board, what the impact on your strategy and performance is likely to prove out. And I'm wondering if you can give us a sense of the conversations you've had on the board and with your new, likely, board members so that we can have a better sense of how you expect this to go. And at a minimum, is it going to be sort of business as usual, which is 2 new members? Or ultimately, are you going to have a sort of different approach to make decisions? And could you even go so far as to have a strategic review committee created with some of these independent board members to pursue a review?

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

So as we've said publicly, we are pleased that we have reached a solution that averts a very distracting proxy fight and that the inclusion of 2 new board members will add an extra degree of scrutiny on the way in which we execute our strategic plan. And so we would not want to comment on any future dynamics between management and the board. But the process today is that the existing board of 14 and management have developed the strategy in close collaboration. And so we expect continued close collaboration between management and the board going forward.

Operator

Our next question comes from Jay Cohen with Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

While we like to see the overhead expense ratios improving, I think in every area within Property Casualty, the acquisition expense ratios rose, and some of that may be business mix change. But can you talk more specifically what's going on there? Maybe that's for Rob.

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

Jay, I think you're right. As we continue to work on our mix of business, in general, what you should think is the higher loss ratio, more complex business simply carries a lower acquisition cost and the business mix that we've been shifting to will carry a somewhat higher acquisition cost. The net effect of that, we think, is a net positive in our overall ROE and a positive in the overall combined ratio.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And so it's offset, to some extent, by lower loss ratios then?

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

That's right, significantly offset by lower loss ratios.

Operator

Our next question comes from Jimmy Bhullar with JPMorgan.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

I'm wondering if you could talk about just pricing trends in the P&C market and how they might have changed in the last few months or so. And related to that, what your expectations are for premium growth in this environment, especially as you raise prices and pull back from certain lines in the P&C market.

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

Yes, so Jimmy, first of all, I always try to remind people, we deal in a lot of countries and in a lot of products. So when people ask about the market, there's no simple single answer to that. And so we experience different results with pricing in different parts of our portfolio. Maybe the bigger change that we would have seen in the fourth quarter is an improvement in the U.S. Casualty pricing environment as we've driven a bunch of our remediation activities, as I said earlier, in 2015, which will benefit us more in 2016. I think the -- our competitors are also seeing many of the same things we're seeing, and so I think there's pretty good discipline with respect to U.S. Casualty at this point. With that said, the U.S. property market, in particular, the Excess & Surplus lines property market, has been and continues to be highly competitive. It's why you see AIG shifting its strategy to an increase in the level of engineers that we've added on to our team and seeking to use capabilities and expertise outside of our capital as the primary advantage and the primary thing we offer in the marketplace. So we do expect it to continue to be a mixed bag, product-by-product and geography-by-geography.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

But just on premium growth, your expectations over the next 2 to 3 years as you're trying to improve your margins, should we assume a dramatic decline in your premium?

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

Yes -- I mentioned on the January 26 call, Jimmy, I believe, we do expect our premium volume to go down in 2016. It will go down partly because of our remediation effort with respect to exits and remediation in that product group 3, partly because of the use of reinsurance. But it will be offset by the fact that we continue to see opportunities to grow in places where we have a sustainable competitive advantage anywhere in the world and with various products.

Operator

Our next question comes from Jay Gelb with Barclays.

Jay H. Gelb
Barclays PLC, Research Division

I had a question on the normalized return on equity target. I'm having a little trouble getting to your ranges, primarily due to the sharp drop-off in partnership income. So in the first half of 2015, there was $1.4 billion of partnership income, and that to dropped off to almost 0 in the fourth quarter. I'm just trying to get a perspective of how much of your ROE targets take into account expectations of a normalized maybe high single-digit return in alternative investments relative to basically 0 that we saw in the fourth quarter.

Siddhartha Sankaran
Executive VP & CFO

Jay, it's Sid here. No, we've factored that in entirely in our 2-year strategic plan and so we've accounted for the change between a normalized return from the hedge funds and alternatives and the reinvestment strategy that I referred to in my remarks.

Jay H. Gelb
Barclays PLC, Research Division

But this is entirely related to essentially 0 returns or maybe more of a headwind in the first half of 2016. I mean, what are you assuming in your ROE target for 2016 for alternative returns?

Siddhartha Sankaran
Executive VP & CFO

Yes, we normalize for performance not volume, and so we're normalizing here. As I said in my remarks, if you assume 9%, that has been the normalized performance that we've assumed. And obviously, as we shift out of the hedge fund portfolio, we're shifting to a normalized return on fixed income and commercial mortgage loans.

Operator

Our next question comes from Michael Nannizzi with Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Talked a bit about Commercial Insurance here, but in Consumer, where we haven't gotten a lot of detail, international has consistently been a problem. When does that get better? And what exactly are we doing there in order to try to fix that business and get it to a better place? I understand Japan and -- but I feel like that merger has been sitting in front of us now for some time with the carrot of lower expenses. Could we get some color on that? And any granularity would really be helpful.

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

Yes, sure, Mike. First, with respect to Japan, the merger is progressing. We're proceeding, right now, through the integration and regression testing of about 110 systems. And there has been a new regulatory requirement for a change in the earthquake property rates. And as you can imagine, whilst we're trying to do this integration and regression testing, to have to stop, open up the systems, introduce those new earthquake rates and then go back to integration and regression testing, that's essentially what's pushed us back 6 months or so in terms of the expectation of the integration date. And our strategy is, in fact, to try to advance as many benefits from the work we'll already done in recognition of the fact that we can do so. And examples of that are our ability to recently change our direct marketing strategy and move that away from American Home legal entity and into Fuji Life and the other companies, which will generate further savings that we can now realize. And so outside of Japan, what I can say is when we did the strategic update, we did mention about the footprint strategy. And many of our Consumer businesses are vestiges from the days when AIG had a multiple financial services presence. For example, in Poland, a number of years ago, we had a consumer finance company, we had a Life business, we had a credit card company. And it's a natural extension of those customer bases and distribution channels to build a Consumer Property Casualty business. But as we've divested away from those, we now have expense overhangs and we have subscale operations in quite a few territories. And the reason why we're moving to a focus on our individual business and 15 territories in our group business and our multinational clients and 35 territories going forward, is to address that expense overhang. And that's primarily been the performance issue in much of the non-Japan part of the international portfolio. We do, of course, have some other portfolio which is like the European warranty business, which we address from time to time. But our loss ratios are generally sustainable and competitive. It's the expense ratio in the international Property Casualty business we need to address.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

But can you provide some more granularity? I mean, I appreciate all of that context but, I mean, in Commercial, we're talking about specific targets for profitability improvement. I mean, it sounds like you've got a little of things that you can ring-fence and talk about areas that are subscale, areas that are at scale. What does the run rate in Japan look like after this? I mean, it seems like all of those are estimate-able, but we're still here talking very qualitatively about things happening. When can we get some more granularity there?

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

So this is very much the thinking behind the modular business reporting, where Japan will be 1 of the first of the 9 modular business units that will be shown in the financial supplement, and we'll give you a clear transparency around ROE and capital and so on. So we are very committed to giving you more granular disclosures. And the team is working hard to be delivering those on a schedule that's consistent with the high quality control of financial disclosures that we obviously want to stick to. But in terms of prospective ROE, perhaps, I should just mention that we have, in our risk-adjusted profit framework, elevated the hurdle rate for all businesses and all territories to a minimum of 10%, which is a shift from where we were a year ago, where territories with low nominal interest rates and with low beta, we rewarded with a lower hurdle rate. And we have, in discussions with several of our large shareholders, agreed that we should have a minimum hurdle rate of 10%, and that applies to Japan as well as elsewhere.

Operator

Our next question comes from John Nadel from Piper Jaffray.

John Matthew Nadel
Piper Jaffray Companies, Research Division

I have one question on rating agency reactions to your strategic update. And the other, just wanted to talk about the parent company cash as we roll forward here into January or February. Peter, I think I was pretty surprised, and I know a number of folks were surprised, by the rating agencies' negative outlooks, and maybe even 1 or 2 ratings being cut following the strategic update. And I don't -- I guess I'm just -- Peter, I just want to gauge your confidence level that these negative outlooks will not turn into downgrades, all else equal, as a result of the $25 billion return of capital. And then separately, just with the parent company ending the year at $9.2 billion of liquid assets, if we roll forward here into the first part of the first quarter, you've already used $5.4 billion. So you've got under $4 billion of cash or liquid assets at the parent. How quickly does that recover?

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

So let me just sort of start and then I'll hand it over to Sid to complete. We've been extremely consistent in saying that we manage the AIG enterprise in a way that factors in all stakeholders. We use that word very deliberately. And our policyholders, in particular, are very mindful of our commitment to maintaining a strong balance sheet and the ability to deliver on large long-term promises. And to the extent that they look at the rating agencies as a guide, we are very mindful of their reactions to our plans and our specific actions. And as we developed this 2-year strategic plan, we worked very closely with all the rating agencies to pressure test different assumptions. And so the actions they took were not a surprise. But I've been saying consistently that the rating agencies were more of a binding constraint than any kind of Fed oversight of AIG. And the guide to our own thinking here is very much our own internal assessment of risk. And we are very pleased, especially in the light of recent market volatility, that we've done so much over the last 4 years to derisk the balance sheet of the company, the vulnerability to contingent liquidity. And so we are confident that once we execute on the goals in this plan, the ratings outlook will become positive again. But Sid, maybe you can answer the specific liquidity questions and elaborate, if you like, on the rating agencies.

Siddhartha Sankaran
Executive VP & CFO

Yes, the only elaboration, Peter, I'd say is, just a reminder, John, we continue to have strong ratings on our core Life and Property Casualty operating companies, most of those with stable outlooks. So we believe our planned operating improvements are going to support maintaining those strong ratings and actually improving them over time. On liquidity, I'd point you to my comments around our target. You've obviously referenced some of the outflows. But just a quick reminder, in the first quarter, we have an assortment of inflows that are coming from dividends, tax-sharing payments as well as further liquidations and asset sales, some of which we've already executed. So again, as I said, we target $6 billion to $8 billion. We may be higher or lower than that from time to time, but we're very confident in the balance sheet. And obviously, that was core to this entire strategic plan.

Operator

Our next question comes from Brian Meredith with UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

Bob, I was hoping you can give us maybe a breakdown of how much of the 400 basis point improvement in the adjusted loss ratio by year-end 2016 comes from the reinsurance, maybe shifting assets to the Legacy Portfolio, normalization in the severe loss ratio and then pricing and underwriting actions. And then lastly also, how are you going to manage not losing good business with the bad business as you go through this process?

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

All right, Brian. Thanks for the question. So let me say that I think it's reasonably easy for me to tell you regarding legacy that we've already informed the market of the exits that we have, and the only thing moving into Legacy is the businesses we have exited. With respect to the drivers, I would say to you, first, that each part of our business, Property, Casualty, Specialty and Financial Lines, plays a part. Obviously, the remediation role for Property and Casualty are the most significant, whereas I see the opportunity for growth in strategic areas, particularly for Financial Lines and for some of our Specialty products. With respect to which actions will drive it, it's reasonably evenly mixed between what I would call reinsurance and business mix. Strategic growth in some of the lines I just described, where we have opportunities, and our loss ratios and our competitive advantages allow us to succeed in the marketplace. And then a contribution, of course, from exits that have already been announced and our work on risk selection and client selection. So I might just say think of it as 3 basic buckets, strategic growth, reinsurance and business mix, exits/client and risk selection as being reasonably equal in terms of their relative contributions.

Operator

Our next question comes from Paul Newsome with Sandler O'Neill.

Jon Paul Newsome
Sandler O'Neill + Partners, L.P., Research Division

I would like a general question about the Property Casualty reserves and how core are they to the capital that you expect to pull out of the company over time. It seems to me that the rating agencies' concerns are primarily focused on whether or not the $3.6 billion was enough. And so if you could talk about either how -- first, how do we get comfortable with those reserve levels? And then how sensitive are the capital amounts you're going to pull out of the company to issues over reserve development?

Siddhartha Sankaran
Executive VP & CFO

Paul, I'd really point you to the comments I made on the January 26 call as well as the information we've released in our 8-K. We believe, after applying enhanced methods and assumptions and strengthening our reserves, that we are going to help mitigate the risk of future quarterly reserve volatility around the selected best-estimate reserve. And as a result, I think our plans are confident in our level of capital for our PC operating subsidiaries.

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

And I think as a reminder, remember, the $25 billion capital return walk that we disclosed on the 26th, the first bar of that chart includes the injection of holding company cash into the subsidiary to fund the reserve strengthening. So it sort of starts off with a fully funded reserve.

Jon Paul Newsome
Sandler O'Neill + Partners, L.P., Research Division

I guess my question is, if we have more unfavorable reserve development, does that mean we have to pull more capital into the Property Casualty business, which means less to the parent?

Siddhartha Sankaran
Executive VP & CFO

Yes -- I mean, look, Paul, I think obviously, capital is going to be sensitive to our future projections. So as I said, our future projections on reserve mitigates the risk of future quarterly reserve volatility, and we don't comment on hypotheticals.

Operator

Our next question comes from Charles Sebaski with BMO Capital Markets.

Charles Joseph Sebaski
BMO Capital Markets Equity Research

Just wanted to follow up, first, on the Commercial P&C accident year loss ratio, on both Slides 4 and 13, you added a footnote about year-end, that the improvement is 4 points and then 2 points is year-end, and I guess that's a change from the January 26 presentation. And wanted to know what the expectation for those actual full years are versus the year-end run rate. And then additionally, Sid, on the $9 billion of capital freed from legacy portfolios that's in the presentation, I don't see where that is highlighted in the January 26 bridge to $25 billion, and I'm wondering is that new capital or was that incorporated somewhere in that bridge to $25 billion.

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

So I'll start just by clarifying. Again, our view is that the decrease in the Commercial adjusted accident year loss ratio will be approximately 6 points in total by the end of 2017. And just a reminder, it's not -- and 4 points at the end of 2016. But it's just -- it's not a linear process, and we can only make the changes as policies come up for renewal with proper notification to our policyholders. So market conditions, renewal timing, et cetera, will impact the way you'll see that emerge. But it is our belief that we have enough levers at our disposal that should enable us to be able to deliver 4 points in 2016 and 2 points additional in 2017.

Siddhartha Sankaran
Executive VP & CFO

Charles, it's Sid here. On your second question, I'd point you to Slide 5 in the strategic update. Just a reminder, the legacy capital is a capital projection. Page 5 illustrates our funding walk for our share repurchase, so what you're going to see is that $9 billion that you're referring to on capital is returned to shareholders via various funding sources in this walk. So I point you to Page 5 in the footnotes there.

Operator

Our next question comes from Larry Greenberg with Janney.

Lawrence David Greenberg
Janney Montgomery Scott LLC, Research Division

I guess back to Rob and reinsurance. I'm curious if you will also utilize excessive loss structures in the plan? And you've mentioned loss net investment income from other sources of the plan. Will there be lost investment income in the future associated with the PC reinsurance?

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

Yes, so first of all, regarding excessive loss, yes, we'll use all types of reinsurance that are available at our disposal. And I just wanted to highlight that maybe one of the bigger change is with our use of proportional or excessive loss reinsurance. But we currently use and we'll continue to use excessive loss. With respect to how it flows through reinvestment results, let me let Sid comment.

Siddhartha Sankaran

Executive VP & CFO

Yes, there will be a reduction in net investment income from lower premiums in reinsurance, and that's been factored into the January 26 strategic update figures for Rob and his PTOI walk.

Lawrence David Greenberg
Janney Montgomery Scott LLC, Research Division

Can that be quantified?

Siddhartha Sankaran
Executive VP & CFO

We're not disclosing that right now. Obviously, as we execute on our strategies, we'll comment on reinsurance transactions and the impact of associated net investment income.

Operator

Our next question comes from Michael Nannizzi with Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Just a quick follow-up here. Rob, on the actions taken in Commercial, most of the changes are implying a reduction in premium. You kind of said in your comments that they'll be some premium reduction from the actions you're taking, but that there'll be premium growth from other opportunities. Can you give us just some context? I mean, what are you thinking about what premiums will be? Like, what's going to happen to that top line on a net basis? And can you give us the gross reductions just so we can understand what actions are being taken and the magnitude of those actions at higher -- or I should say, lower profitability, just to understand sort of what that template looks like?

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

All right. So let me see if I can help you out with this, Michael. I disclosed, again, some of this on the January 26 call. I expect that there'll be something like $1 billion of lower premium as it relates to reinsurance transactions. Now that will depend on actual deals we get done, the timing we get them done, et cetera, but that gives you a basic idea of relative size. With respect to exits and remediation and other actions we'll take, you should expect something like about the same amount of reduction in premium, which should be another $1 billion. So you're talking about $2 billion of -- both in the reduction direction. With that said, we had a change in the mix of business and very attractive opportunities in more strategic parts of our business that we think currently meet our ROE target hurdles. And we will grow -- and that number, you should think of as being something in the vicinity of $600 million. So we think our reduction in net premiums in 2016 is approximately $1.4 billion, $1.5 billion. Again, it'll depend on what happens in the market, market conditions, et cetera. But that gives you a basic idea of what we're expecting.

Operator

Our next question comes from Meyer Shields with KBW.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Sid, you mentioned something about additional disclosures by year-end '16, and I'm not sure what you're referencing.

Siddhartha Sankaran
Executive VP & CFO

Well, I think that was just in response to questions about modular business units and the Operating ROE versus Legacy.

Operator

Our next question comes from Brian Meredith with UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

Just quickly, Sid, could you remind us where you need your fixed-charge coverage ratio to kind of be to maintain your ratings level and where it is right now? And what's the best way to track that?

Siddhartha Sankaran
Executive VP & CFO

Well, first of all, it just depends agency-by-agency, so I'd point you to their guidance. And what I'd say in all of our operating projections, we meet their expectations and continue to target strong fixed-charge coverage. But it'll depend. It differs between S&P, Moody's and others.

Operator

Our next question comes from Charles Sebaski with BMO Capital Markets.

Charles Joseph Sebaski
BMO Capital Markets Equity Research

I guess a question on the Consumer business, and particularly Japan. Peter, you talked about the improvement or the higher hurdle rate of a 10% ROE for the Japanese business relative to how you had it before. What would be the expectation of contraction in that business? I guess, to me, a higher hurdle of 10% ROE would mean that some Japanese insurers might be able to be -- suffice with less?

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

Yes, Charles, I'll take that. Yes, first of all, we're already pricing our Life business at IRRs that are above the hurdle rates, even Peter's new hurdle rate, and has been some time in the low double digits. And that has been a fast-growing business for us. We made a decision a couple of years ago to consume those GAAP earnings at the rate of growth. So that has been masking our results in Japan a little bit. The other thing I think that's important to point out is, if we take away the onetime project expenses associated with the merger and integration of Fuji Fire and Marine, the underlying business portfolio is generating returns, we believe, in that low double-digit area. And since we've acquired Fuji Fire and Marine, we've brought their loss ratio on personal accident business down by 9 full points, and on automobile, down by 5 full points. And as I mentioned in my comments, we actually grew that business for the first time in quite a long time this year. So we believe that -- we're hoping that with the modular reporting, you'll be able to understand better the components of the Japanese results in the context of the hurdles that we set.

Charles Joseph Sebaski
BMO Capital Markets Equity Research

Will the new hurdle have no change in the business planning? I guess, to me, a new hurdle would mean that that's a change from what's currently going on, and you're basically saying that you're already at that hurdle, so no change is necessary.

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

Well, I think -- Charles, this is Peter. I think that at an aggregate level, you can see that you're over the hurdle, but within the subcomponent parts, the mix changes when you raise the hurdle rate on everything. So I think that you'll see greater selectivity of business so that the very high ROE business subsidizes, in a sense, the stuff that's sort of 8% to 10%. And there'll be less of the 8% to 10% and so there's a trade-off there. But I believe that our risk-adjusted profit framework, by targeting the spread between ROE and the hurdle rates, which we call the RAP spread, times the equity employed, and maximizing that risk-adjusted profit is the way to make the volume margin trade-off in a value-accretive way for shareholders.

Operator

That does conclude our question-and-answer session. At this time, I would like to turn the conference back over to Liz Werner for any additional or closing remarks.

Elizabeth A. Werner
Head of Investor Relations and Vice President

Thank you, Anthony. We appreciate all your questions this morning, and looking forward to see you in Q -- in coming days. Thank you.

Operator
That does conclude our conference for today. Thank you for your participation.