

A relevered AIG = less capital flexibility just as the fun starts

AIG reported Q2 operating EPS of \$0.66 versus \$0.50 consensus and \$1.43 YoY. Operating results were driven by an improving underlying general insurance result, offset by Covid-19 losses, and lower net investment income.

On a net income basis the quarterly results included a lot of moving pieces. Most notable were a \$6.7bn after-tax loss relating to the disposal of legacy assets through the Fortitude Re sale on the one hand, and a ~\$10bn positive swing in AOCI on the other (likely driven by lower rates driving bond values higher). All in, book value was down 3% for the quarter to \$71.68, but down 8% on its chosen tangible adjusted metric that looks past various (arguably) less fundamental items including AOCI.

Below, we go through the operating results in detail. AIG is a more complicated company than most at the best of times, and this quarter included more than a typical amount of moving pieces – including the impact of its new quota share of personal lines business in Lloyd's, a seemingly significant impact to travel-related coverages in personal, and of course all the complications that come from Covid-19 – both direct and indirect.

Frankly, with all the noise, it makes the quarter harder to benchmark the firm's progress against its urgent goals to improve its P&C operations without more information beyond the numbers from management. That said, we'd highlight the following as key takeaways from the reported results that will hopefully get more scrutiny on this morning's call (08:00 ET).

First, the underlying results included some encouraging data points, particularly in commercial lines loss ratios.

The company's press release highlighted prominently the 1.2pt YoY improvement in the general insurance underlying combined ratio to 94.9%.

However, looking past the commentary, the underlying combined improvement was more than all driven by the expense ratio, with the underlying loss ratio actually up 0.2pts.

Beneath the headline level though, were several moving pieces. The negative impact was driven exclusively by North American personal lines (+15pts YoY), likely due to travel coverages, with every other segment improving. This included notable improvement in North America commercial lines (down 1.7pts YoY) and international commercial lines (down 4.2pts).

In particular, the North American commercial lines progress is interesting given the historic challenges in that segment. With many peer companies reporting flattish underlying loss ratios, we'll be looking for color from the company as to how much of this was recognition of prior re-underwriting actions, mix shift or the recognition of frequency benefits from Covid-19.

Second, the expense ratio improved, but with one-off benefits seen at peers, it is hard to judge this as progress on expense discipline rather than indirect benefits from Covid-19.

As noted above, the underlying underwriting improvement was driven by the expense ratio, which was down 1.4pts to 33.4%. Though the release ascribed

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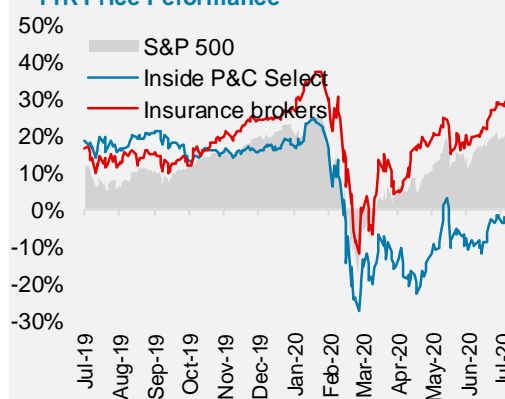
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Composite	YTD px chg.	P/B
Large comm.	(24.8)%	0.8x
Regional	(25.5)%	1.3x
Specialty	(16.4)%	1.5x
Personal	5.3%	2.0x
Bermuda	(21.7)%	1.1x
Florida	(28.9)%	0.9x
Brokers	2.8%	-
IPC Select	(16.9)%	1.1x
S&P 500 Fin.	(21.8)%	-
S&P 500	2.0%	-

1YR Price Performance



this to “continued expense discipline”, it is notable that this has been a consistent theme across peer companies without a significant auto component (= rebates) including 1.2pts at Chubb, 0.5pts at WR Berkley, 0.7pts at Hartford commercial, 2.8pts at RLI and 0.2pts at Travelers commercial.

With the company kicking off its “AIG-200” operating expense initiative at a challenging juncture, given the operating constraints of Covid-19 (not to mention the increased difficulty of reducing head count without damaging morale), we’d be interested in the underlying story on expenses. We’d be particularly interested to know the breakdown between one-off expense benefits (T&E, variable comp accruals) versus recurring (actual expense discipline or tech improvements).

Third, capital flexibility is looking a little tighter with leverage ratios elevated by additional debt issuance and book value erosion.

AIG began the year talking down the possibility of buybacks in H1 and talking up the likelihood of reducing financial leverage. This was followed by an ill-timed \$500mn tactical accelerated share price right before the collapse of its share price, followed by the issuance of \$4.1bn of additional debt that has – in combination with book-value erosion – taken financial leverage from 26.2% at year end to 30.6% at mid-year. This is the highest level since at least 2013.

Both of these tactical moves make sense in isolation, The ASR could be seen in the context of management “messaging” on valuation after the Q4 earnings disappointment led to a sell-off. The debt issuance makes sense in the context of terming out with historically low interest rates and the specter of locked capital markets following Covid-19-related dislocation earlier in the year prior to the Fed’s aggressive policy of interventionism.

That said, the tactical moves have seemingly muddled the water on prior stated strategy. The ASR now looks like a wasted bullet, and with only \$1.3bn of debt maturing this year, there is not a natural pathway to deleveraging without active capital management.

Given (a) the mixed signals coming out of the company, (b) a prior commitment to growth through M&A and (c) a valuation that should mean any capital deployment into anything other than deleveraging or buybacks would face a high hurdle return rate, we’d expect this to be an area of focus for the call.

Notably, the company’s self-disclosed metric of \$10.7bn of holding company liquidity looks meaningfully over-stated in practical terms – or at least emphasizes only the sources of liquidity without adjusting for the imminent uses. In particular, the \$10.7bn metric includes \$4.5bn of available revolver as we understand it. This leaves \$6.2bn – just enough to pay its >\$1.2bn tax payment due to the Treasury and conceivably reduce leverage back to year-end levels (which management said were too high). This leaves little buffer against uncertainty should any unexpected sources of volatility occur, such as catastrophe losses, particularly as the company has ~\$2bn in annual financing costs.

This is not to overstate liquidity as an issue – the firm has sources of liquidity including its insurance companies and a large revolver that give it plenty of runway. But it does limit its capital flexibility somewhat, and leaves it (a) less well positioned relative to some peers with lower leverage should opportunities arise to deploy excess capital and (b) less able to tactically take advantage of its discounted stock price – with management (in hindsight) essentially electing to make its bets on Validus and Gladfelter at elevated valuations that now limits its ability to buy back stock, with the shares still down ~50% from when they took over. From an investor’s perspective, it also increases the risk of a dilutive equity raise should any additional volatility emerge. This should be a particular concern

given how out of the money management long-term comp is that reduces alignment (= a compelling reason to rebase the options).

Fourth, the release seems to continue a trend of a growing emphasis on “spin”.

We can't help but add a few more “meta points” to AIG's Q2 report. We've been talking for a while about the tension between management's two main initiatives – on the one hand, driving a fundamental turnaround in P&C that includes a re-underwriting effort of historical proportions, but on the other, a revealed preference for providing “cover” for these actions through quasi-financial engineering like (a) overpaying for lower loss ratio business to replace shed premiums, and (b) de-risking through capital-arbitrage-style transactions like the Lloyd's syndicate and Fortitude, and (c) executing transactions that reduce book as a way of meeting ROE targets.

However, though we can't quantify this, this quarter's release – when the financial engineering elements were on greater display than the fundamental improvements – seemed to continue a trend of increased effort to control the narrative.

Examples include (a) reporting net income ROEs as “not meaningful” rather than negative (the *change* in ROE might be NM, but the negative ROE is very meaningful), (b) reporting a broken out life and retirement ROE in its highlights (13.2%) but not a P&C ROE (0.3%), and (c) management commentary that refers to the underlying combined ratio improvement due to “expense discipline” that is likely more due to similar one-off benefits due to Covid-19 seen at peers.

All of this – and others – feels a little “spin” heavy. And while this does not put AIG into a unique category among its P&C peers by any means, it seems a notable meta-data point of sorts given management's prior confidence to take a long-term view and not worry too much about managing short-term perceptions from external stakeholders.

Of course, there is some unavoidable context. AIG's share price remains down 37% YTD versus a 2% gain for the S&P 500, down 17% for Inside P&C Select and down 30% for S&P 500 Life & Health. It's also still down ~50% since management took over. We'd additionally note that COO Peter Zaffino has seen a series of announcements inflating his title and adding to his responsibilities, hinting at a transition plan in action. With that as the backdrop, the need to manufacture a sense of momentum and cementing a positive narrative of a turnaround well underway is a little more understandable.

[Read more below.](#)

A leveraged AIG = limited capital flexibility just as the fun starts

AIG's Q2 results included six-quarter high cat losses of \$674mn pre-tax (11.9 points), including \$458mn from Covid (8.0 points) and \$126mn from civil unrest (2.2 points). Recall, in Q1 AIG incurred \$272mn of Covid losses (4.5 points).

Among Inside P&C Select carriers with Q2 reports available, AIG is ranked second on the amount of year to date Covid charges, next to Chubb with \$1.4bn (see chart below).

Exhibit: Covid loss disclosures

Source: Company reports

Company	Q1 Covid losses	Q2 Covid losses	YTD Covid losses	YTD Covid losses as % of NEP	YTD combined ratio
Chubb	\$13mn	\$1,365mn	\$1,378mn	9.4%	101.0%
AIG	\$272mn	\$458mn	\$730mn	6.2%	103.7%
Markel	\$325mn	\$0mn	\$325mn	12.1%	103.0%
Arch	\$87mn	\$173mn	\$260mn	8.3%	95.8%
Axis	\$235mn	-	\$235mn	10.7%	107.1%
Hartford (P&C)	-	\$213mn	\$213mn	3.6%	96.3%
Travelers	\$86mn	\$114mn	\$200mn	1.4%	99.5%
CNA	\$13mn	\$182mn	\$195mn	5.6%	104.8%
WR Berkley	\$65mn	\$85mn	\$150mn	4.5%	97.8%
RenRe	\$104mn	-	\$104mn	5.4%	85.4%
Cincinnati	-	\$65mn	\$65mn	2.3%	100.8%
Hanover	\$13mn	\$6mn	\$19mn	1.4%	95.7%
RLI	\$5mn	\$6mn	\$11mn	2.6%	90.2%

The underwriting results were further worsened by the 15pt deterioration in North America personal underlying loss ratio, which were related to Covid-related shift in the business mix and the cessations under new quota share reinsurance agreements.

These negative developments were slightly offset by improved expense ratios across all segments.

The results were also hit by the \$276mn of private equity losses recognized with one-quarter lag within net investment income.

Key data points on the group-level results include:

- A 9.3pt deterioration on the cat ratio
- A 37.8% decline in net investment income, largely due to one-quarter lag in private equity funds' performance.
- Net written premium was down 15.7%, driven by a significant decline in personal insurance due to the Lloyd's syndicate quota share
- A \$7.9bn accounting loss, due to sale of Fortitude Re and net realized losses from variable annuity and interest rate hedges.
- Reported parent company liquidity of \$10.7bn

Exhibit: AIG earnings summary

Source: Company reports

(\$mn)	American International Group (General Insurance)					
Period:	Q2:19	Q3:19	Q4:19	Q1:20	Q2:20	VAR
Operating EPS cons	\$ 1.43	\$ 0.56	\$ 1.03	\$ 0.11	\$ 0.66	-54.0%
GWP	8,654	8,583	7,306	10,086	8,474	(2.1%)
NWP	6,581	6,648	5,830	5,921	5,549	(15.7%)
NEP	6,694	6,659	6,372	6,079	5,737	(14.3%)
NII	833	756	766	588	518	(37.8%)
U/W gain	147	(249)	12	(87)	(343)	(333.3%)
Adj.	0.0%	0.3%	(0.3%)	0.0%	0.0%	0.0pts
Cats	2.6%	7.5%	6.5%	6.9%	11.9%	9.3pts
PPD	(0.9%)	0.0%	(2.2%)	(0.9%)	(0.8%)	0.1pts
AY ex-cat LR	61.3%	61.5%	61.6%	60.8%	61.5%	0.2pts
Loss ratio	63.0%	69.3%	65.6%	66.8%	72.6%	9.6pts
Expense ratio	34.8%	34.4%	34.2%	34.7%	33.4%	(1.4)pts
Combined ratio	97.8%	103.7%	99.8%	101.5%	106.0%	8.2pts

Personal lines drive NWP lower

Although general insurance gross written premium was down only 2.1% to \$8.5bn, net written premium logged much higher decline of 15.7% percent due to increased reinsurance purchases.

The decrease was driven by a substantial decline in North America personal lines, where NWP fell \$1.1bn to negative \$150mn. The decline is a result of cessions associated with new quota share agreements and lower travel-related insurance volume.

In commercial, NWP was largely up across all product lines, except for liability lines where the premiums fell by 9.6%

Key data points by geography:

- **North America:** NWP was down 29% to \$2.3bn, driven by the decline in personal lines, partly offset by a 5.6% growth in commercial.
- **International:** NWP was down 2% on a reported basis or down 1% on a constant dollar basis. The firm attributed this to “strong rate improvement” and higher retention, offset by the decline in personal NWP due to Covid.

Key data points by line of business include:

- Property was up 9% to \$1.1bn.
- Specialty risks grew premiums 14.6% to \$1.2bn.
- Liability down 9.6% to \$820mn.
- Financial lines up 4.3% to \$1bn.
- Total personal down 45.3% to \$1.5bn, driven by 55.2% decline in personal lines.

Exhibit: AIG NWP by product line

Source: Company reports

AIG NWP by product line						
Period:	Q2:19	Q3:19	Q4:19	Q1:20	Q2:20	VAR
General Insurance						
Property	1,004	773	559	119	1,094	9.0%
Special Risks	1,012	1,231	963	1,787	1,160	14.6%
Liability	910	1,060	838	948	823	(9.6%)
Financial Lines	954	967	1,008	948	995	4.3%
Total Commercial	3,880	4,031	3,368	3,802	4,072	4.9%
Personal Lines	1,574	1,527	1,494	1,030	705	(55.2%)
Accident & Health	1,127	1,090	968	1,089	772	(31.5%)
Total Personal	2,701	2,617	2,462	2,119	1,477	(45.3%)
GI NWP	6,581	6,648	5,830	5,921	5,549	(15.7%)

AIG's firm-wide CR increased by 8.2pts to 106%.

The underwriting results weakened driven by:

- A 9.3pt **deterioration** in catastrophe ratio (8.0 pts – Covid, 2.2 pts – Civil unrest)
- A 0.2pt **deterioration** in the underlying loss ratio (significant increase in personal lines, almost completely offset by the improvement in all other segments)
- A 0.1pt **deterioration** in prior period development.

Partially offset by:

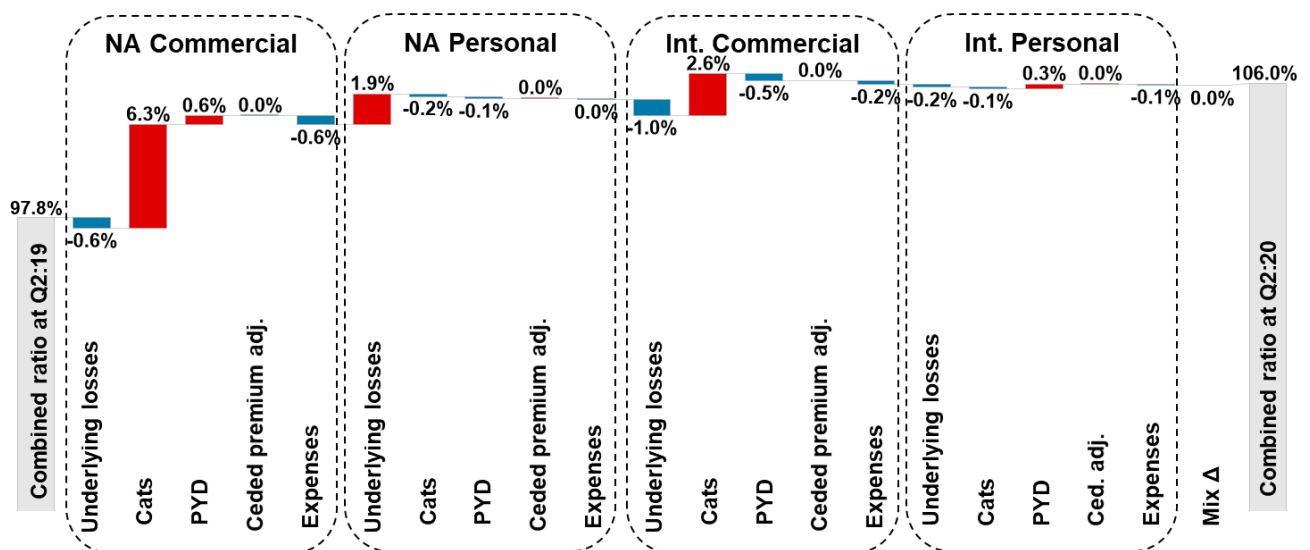
- A 1.4pt **improvement** in expense ratio, due to changes in business mix, and likely expense savings due to lower T&E activity.

By segment, North America commercial was the biggest contributor to the deterioration in underwriting results, having incurred most reserve charges related to Covid-related and civil unrest.

See Chart below.

Exhibit: AIG YoY combined ratio change breakdown

Source: Company reports, Inside P&C



NA Commercial Lines sees significant catastrophe losses

The North American Commercial lines business saw a substantial level of catastrophe losses (22.6pts on the combined, up 17.2pts YoY). The figure more than offset a 1.7pt decline in the underlying loss ratio and a 1.5pt improvement in the expense ratio.

Key data points include:

- The accident year loss ratio improved 1.7pts to 70.8%.
- Catastrophes contributed 22.6pts, up 17.2pts YoY.
- PPD removed 1.6pts from combined, 1.5pts less than last year.
- Expense ratio down 1.5pts to 25.2%.
- Combined ratio up 15.5pts to 117%.

Exhibit: AIG NA commercial lines performance results

Source: Company reports

(\$mn)	AIG, North America commercial					
Period:	Q2:19	Q3:19	Q4:19	Q1:20	Q2:20	VAR
NWP	2,364	2,502	1,990	2,225	2,497	5.6%
NEP	2,457	2,435	2,333	2,145	2,263	(7.9%)
<i>U/W gain</i>	(36)	(123)	(111)	(1)	(385)	969.4%
<i>Adj.</i>	0.0%	0.8%	(0.7%)	0.0%	0.0%	0.0pts
<i>Cats</i>	5.4%	6.4%	8.0%	6.7%	22.6%	17.2pts
<i>PPD</i>	(3.1%)	(1.6%)	2.1%	(2.2%)	(1.6%)	1.5pts
<i>AY ex-cat LR</i>	72.5%	75.3%	71.3%	68.2%	70.8%	(1.7)pts
<i>Loss ratio</i>	74.8%	80.9%	80.7%	72.7%	91.8%	17.0pts
<i>Expense ratio</i>	26.7%	24.1%	24.1%	27.3%	25.2%	(1.5)pts
Combined ratio	101.5%	105.0%	104.8%	100.0%	117.0%	15.5pts

International Commercial catastrophes offset by improved underlying loss ratio, PYD, and expense base

The international commercial lines combined ratio worsened 4pts to 100.8%, driven by substantially higher catastrophe losses, offset by an improved underlying result, PYD, and expense figure.

Key data points include:

- Accident year loss ratio improved 4.2pts to 57.4%
- Cats added 11.3pts to the combined, 11pts higher than last year.
- PPD removed 2.4pts from the combined, 2pts more than last year.
- Expense ratio improved 0.8pts to 34.5%.
- Combined ratio worsened 4pts to 100.8%.

Exhibit: AIG international commercial lines results

Source: Company reports

(\$mn)	AIG, International commercial					
Period:	Q2:19	Q3:19	Q4:19	Q1:20	Q2:20	VAR
NWP	1,516	1,528	1,379	1,577	1,575	3.9%
NEP	1,574	1,578	1,528	1,513	1,506	(4.3%)
<i>U/W gain</i>	51	(65)	(25)	(41)	(13)	(125.5%)
<i>Adj.</i>	0.0%	0.0%	0.0%	0.0%	0.0%	0.0pts
<i>Cats</i>	0.3%	8.0%	3.3%	11.3%	11.3%	11.0pts
<i>PPD</i>	(0.4%)	2.1%	1.1%	(2.5%)	(2.4%)	(2.0)pts
<i>AY ex-cat LR</i>	61.6%	57.8%	61.0%	58.2%	57.4%	(4.2)pts
<i>Loss ratio</i>	61.5%	67.9%	65.4%	67.0%	66.3%	4.8pts
<i>Expense ratio</i>	35.3%	36.2%	36.2%	35.6%	34.5%	(0.8)pts
Combined ratio	96.8%	104.1%	101.6%	102.6%	100.8%	4.0pts

NA Personal Lines sees 15pt increase in underlying loss ratio

The North American personal lines combined ratio deteriorated 12.3pts to 108.7%, driven by a 15pt deterioration in the underlying loss ratio to 61.7%.

Key data points include:

- Accident year loss ratio deteriorated 15pts to 61.7%.
- Catastrophes added 2.6pts to the combined, down 1.3pts YoY.
- PPD of 1.3pts was down 1.1pts YoY
- Expense ratio down 0.3 pts to 43.1%.
- Combined ratio worsened 12.3pts to 108.7% YoY.

Exhibit: AIG NA personal lines results

Source: Company reports

(\$mn)	AIG, North America personal					
Period:	Q2:19	Q3:19	Q4:19	Q1:20	Q2:20	VAR
NWP	943	902	824	545	(150)	(115.9%)
NEP	845	823	807	774	390	(53.8%)
U/W gain	31	(62)	92	(85)	(34)	(209.7%)
Adj.	0.0%	0.1%	(0.6%)	0.0%	0.0%	0.0pts
Cats	3.9%	9.0%	14.8%	7.9%	2.6%	(1.3)pts
PPD	2.4%	3.0%	(17.8%)	5.1%	1.3%	(1.1)pts
AY ex-cat LR	46.7%	52.1%	49.3%	57.8%	61.7%	15.0pts
<i>Loss ratio</i>	53.0%	64.2%	45.7%	70.8%	65.6%	12.6pts
<i>Expense ratio</i>	43.4%	43.4%	42.9%	40.2%	43.1%	(0.3)pts
Combined ratio	96.4%	107.6%	88.6%	111.0%	108.7%	12.3pts

International Personal Lines excluding top line contraction, margin items flat across the board

International personal lines saw a significant reduction in premium volumes, with a 7.5% decline in NWP to \$1.6bn. From a margin perspective, the unit was fairly flat with different line items up/down in the range of plus/minus 1pt. The segment's combined of 94.3% was down 0.2pts YoY.

Key data points include:

- Accident year loss ratio improved 0.7pts to 52.1%.
- Negative 0.4pts in catastrophes for the quarter, down from 0pts last year
- PPD up 1.1pts to 1.2%.
- Expense ratio down 0.2pts to 41.4%
- Combined ratio down 0.2pts to 94.3%.

Exhibit: AIG international personal lines results

Source: Company reports

(\$mn)	AIG, International personal					
Period:	Q2:19	Q3:19	Q4:19	Q1:20	Q2:20	VAR
NWP	1,758	1,716	1,637	1,574	1,627	(7.5%)
NEP	1,818	1,823	1,704	1,647	1,578	(13.2%)
U/W gain	101	1	56	40	89	(11.9%)
Adj.	0.0%	0.0%	0.0%	0.0%	0.0%	0.0pts
Cats	0.0%	8.0%	3.3%	2.7%	(0.4%)	(0.4)pts
PPD	0.1%	(1.1%)	(3.5%)	(0.6%)	1.2%	1.1pts
AY ex-cat LR	52.8%	50.5%	54.7%	54.8%	52.1%	(0.7)pts
<i>Loss ratio</i>	52.9%	57.4%	54.5%	56.9%	52.9%	0.0pts
<i>Expense ratio</i>	41.6%	42.5%	42.3%	40.7%	41.4%	(0.2)pts
Combined ratio	94.5%	99.9%	96.8%	97.6%	94.3%	(0.2)pts

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