AMERICAN FINANCIAL GROUP INC
Form 10-Q
November 06, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
Quarterly Report Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934
For the Quarterly Period Ended September 30, 2014 Commission File No. 1-13653

AMERICAN FINANCIAL GROUP, INC.
Incorporated under the Laws of Ohio IRS Employer I.D. No. 31-1544320
301 East Fourth Street, Cincinnati, Ohio 45202
(513) 579-2121

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes þ No ¨

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes þ No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No þ

As of November 1, 2014, there were 87,870,863 shares of the Registrant’s Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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PART I
ITEM I — FINANCIAL STATEMENTS
AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET (UNAUDITED)
(Dollars in Millions)

	September 30, 2014	December 31, 2013
Assets:		
Cash and cash equivalents	$ 1,310	$ 1,639
Investments:		
Fixed maturities, available for sale at fair value (amortized cost — $28,409 and $25,366)	29,965	26,456
Fixed maturities, trading at fair value	342	305
Equity securities, at fair value (cost — $1,279 and $987)	1,474	1,179
Mortgage loans	1,064	781
Policy loans	230	238
Real estate and other investments	766	715
Total cash and investments	35,151	31,313
Recoverables from reinsurers	3,134	3,157
Prepaid reinsurance premiums	587	408
Agents' balances and premiums receivable	901	739
Deferred policy acquisition costs	858	975
Assets of managed investment entities	2,946	2,888
Other receivables	1,140	854
Variable annuity assets (separate accounts)	649	665
Other assets	985	903
Goodwill	201	185
Total assets	$ 46,552	$ 42,087
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	$ 7,645	$ 6,410
Unearned premiums	2,114	1,757
Annuity benefits accumulated	23,044	20,944
Life, accident and health reserves	2,098	2,008
Payable to reinsurers	673	508
Liabilities of managed investment entities	2,625	2,567
Long-term debt	1,062	913
Variable annuity liabilities (separate accounts)	649	665
Other liabilities	1,564	1,546
Total liabilities	41,474	37,318
Shareholders' equity:		
Common Stock, no par value		
— 200,000,000 shares authorized	88	90
— 88,490,967 and 89,513,386 shares outstanding		
Capital surplus	1,150	1,123
Retained earnings:		
Appropriated — managed investment entities	2	49
Unappropriated	2,946	2,777

Accumulated other comprehensive income, net of tax	718	560
Total shareholders’ equity	4,904	4,599
Noncontrolling interests	174	170
Total equity	5,078	4,769
Total liabilities and equity	$ 46,552	$ 42,087

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF EARNINGS (UNAUDITED)
(In Millions, Except Per Share Data)

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Revenues:				
Property and casualty insurance net earned premiums	$1,132	$949	$2,817	$2,345
Life, accident and health net earned premiums	27	29	82	87
Net investment income	377	338	1,117	996
Realized gains on securities (*)	13	56	44	154
Income (loss) of managed investment entities:				
Investment income	29	32	84	98
Gain (loss) on change in fair value of assets/liabilities	(25)	15	(35)	(21)
Other income	28	24	75	71
Total revenues	1,581	1,443	4,184	3,730
Costs and Expenses:				
Property and casualty insurance:				
Losses and loss adjustment expenses	784	680	1,815	1,503
Commissions and other underwriting expenses	302	261	869	772
Annuity benefits	157	140	491	394
Life, accident and health benefits	37	42	119	120
Annuity and supplemental insurance acquisition expenses	46	40	122	128
Interest charges on borrowed money	18	18	53	54
Expenses of managed investment entities	19	22	60	68
Other expenses	73	98	219	248
Total costs and expenses	1,436	1,301	3,748	3,287
Earnings before income taxes	145	142	436	443
Provision for income taxes	54	44	155	155
Net earnings, including noncontrolling interests	91	98	281	288
Less: Net earnings (loss) attributable to noncontrolling interests	(25)	15	(44)	(25)
Net Earnings Attributable to Shareholders	$116	$83	$325	$313
Earnings Attributable to Shareholders per Common Share:				
Basic	$1.30	$0.94	$3.64	$3.51
Diluted	$1.28	$0.92	$3.56	$3.44
Average number of Common Shares:				
Basic	89.0	89.1	89.4	89.4
Diluted	90.9	91.0	91.4	91.2
Cash dividends per Common Share	$0.22	$0.195	$0.66	$0.585

(*) Consists of the following:

Realized gains before impairments	$24	$61	$57	$160
Losses on securities with impairment	(11)	(5)	(13)	(6)

Non-credit portion recognized in other comprehensive income (loss)	—	—	—	—
Impairment charges recognized in earnings	(11)	(5)	(13)	(6)
Total realized gains on securities	$13	$56	$44	$154

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (UNAUDITED)
(In Millions)

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Net earnings, including noncontrolling interests	$91	$98	$281	$288
Other comprehensive income (loss), net of tax:				
Net unrealized gains (losses) on securities:				
Unrealized holding gains (losses) on securities arising during the period	(73)	4	194	(162)
Reclassification adjustment for realized gains included in net earnings	(8)	(36)	(28)	(99)
Total net unrealized gains (losses) on securities	(81)	(32)	166	(261)
Foreign currency translation adjustments	(2)	3	(5)	(6)
Other comprehensive income (loss), net of tax	(83)	(29)	161	(267)
Total comprehensive income, net of tax	8	69	442	21
Less: Comprehensive income (loss) attributable to noncontrolling interests	(27)	15	(41)	(31)
Comprehensive income attributable to shareholders	$35	$54	$483	$52

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (UNAUDITED)
(Dollars in Millions)

	Shareholders' Equity							
	Common	Common Stock and Capital	Retained Earnings		Accumulated Other Comp		Noncon-trolling	Total
	Shares	Surplus	Approp.	Unapprop.	Inc. (Loss)	Total	Interests	Equity
Balance at December 31, 2013	89,513,386	$1,213	$49	$2,777	$560	$4,599	$170	$4,769
Net earnings	—	—	—	325	—	325	(44)	281
Other comprehensive income	—	—	—	—	158	158	3	161
Allocation of losses of managed investment entities	—	—	(47)	—	—	(47)	47	—
Dividends on Common Stock	—	—	—	(59)	—	(59)	—	(59)
Shares issued:								
Exercise of stock options	972,847	34	—	—	—	34	—	34
Other benefit plans	227,782	7	—	—	—	7	—	7
Dividend reinvestment plan	9,749	1	—	—	—	1	—	1
Stock-based compensation expense	—	14	—	—	—	14	—	14
Shares acquired and retired	(2,209,007)	(31)	—	(96)	—	(127)	—	(127)
Shares exchanged — benefit plans	(23,790)	—	—	(1)	—	(1)	—	(1)
Other	—	—	—	—	—	—	(2)	(2)
Balance at September 30, 2014	88,490,967	$1,238	$2	$2,946	$718	$4,904	$174	$5,078
Balance at December 31, 2012	88,979,303	$1,152	$75	$2,520	$831	$4,578	$170	$4,748
Net earnings	—	—	—	313	—	313	(25)	288
Other comprehensive loss	—	—	—	—	(261)	(261)	(6)	(267)
Allocation of losses of managed investment entities	—	—	(30)	—	—	(30)	30	—
Dividends on Common Stock	—	—	—	(52)	—	(52)	—	(52)
Shares issued:								
Exercise of stock options	1,350,551	44	—	—	—	44	—	44
Other benefit plans	376,574	6	—	—	—	6	—	6
Dividend reinvestment plan	10,514	—	—	—	—	—	—	—
	—	15	—	—	—	15	—	15

Stock-based compensation expense								
Shares acquired and retired	(1,448,156)	(19)	—	(51)	—	(70)	—	(70)
Shares exchanged — benefit plans	(45,179)	—	—	(1)	—	(1)	—	(1)
Other	—	—	—	—	—	—	(1)	(1)
Balance at September 30, 2013	89,223,607	$1,198	$45	$ 2,729	$ 570	$4,542	$168	$4,710

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)
(In Millions)

	Nine months ended September 30,	
	2014	2013
Operating Activities:		
Net earnings, including noncontrolling interests	$281	$288
Adjustments:		
Depreciation and amortization	95	110
Annuity benefits	491	394
Realized gains on investing activities	(48)	(162)
Net (purchases) sales of trading securities	(39)	20
Deferred annuity and life policy acquisition costs	(144)	(148)
Change in:		
Reinsurance and other receivables	(459)	(288)
Other assets	(38)	(108)
Insurance claims and reserves	505	(7)
Payable to reinsurers	162	126
Other liabilities	(92)	161
Managed investment entities’ assets/liabilities	(44)	(23)
Other operating activities, net	4	25
Net cash provided by operating activities	674	388
Investing Activities:		
Purchases of:		
Fixed maturities	(5,358)	(4,903)
Equity securities	(356)	(334)
Mortgage loans	(355)	(100)
Real estate, property and equipment	(34)	(43)
Businesses	(267)	—
Proceeds from:		
Maturities and redemptions of fixed maturities	2,252	2,356
Repayments of mortgage loans	74	97
Sales of fixed maturities	262	257
Sales of equity securities	97	278
Cash and cash equivalents of businesses acquired	1,078	—
Managed investment entities:		
Purchases of investments	(1,075)	(1,061)
Proceeds from sales and redemptions of investments	1,153	1,515
Other investing activities, net	94	25
Net cash used in investing activities	(2,435)	(1,913)
Financing Activities:		
Annuity receipts	2,725	2,852
Annuity surrenders, benefits and withdrawals	(1,289)	(1,157)
Net transfers from variable annuity assets	36	25
Additional long-term borrowings	145	—

Reductions of long-term debt	(1)	(40)
Issuances of managed investment entities' liabilities	538	747
Retirement of managed investment entities' liabilities	(571)	(1,196)
Issuances of Common Stock	35	45
Repurchases of Common Stock	(127)	(70)
Cash dividends paid on Common Stock	(59)	(52)
Other financing activities, net	—	(3)
Net cash provided by financing activities	1,432	1,151
Net Change in Cash and Cash Equivalents	(329)	(374)
Cash and cash equivalents at beginning of period	1,639	1,705
Cash and cash equivalents at end of period	$1,310	$1,331

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A. Accounting Policies

Basis of Presentation The accompanying consolidated financial statements for American Financial Group, Inc. ("AFG") and its subsidiaries are unaudited; however, management believes that all adjustments (consisting only of normal recurring accruals unless otherwise disclosed herein) necessary for fair presentation have been made. The results of operations for interim periods are not necessarily indicative of results to be expected for the year. The financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all information and footnotes necessary to be in conformity with U.S. generally accepted accounting principles.

Certain reclassifications have been made to prior periods to conform to the current year's presentation. All significant intercompany balances and transactions have been eliminated. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements. Events or transactions occurring subsequent to September 30, 2014, and prior to the filing of this Form 10-Q, have been evaluated for potential recognition or disclosure herein.

The preparation of the financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Changes in circumstances could cause actual results to differ materially from those estimates.

Fair Value Measurements Accounting standards define fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. The standards establish a hierarchy of valuation techniques based on whether the assumptions that market participants would use in pricing the asset or liability ("inputs") are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect AFG's assumptions about the assumptions market participants would use in pricing the asset or liability. Other than the recording of the acquisition of Summit Holding Southeast, Inc. and its related companies (see Note B — "Acquisitions"), AFG did not have any significant nonrecurring fair value measurements of nonfinancial assets and liabilities in the first nine months of 2014 or 2013.

Investments Fixed maturity and equity securities classified as "available for sale" are reported at fair value with unrealized gains and losses included in accumulated other comprehensive income ("AOCI") in AFG's Balance Sheet. Fixed maturity and equity securities classified as "trading" are reported at fair value with changes in unrealized holding gains or losses during the period included in net investment income. Mortgage and policy loans are carried primarily at the aggregate unpaid balance.

Premiums and discounts on fixed maturity securities are amortized using the interest method; mortgage-backed securities (“MBS”) are amortized over a period based on estimated future principal payments, including prepayments. Prepayment assumptions are reviewed periodically and adjusted to reflect actual prepayments and changes in expectations.

Gains or losses on securities are determined on the specific identification basis. When a decline in the value of a specific investment is considered to be other-than-temporary at the balance sheet date, a provision for impairment is charged to earnings (included in realized gains (losses) on securities) and the cost basis of that investment is reduced. If management can assert that it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will have to sell the security before recovery of its amortized cost basis, then the other-than-temporary impairment is separated into two components: (i) the amount related to credit losses (recorded in earnings) and (ii) the amount related to all other factors (recorded in other comprehensive income). The credit-related portion of an other-than-temporary impairment is measured by comparing a security’s amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge. Both components are shown in the Statement of Earnings. If management intends to sell an impaired security, or it is more likely than not that it will be required to sell the security before recovery, an impairment charge to earnings is recorded to reduce the amortized cost of that security to fair value.

Derivatives   Derivatives included in AFG’s Balance Sheet are recorded at fair value. Changes in fair value of derivatives are included in earnings, unless the derivatives are designated as cash flow hedges. Derivatives that do not qualify for hedge accounting under GAAP consist primarily of (i) components of certain fixed maturity securities (primarily interest-only MBS) and (ii) the equity-based component of certain annuity products (included in annuity benefits accumulated) and related call options (included in other investments) designed to be consistent with the characteristics of the liabilities and used to mitigate the risk embedded in those annuity products.

To qualify for hedge accounting, at the inception of a derivative contract, AFG formally documents the relationship between the terms of the hedge and the hedged items and its risk management objective. This documentation includes defining how hedge effectiveness and ineffectiveness will be measured on a retrospective and prospective basis. Changes in the fair value of derivatives that are designated and qualify as highly effective cash flow hedges are recorded in AOCI and are reclassified into earnings when the variability of the cash flows from the hedged items impact earnings. Any hedge ineffectiveness is immediately recorded in current period earnings. When the change in the fair value of a qualifying cash flow hedge is included in earnings, it is included in the same line item in the Consolidated Statement of Earnings as the cash flows from the hedged item. Qualifying highly effective cash flow hedges include interest rate swaps, which are used to mitigate interest rate risk related to certain floating-rate securities included in AFG’s portfolio of fixed maturity securities.

Goodwill   Goodwill represents the excess of cost of subsidiaries over AFG’s equity in their underlying net assets. Goodwill is not amortized, but is subject to an impairment test at least annually. An entity is not required to complete the quantitative annual goodwill impairment test on a reporting unit if the entity elects to perform a qualitative analysis and determines that it is more likely than not that the reporting unit’s fair value exceeds its carrying amount.

Reinsurance   Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policies. AFG’s property and casualty insurance subsidiaries report as assets (i) the estimated reinsurance recoverable on paid and unpaid losses, including an estimate for losses incurred but not reported, and (ii) amounts paid or due to reinsurers applicable to the unexpired terms of policies in force. Payable to reinsurers includes ceded premiums due to reinsurers as well as ceded premiums retained by AFG’s property and casualty insurance subsidiaries under contracts to fund ceded losses as they become due. AFG’s insurance subsidiaries also assume reinsurance from other companies. Earnings on reinsurance assumed is recognized based on information received from ceding companies.

A subsidiary cedes life insurance policies to a third party on a funds withheld basis whereby the subsidiary retains the assets (securities) associated with the reinsurance contract. Interest is credited to the reinsurer based on the actual investment performance of the retained assets. This reinsurance contract is considered to contain an embedded derivative (that must be adjusted to fair value) because the yield on the payable is based on a specific block of the ceding company’s assets, rather than the overall creditworthiness of the ceding company. AFG determined that changes in the fair value of the underlying portfolio of fixed maturity securities is an appropriate measure of the value of the embedded derivative. The securities related to this contract are classified as “trading.” The adjustment to fair value on the embedded derivative offsets the investment income recorded on the adjustment to fair value of the related trading portfolio.

Deferred Policy Acquisition Costs (“DPAC”) Policy acquisition costs (principally commissions, premium taxes and certain underwriting and policy issuance costs) directly related to the successful acquisition or renewal of an insurance contract are deferred. DPAC also includes capitalized costs associated with sales inducements offered to fixed annuity policyholders such as enhanced interest rates and premium and persistency bonuses.

For the property and casualty companies, DPAC is limited based upon recoverability without any consideration for anticipated investment income and is charged against income ratably over the terms of the related policies. A premium deficiency is recognized if the sum of expected claims costs, claims adjustment expenses and unamortized acquisition costs exceed the related unearned premiums. A premium deficiency is first recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency is greater than unamortized acquisition costs, a liability is accrued for the excess deficiency and reported with unpaid losses and loss adjustment expenses.

DPAC related to annuities is deferred to the extent deemed recoverable and amortized, with interest, in relation to the present value of actual and expected gross profits on the policies. Expected gross profits consist principally of estimated future investment margin (estimated future net investment income less interest credited on policyholder funds) and surrender, mortality, and other life and annuity policy charges, less death, annuitization and guaranteed withdrawal benefits in excess of account balances and estimated future policy administration expenses. To the extent that realized gains and losses result in adjustments to the amortization of DPAC related to annuities, such adjustments are reflected as components of realized gains (losses) on securities.

DPAC related to traditional life and health insurance is amortized over the expected premium paying period of the related policies, in proportion to the ratio of annual premium revenues to total anticipated premium revenues. See "Life, Accident and Health Reserves" below for details on the impact of loss recognition on the accounting for traditional life and health insurance contracts.

DPAC includes the present value of future profits on business in force of annuity and life, accident and health insurance companies acquired ("PVFP"). PVFP represents the portion of the costs to acquire companies that is allocated to the value of the right to receive future cash flows from insurance contracts existing at the date of acquisition. PVFP is amortized with interest in relation to expected gross profits of the acquired policies for annuities and universal life products and in relation to the premium paying period for traditional life and health insurance products.

DPAC and certain other balance sheet amounts related to annuity, long-term care and life businesses are also adjusted, net of tax, for the change in expense that would have been recorded if the unrealized gains (losses) from securities had actually been realized. These adjustments are included in unrealized gains (losses) on marketable securities, a component of AOCI in AFG's Balance Sheet.

Managed Investment Entities   A company is considered the primary beneficiary of, and therefore must consolidate, a variable interest entity ("VIE") based primarily on its ability to direct the activities of the VIE that most significantly impact that entity's economic performance and the obligation to absorb losses of, or receive benefits from, the entity that could potentially be significant to the VIE.

AFG manages, and has investments in, collateralized loan obligations ("CLOs") that are VIEs (see Note H — "Managed Investment Entities"). Both the management fees (payment of which is subordinate to other obligations of the CLOs) and the investments in the CLOs are considered variable interests. AFG has determined that it is the primary beneficiary of the CLOs because (i) its role as asset manager gives it the power to direct the activities that most significantly impact the economic performance of the CLOs and (ii) it has exposure to CLO losses (through its investments in the CLO debt tranches) and the right to receive benefits (through its subordinated management fees and returns on its investments), both of which could potentially be significant to the CLOs.

Because AFG has no right to use the CLO assets and no obligation to pay the CLO liabilities, the assets and liabilities of the CLOs are shown separately in AFG's Balance Sheet (at fair value). AFG has elected the fair value option for reporting on the CLO assets and liabilities to improve the transparency of financial reporting related to the CLOs. The excess of fair value of the CLOs' assets over the fair value of the liabilities is recorded in AFG's Balance Sheet as appropriated retained earnings — managed investment entities, representing amounts that ultimately will inure to the benefit of the CLO debt holders.

The net gain or loss from accounting for the CLO assets and liabilities at fair value is separately presented in AFG's Statement of Earnings. CLO earnings attributable to AFG's shareholders represent the change in fair value of AFG's investments in the CLOs (including distributions) and management fees earned. All other CLO earnings (losses) are not attributable to AFG's shareholders and will ultimately inure to the benefit of the CLO debt holders. As a result, such CLO earnings (losses) are included in net earnings (loss) attributable to noncontrolling interests in AFG's Statement of Earnings and in appropriated retained earnings — managed investment entities in the Balance Sheet. As the CLOs approach maturity (2016 to 2026), it is expected that losses attributable to noncontrolling interests will reduce appropriated retained earnings towards zero as the fair values of the assets and liabilities converge and the CLO assets are used to pay the CLO debt.

At September 30, 2014, assets and liabilities of managed investment entities included $153 million in assets and $124 million in liabilities of a temporary warehousing entity that was established in connection with the formation of a new CLO that is expected to close in the fourth quarter of 2014. Upon closing, all warehoused assets are expected to be transferred to the new CLO and the liabilities will be repaid.

In August 2014, the FASB issued Accounting Standards Update ("ASU") 2014-13 to address the diversity in practice regarding the accounting for assets and liabilities of a consolidated collateralized financing entity (such as a CLO) when an election has been made to account for that entity's assets and liabilities at fair value. As discussed above, the fair values of a CLO's assets may differ from the fair values of its liabilities even though the liabilities only have recourse to the assets, which results in "appropriated retained earnings — managed investment entities" in AFG's Balance Sheet. Under ASU 2014-13, AFG will have the option to set the carrying value of the CLO liabilities equal to the fair value of the CLO assets (which have more observable fair values) as an alternative to reporting those liabilities at fair value. Under this alternative, CLO earnings attributable to AFG's shareholders would continue to be measured by the change in the fair value of AFG's investments in the CLOs and management fees earned. However, as a result of setting the carrying value of the CLO liabilities equal to the fair value of the CLO assets, there would no longer be any excess carrying value of CLO assets over the carrying value of CLO liabilities to be reported as "appropriated retained earnings — managed investment entities" in AFG's Balance Sheet or any CLO earnings to be attributed to noncontrolling interests in AFG's Statement of Earnings. If AFG elects to continue to measure both the CLO assets and liabilities at fair value, ASU 2014-13 will require amounts currently reflected as "appropriated retained earnings — managed investment entities" to be reclassified to unappropriated retained earnings in the Balance Sheet and amounts currently attributed to noncontrolling interests in the Statement of Earnings to be included in earnings attributable to AFG shareholders. AFG will be required to adopt this guidance effective on January 1, 2016, but may elect to early adopt the guidance as of January 1, 2015 (as permitted). AFG expects to elect the alternative measurement guidance, which is not expected to have a material impact on AFG's net earnings attributable to shareholders. Management is currently evaluating the early adoption provisions, transition guidance and overall impact of the ASU on AFG's Consolidated Financial Statements.

Unpaid Losses and Loss Adjustment Expenses   The net liabilities stated for unpaid claims and for expenses of investigation and adjustment of unpaid claims represent management's best estimate and are based upon (i) the accumulation of case estimates for losses reported prior to the close of the accounting period on direct business written; (ii) estimates received from ceding reinsurers and insurance pools and associations; (iii) estimates of unreported losses (including possible development on known claims) based on past experience; (iv) estimates based on experience of expenses for investigating and adjusting claims; and (v) the current state of the law and coverage litigation. Establishing reserves for asbestos, environmental and other mass tort claims involves considerably more judgment than other types of claims due to, among other things, inconsistent court decisions, an increase in bankruptcy filings as a result of asbestos-related liabilities, novel theories of coverage, and judicial interpretations that often expand theories of recovery and broaden the scope of coverage.

Loss reserve liabilities are subject to the impact of changes in claim amounts and frequency and other factors. Changes in estimates of the liabilities for losses and loss adjustment expenses are reflected in the Statement of Earnings in the period in which determined. Despite the variability inherent in such estimates, management believes that the liabilities for unpaid losses and loss adjustment expenses are adequate.

Annuity Benefits Accumulated   Annuity receipts and benefit payments are recorded as increases or decreases in annuity benefits accumulated rather than as revenue and expense. Increases in this liability for interest credited are charged to expense and decreases for policy charges are credited to other income.

For certain products, annuity benefits accumulated also includes reserves for accrued persistency and premium bonuses, guaranteed withdrawals and excess benefits expected to be paid on future deaths and annuitizations ("EDAR"). The liabilities for EDAR and guaranteed withdrawals are accrued for and modified using assumptions consistent with those used in determining DPAC and DPAC amortization, except that amounts are determined in relation to the present value of total expected assessments. Total expected assessments consist principally of estimated future investment margin, surrender, mortality, and other life and annuity policy charges, and unearned revenues once they are recognized as income.

Annuity benefits accumulated also includes amounts advanced from the Federal Home Loan Bank of Cincinnati.

Unearned Revenue Certain upfront policy charges on annuities are deferred as unearned revenue (included in other liabilities) and recognized in net earnings using the same assumptions and estimated gross profits used to amortize DPAC.

Life, Accident and Health Reserves Liabilities for future policy benefits under traditional life, accident and health policies are computed using the net level premium method. Computations are based on the original projections of investment yields, mortality, morbidity and surrenders and include provisions for unfavorable deviations unless a loss recognition event (premium deficiency) occurs. Claim reserves and liabilities established for accident and health claims are modified as necessary to reflect actual experience and developing trends.

For long-duration contracts (such as traditional life and long-term care policies), loss recognition occurs when, based on current expectations as of the measurement date, existing contract liabilities plus the present value of future premiums (including reasonably expected rate increases) are not expected to cover the present value of future claims payments and related settlement and maintenance costs (excluding overhead) as well as unamortized acquisition costs. If a block of business is determined to be in loss recognition, a charge is recorded in earnings in an amount equal to the excess of the present value of expected future claims costs and unamortized acquisition costs over existing reserves plus the present value of expected future premiums (with no provision for adverse deviation). The charge is recorded first to reduce unamortized acquisition costs and then as an additional reserve (if unamortized acquisition costs have been reduced to zero).

In addition, reserves for traditional life and long-term care policies are subject to adjustment for loss recognition charges that would have been recorded if the unrealized gains from securities had actually been realized. This adjustment is included in unrealized gains (losses) on marketable securities, a component of AOCI in AFG's Balance Sheet.

Variable Annuity Assets and Liabilities   Separate accounts related to variable annuities represent the fair value of deposits invested in underlying investment funds on which AFG earns a fee. Investment funds are selected and may be changed only by the policyholder, who retains all investment risk.

AFG's variable annuity contracts contain a guaranteed minimum death benefit ("GMDB") to be paid if the policyholder dies before the annuity payout period commences. In periods of declining equity markets, the GMDB may exceed the value of the policyholder's account. A GMDB liability is established for future excess death benefits using assumptions together with a range of reasonably possible scenarios for investment fund performance that are consistent with DPAC capitalization and amortization assumptions.

Premium Recognition   Property and casualty premiums are earned generally over the terms of the policies on a pro rata basis. Unearned premiums represent that portion of premiums written which is applicable to the unexpired terms of policies in force. On reinsurance assumed from other insurance companies or written through various underwriting organizations, unearned premiums are based on information received from such companies and organizations. For traditional life, accident and health products, premiums are recognized as revenue when legally collectible from policyholders. For interest-sensitive life and universal life products, premiums are recorded in a policyholder account, which is reflected as a liability. Revenue is recognized as amounts are assessed against the policyholder account for mortality coverage and contract expenses.

Noncontrolling Interests   For Balance Sheet purposes, noncontrolling interests represents the interests of shareholders other than AFG in consolidated entities. In the Statement of Earnings, net earnings and losses attributable to noncontrolling interests represents such shareholders' interest in the earnings and losses of those entities.

Income Taxes   Deferred income taxes are calculated using the liability method. Under this method, deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases and are measured using enacted tax rates. A valuation allowance is established to reduce total deferred tax assets to an amount that will more likely than not be realized.

AFG recognizes the tax benefits of uncertain tax positions only when the position is more likely than not to be sustained under examination by the appropriate taxing authority. Interest and penalties on AFG's reserve for uncertain tax positions are recognized as a component of tax expense.

Stock-Based Compensation   All share-based grants are recognized as compensation expense on a straight-line basis over their vesting periods based on their calculated fair value at the date of grant. AFG uses the Black-Scholes pricing model to measure the fair value of employee stock options. See Note K — “Shareholders’ Equity” for further information.

Benefit Plans   AFG provides retirement benefits to qualified employees of participating companies through the AFG 401(k) Retirement and Savings Plan, a defined contribution plan. AFG makes all contributions to the retirement fund portion of the plan and matches a percentage of employee contributions to the savings fund. Company contributions are expensed in the year for which they are declared. AFG and many of its subsidiaries provide health care and life insurance benefits to eligible retirees. AFG also provides postemployment benefits to former or inactive employees (primarily those on disability) who were not deemed retired under other company plans. The projected future cost of providing these benefits is expensed over the period employees earn such benefits.

Earnings Per Share   Although basic earnings per share only considers shares of common stock outstanding during the period, the calculation of diluted earnings per share includes the following adjustments to weighted average common shares related to stock-based compensation plans: third quarter of 2014 and 2013 — 1.9 million and 1.9 million; first nine months of 2014 and 2013 — 2.0 million and 1.8 million, respectively.

AFG’s weighted average diluted shares outstanding excludes the following anti-dilutive potential common shares related to stock compensation plans: third quarter of 2014 and 2013 — 1.2 million and 1.0 million; first nine months of 2014 and 2013 — 1.0 million and 1.3 million, respectively. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2014 and 2013 periods.

Statement of Cash Flows   For cash flow purposes, “investing activities” are defined as making and collecting loans and acquiring and disposing of debt or equity instruments and property and equipment. “Financing activities” include obtaining resources from owners and providing them with a return on their investments, borrowing money and repaying amounts borrowed. Annuity receipts, surrenders, benefits and withdrawals are also reflected as financing activities. All other activities are considered “operating.” Short-term investments having original maturities of three months or less when purchased are considered to be cash equivalents for purposes of the financial statements.

B. Acquisitions

On March 27, 2014, AFG completed a renewal rights agreement with Selective Insurance Company of America to acquire Selective’s pooled public entity book of business for $8 million. At the acquisition date, this book of business had approximately $38 million in in-force gross written premiums.

On April 1, 2014, AFG acquired Summit Holding Southeast, Inc. and its related companies (“Summit”), from Liberty Mutual Insurance for $259 million using cash on hand at the parent company. Immediately following the acquisition, AFG made a capital contribution of $140 million, bringing its total capital investment in the Summit business to $399 million. Summit is based in Lakeland, Florida and is a leading provider of specialty workers’ compensation solutions in the southeastern United States with over $500 million in net written premiums in 2013. Summit continues to operate under the Summit brand as a member of AFG’s Great American Insurance Group. Summit is included in the Specialty casualty sub-segment and generated a total of $268 million in net earned premiums in the second and third quarters of 2014.

Expenses related to the acquisition were less than $1 million and were expensed as incurred. The purchase price was allocated to the acquired assets and liabilities of Summit based on management's best estimate of fair value as of the acquisition date. The allocation of the purchase price is shown in the table below (in millions):

Total purchase price		$259
Tangible assets acquired:		
Cash and cash equivalents	$1,078	
Fixed maturities, available for sale	92	
Recoverables from reinsurers	116	
Agents' balances and premiums receivable	41	
Deferred tax assets, net (a)	67	
Other receivables	21	
Other assets	11	
Total tangible assets acquired		1,426
Liabilities acquired:		
Unpaid losses and loss adjustment expenses	1,142	
Unearned premiums	3	
Payable to reinsurers	3	
Other liabilities	66	
Total liabilities acquired		1,214
Net tangible assets acquired, at fair value		212
Excess purchase price over net tangible assets acquired		$47
Allocation of excess purchase price:		
Intangible assets acquired (b)		$47
Deferred tax on intangible assets acquired (a)		(16)
Goodwill		16
		$47

(a) Included with AFG's net deferred tax liabilities, which are included in Other liabilities in AFG's Consolidated Balance Sheet.
(b) Included in Other assets in AFG's Consolidated Balance Sheet.

AFG believes that the agents' balances and other acquired receivables are collectible. The intangible assets acquired include $1 million in indefinite lived intangible assets related to state insurance licenses and $46 million in finite lived intangibles, primarily related to agency relationships. The finite lived intangibles will be amortized over an average life of 7 years. The fair value of the acquired liability for unpaid losses and loss adjustment expenses and related recoverables from reinsurers was estimated by discounting actuarial projected future net cash flows using the U.S. Treasury yield curve (with an adjustment for the illiquidity of insurance reserves) and then adding a risk adjustment to reflect the net present value of the profit that a market participant would require in return for the assumption of the risk associated with the reserves. The fair value of Summit's agency relationship was estimated using a multi-period excess earnings method, which is a form of the income approach. The acquisition resulted in the recognition of $16 million in non-deductible goodwill based on the excess of the purchase price over the fair value of the net assets acquired. The goodwill represents the fair value of acquired intangible assets that do not qualify for separate recognition, including the value of Summit's assembled workforce.

C. Segments of Operations

AFG manages its business as four segments: (i) Property and casualty insurance, (ii) Annuity, (iii) Run-off long-term care and life and (iv) Other, which includes holding company costs and the operations attributable to the noncontrolling interests of the managed investment entities.

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes physical damage and liability coverage for buses, trucks and recreational vehicles, inland and ocean marine, agricultural-related products and other property coverages, (ii) Specialty casualty, which includes primarily excess and surplus, general liability, executive liability, professional liability, umbrella and excess liability, specialty coverage in targeted markets, customized programs for small to mid-sized businesses and workers' compensation insurance, and (iii) Specialty financial, which includes risk management insurance programs for leasing and financing institutions (including collateral and lender-placed mortgage property insurance), surety and fidelity products and trade credit insurance. Premiums and underwriting profit included under Other specialty represent business assumed by AFG's internal reinsurance program from the operations that make up AFG's other Specialty sub-segments and amortization of deferred gains on retroactive reinsurance transactions related to the sales of businesses in prior years. AFG's annuity business markets traditional fixed and fixed-indexed annuities in the retail, financial institutions and education markets. AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services. The following tables (in millions) show AFG's revenues and earnings before income taxes by segment and sub-segment.

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Revenues				
Property and casualty insurance:				
Premiums earned:				
Specialty				
Property and transportation	$504	$517	$1,129	$1,111
Specialty casualty	486	289	1,266	825
Specialty financial	115	121	348	350
Other specialty	27	22	74	59
Total premiums earned	1,132	949	2,817	2,345
Net investment income	76	65	219	196
Other income	4	1	8	10
Total property and casualty insurance	1,212	1,015	3,044	2,551
Annuity:				
Net investment income	287	259	851	764
Other income	20	17	57	46
Total annuity	307	276	908	810
Run-off long-term care and life	48	50	147	147
Other	1	46	41	68
Total revenues before realized gains	1,568	1,387	4,140	3,576
Realized gains on securities	13	56	44	154
Total revenues	$1,581	$1,443	$4,184	$3,730

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	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Earnings Before Income Taxes				
Property and casualty insurance:				
Underwriting:				
Specialty				
Property and transportation	$11	$16	$(1)	$(5)
Specialty casualty	32	19	100	70
Specialty financial	21	22	46	50
Other specialty	6	5	13	16
Other lines (a)	(24)	(54)	(25)	(61)
Total underwriting	46	8	133	70
Investment and other income, net	64	53	180	169
Total property and casualty insurance	110	61	313	239
Annuity (b)	86	78	243	231
Run-off long-term care and life	1	(4)	(3)	(7)
Other (c)	(65)	(49)	(161)	(174)
Total earnings before realized gains and income taxes	132	86	392	289
Realized gains on securities	13	56	44	154
Total earnings before income taxes	$145	$142	$436	$443

(a) Includes special charges of $24 million and $54 million in the third quarter of 2014 and 2013, respectively, to increase asbestos and environmental (“A&E”) reserves.

(b) Includes a $5 million charge in the second quarter of 2013 to cover expected assessments from state guaranty funds related to the insolvency and liquidation of an unaffiliated life insurance company.

(c) Includes holding company expenses and earnings (losses) of managed investment entities attributable to noncontrolling interest of ($29) million and $12 million for the third quarter and ($47) million and ($30) million for the first nine months of 2014 and 2013, respectively. Holding company expenses includes special charges totaling $6 million in the third quarter of 2014 and $22 million in the third quarter of 2013 to increase A&E reserves related to AFG’s former railroad and manufacturing operations.

D. Fair Value Measurements

Accounting standards for measuring fair value are based on inputs used in estimating fair value. The three levels of the hierarchy are as follows:

Level 1 — Quoted prices for identical assets or liabilities in active markets (markets in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis). AFG's Level 1 financial instruments consist primarily of publicly traded equity securities and highly liquid government bonds for which quoted market prices in active markets are available and short-term investments of managed investment entities.

Level 2 — Quoted prices for similar instruments in active markets; quoted prices for identical or similar assets or liabilities in inactive markets (markets in which there are few transactions, the prices are not current, price quotations vary substantially over time or among market makers, or in which little information is released publicly); and valuations based on other significant inputs that are observable in active markets. AFG's Level 2 financial instruments include separate account assets, corporate and municipal fixed maturity securities, mortgage-backed securities ("MBS") and investments of managed investment entities priced using observable inputs. Level 2 inputs include benchmark yields, reported trades, corroborated broker/dealer quotes, issuer spreads and benchmark securities. When non-binding broker quotes can be corroborated by comparison to similar securities priced using observable inputs, they are classified as Level 2.

Level 3 — Valuations derived from market valuation techniques generally consistent with those used to estimate the fair values of Level 2 financial instruments in which one or more significant inputs are unobservable or when the market for a security exhibits significantly less liquidity relative to markets supporting Level 2 fair value measurements. The unobservable inputs may include management's own assumptions about the assumptions market participants would use based on the best information available in the circumstances. AFG's Level 3 is comprised of financial instruments, including liabilities of managed investment entities, whose fair value is estimated based on non-binding broker quotes or internally developed using significant inputs not based on, or corroborated by, observable market information.

AFG's management is responsible for the valuation process and uses data from outside sources (including nationally recognized pricing services and broker/dealers) in establishing fair value. AFG's internal investment professionals are a group of approximately 20 analysts whose primary responsibility is to manage AFG's investment portfolio. These professionals monitor individual investments as well as overall industries and are active in the financial markets on a daily basis. The group is led by AFG's chief investment officer, who reports directly to one of AFG's Co-CEOs. Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by AFG's internal investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, these investment managers consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. In addition, the Company communicates directly with the pricing service regarding the methods and assumptions used in pricing, including verifying, on a test basis, the inputs used by the service to value specific securities.

Assets and liabilities measured and carried at fair value in the financial statements are summarized below (in millions):

	Level 1	Level 2	Level 3	Total
September 30, 2014				
Assets:				
Available for sale ("AFS") fixed maturities:				
U.S. Government and government agencies	$168	$182	$15	$365
States, municipalities and political subdivisions	—	6,304	66	6,370
Foreign government	—	204	—	204
Residential MBS	—	4,326	263	4,589
Commercial MBS	—	2,464	27	2,491
Asset-backed securities ("ABS")	—	3,440	179	3,619
Corporate and other	30	11,855	442	12,327
Total AFS fixed maturities	198	28,775	992	29,965
Trading fixed maturities	30	312	—	342
Equity securities	1,305	88	81	1,474
Assets of managed investment entities ("MIE")	281	2,636	29	2,946
Variable annuity assets (separate accounts) (*)	—	649	—	649
Other investments — derivatives	—	288	—	288
Total assets accounted for at fair value	$1,814	$32,748	$1,102	$35,664
Liabilities:				
Liabilities of managed investment entities	$242	$—	$2,383	$2,625
Derivatives in annuity benefits accumulated	—	—	1,085	1,085
Other liabilities — derivatives	—	13	—	13
Total liabilities accounted for at fair value	$242	$13	$3,468	$3,723
December 31, 2013				
Assets:				
Available for sale fixed maturities:				
U.S. Government and government agencies	$147	$152	$15	$314
States, municipalities and political subdivisions	—	5,311	61	5,372
Foreign government	—	208	—	208
Residential MBS	—	3,994	316	4,310
Commercial MBS	—	2,696	28	2,724
Asset-backed securities	—	2,418	75	2,493
Corporate and other	28	10,672	335	11,035
Total AFS fixed maturities	175	25,451	830	26,456
Trading fixed maturities	—	305	—	305
Equity securities	1,023	125	31	1,179
Assets of managed investment entities	266	2,592	30	2,888
Variable annuity assets (separate accounts) (*)	—	665	—	665
Other investments — derivatives	—	274	—	274
Total assets accounted for at fair value	$1,464	$29,412	$891	$31,767
Liabilities:				
Liabilities of managed investment entities	$156	$—	$2,411	$2,567
Derivatives in annuity benefits accumulated	—	—	804	804

Other liabilities — derivatives	—	10	—	10
Total liabilities accounted for at fair value	$156	$10	$3,215	$3,381

(*) Variable annuity liabilities equal the fair value of variable annuity assets.

During the third quarter ended September 30, 2014, there were no transfers from Level 1 to Level 2. During the nine months ended September 30, 2014, nine perpetual preferred stocks with an aggregate fair value of $55 million were transferred from Level 1 to Level 2 due to insufficient trade data to warrant classification in Level 1. During the third quarter and nine months ended September 30, 2014, there were fourteen perpetual preferred stocks with an aggregate fair value of $96 million transferred from Level 2 to Level 1 as a result of increases in trade frequency sufficient to warrant classification in Level 1. During the first nine months of 2013 (in the third quarter), there was one perpetual preferred stock with a fair value of $10 million transferred from Level 1 to Level 2 due to a decrease in trade frequency, resulting in lack of available trade data sufficient to warrant classification in Level 1. Transfers from Level 2 to Level 1 for the third quarter and nine months ended September 30, 2013 included six and ten perpetual preferred stocks with an aggregate fair value of $46 million and one common stock with a fair value of $16 million. In addition, for the nine months ended September 30, 2013, one mandatory redeemable preferred stock with a fair value of $11 million was transferred from Level 2 to Level 1. All Level 2 to Level 1 transfers were a result of increases in trade frequency sufficient to warrant classification in Level 1. Approximately 3% of the total assets carried at fair value on September 30, 2014, were Level 3 assets. Approximately 85% ($919 million) of the Level 3 assets were priced using non-binding broker quotes, for which there is a lack of transparency as to the inputs used to determine fair value. Details as to the quantitative inputs are neither provided by the brokers nor otherwise reasonably obtainable by AFG. Since internally developed Level 3 asset fair values represent less than one-half of 1% of the total assets measured at fair value and approximately 2% of AFG's shareholders' equity, changes in unobservable inputs used to determine internally developed fair values would not have a material impact on AFG's financial position.

The fair values of the liabilities of managed investment entities were determined using primarily non-binding broker quotes, which were reviewed by AFG's investment professionals. AFG's investment professionals are familiar with the cash flow models used by the brokers to determine the fair value of these liabilities and review the broker quotes based on their knowledge of the CLO market and the market for the underlying assets. Their review includes consideration of expected reinvestment, default and recovery rates on the assets supporting the CLO liabilities, as well as surveying general CLO liability fair values and analysis provided by third parties.

The only significant Level 3 assets or liabilities carried at fair value in the financial statements that were not measured using broker quotes are the derivatives embedded in AFG's fixed-indexed annuity liabilities, which are measured using a discounted cash flow approach and had a fair value of $1.09 billion at September 30, 2014. The following table presents information about the unobservable inputs used by management in determining fair value of these embedded derivatives. See Note F — "Derivatives."

Unobservable Input	Range
Adjustment for insurance subsidiary's credit risk	0.30% – 1.60% over the risk free rate
Risk margin for uncertainty in cash flows	0.3% reduction in the discount rate
Surrenders	4% – 16% of indexed account value
Partial surrenders	2% – 6% of indexed account value
Annuitizations	1% – 2% of indexed account value
Deaths	1.5% – 2.5% of indexed account value
Budgeted option costs	2.5% – 4.0% of indexed account value

The range of adjustments for insurance subsidiary's credit risk reflects credit spread variations across the yield curve. The range of projected surrender rates reflects the specific surrender charges and other features of AFG's individual fixed-indexed annuity products with an expected range of 6% to 12% in the majority of future calendar years (4% to 16% over all periods). Increasing the budgeted option cost or risk margin for uncertainty in cash flows assumptions in the table above would increase the fair value of the fixed-indexed annuity embedded derivatives, while increasing any of the other unobservable inputs in the table above would decrease the fair value of the embedded derivatives.

Changes in balances of Level 3 financial assets and liabilities carried at fair value during the third quarter and first nine months of 2014 and 2013 are presented below (in millions). The transfers into and out of Level 3 were due to changes in the availability of market observable inputs. All transfers are reflected in the table at fair value as of the end of the reporting period.

	Balance at June 30, 2014	Total realized/unrealized gains (losses) included in Net income	Other comprehensive income (loss)	Purchases and issuances	Sales and Settlements	Transfer into Level 3	Transfer out of Level 3	Balance at September 30, 2014
AFS fixed maturities:								
U.S. government agency	$15	$—	$ —	$—	$ —	$—	$—	$15
State and municipal	61	(1)	(1)	—	—	7	—	66
Residential MBS	256	—	(1)	8	(8)	20	(12)	263
Commercial MBS	28	(1)	—	—	—	—	—	27
Asset-backed securities	204	—	(3)	8	(7)	—	(23)	179
Corporate and other	313	(1)	1	51	(13)	91	—	442
Equity securities	81	—	(2)	2	—	—	—	81
Assets of MIE	27	—	—	3	(1)	—	—	29
Liabilities of MIE (*)	(2,322)	5	—	(135)	69	—	—	(2,383)
Embedded derivatives	(1,026)	(21)	—	(51)	13	—	—	(1,085)

(*) Total realized/unrealized gains (losses) included in net income includes gains of $6 million related to liabilities outstanding as of September 30, 2014. See Note H — “Managed Investment Entities.”

	Balance at June 30, 2013	Total realized/unrealized gains (losses) included in Net income	Other comprehensive income (loss)	Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at September 30, 2013
AFS fixed maturities:								
U.S. government agency	$20	$—	$ (1)	$—	$—	$—	$—	$19
State and municipal	63	—	(1)	—	—	—	—	62
Residential MBS	329	1	8	—	(13)	43	(47)	321
Commercial MBS	28	1	(1)	—	—	—	—	28
Asset-backed securities	180	—	—	—	(4)	11	(1)	186
Corporate and other	295	—	(4)	6	(3)	—	(4)	290

Equity securities	78	(2)	—	—	—	—	(19)	57
Assets of MIE	31	—	—	—	—	—	—	31
Liabilities of MIE (*)	(2,482)	17	—	(95)	236	—	—	(2,324)
Embedded derivatives	(577)	(33)	—	(53)	10	—	—	(653)

(*) Total realized/unrealized gains (losses) included in net income includes gains of $20 million related to liabilities outstanding as of September 30, 2013. See Note H — “Managed Investment Entities.”

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	Balance at December 31, 2013	Total realized/unrealized gains (losses) included in Net income	Other comprehensive income (loss)	Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at September 30, 2014
AFS fixed maturities:								
U.S. government agency	$15	$—	$ —	$—	$—	$—	$—	$15
State and municipal	61	(1)	(1)	—	—	7	—	66
Residential MBS	316	3	5	8	(23)	58	(104)	263
Commercial MBS	28	(1)	—	—	—	—	—	27
Asset-backed securities	75	3	(2)	68	(23)	81	(23)	179
Corporate and other	335	4	4	72	(59)	91	(5)	442
Equity securities	31	1	2	48	(9)	22	(14)	81
Assets of MIE	30	(2)	—	3	(2)	—	—	29
Liabilities of MIE (*)	(2,411)	(3)	—	(335)	366	—	—	(2,383)
Embedded derivatives	(804)	(153)	—	(162)	34	—	—	(1,085)

(*) Total realized/unrealized gains (losses) included in net income includes gains of $12 million related to liabilities outstanding as of September 30, 2014. See Note H — “Managed Investment Entities.”

	Balance at December 31, 2012	Total realized/unrealized gains (losses) included in Net income	Other comprehensive income (loss)	Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at September 30, 2013
AFS fixed maturities:								
U.S. government agency	$20	$—	$ (1)	$—	$—	$—	$—	$19
State and municipal	58	—	(2)	10	—	—	(4)	62
Residential MBS	371	5	7	6	(42)	68	(94)	321
Commercial MBS	22	—	(1)	—	—	7	—	28
Asset-backed securities	253	3	(2)	12	(49)	11	(42)	186
Corporate and other	236	—	(14)	61	(9)	24	(8)	290
Equity securities	37	(2)	2	48	—	—	(28)	57
Assets of MIE	40	(3)	—	6	(6)	—	(6)	31
Liabilities of MIE (*)	(2,745)	(22)	—	(501)	925	—	19	(2,324)
Embedded derivatives	(465)	(110)	—	(102)	24	—	—	(653)

(*) Total realized/unrealized gains (losses) included in net income includes gains of $2 million related to liabilities outstanding as of September 30, 2013. See Note H — “Managed Investment Entities.”

Fair Value of Financial Instruments The carrying value and fair value of financial instruments that are not carried at fair value in the financial statements are summarized below (in millions):

	Carrying Value	Fair Value	Level 1	Level 2	Level 3
September 30, 2014					
Financial assets:					
Cash and cash equivalents	$1,310	$1,310	$1,310	$—	$—
Mortgage loans	1,064	1,063	—	—	1,063
Policy loans	230	230	—	—	230
Total financial assets not accounted for at fair value	$2,604	$2,603	$1,310	$—	$1,293
Financial liabilities:					
Annuity benefits accumulated (*)	$22,839	$22,286	$—	$—	$22,286
Long-term debt	1,062	1,164	—	1,089	75
Total financial liabilities not accounted for at fair value	$23,901	$23,450	$—	$1,089	$22,361
December 31, 2013					
Financial assets:					
Cash and cash equivalents	$1,639	$1,639	$1,639	$—	$—
Mortgage loans	781	779	—	—	779
Policy loans	238	238	—	—	238
Total financial assets not accounted for at fair value	$2,658	$2,656	$1,639	$—	$1,017
Financial liabilities:					
Annuity benefits accumulated (*)	$20,741	$19,959	$—	$—	$19,959
Long-term debt	913	985	—	909	76
Total financial liabilities not accounted for at fair value	$21,654	$20,944	$—	$909	$20,035

(*) Excludes life contingent annuities in the payout phase.

The carrying amount of cash and cash equivalents approximates fair value. Fair values for mortgage loans are estimated by discounting the future contractual cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings. The fair value of policy loans is estimated to approximate carrying value; policy loans have no defined maturity dates and are inseparable from insurance contracts. The fair value of annuity benefits was estimated based on expected cash flows discounted using forward interest rates adjusted for the Company's credit risk and includes the impact of maintenance expenses and capital costs. Fair values of long-term debt are based primarily on quoted market prices.

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E. Investments

Available for sale fixed maturities and equity securities at September 30, 2014 and December 31, 2013, consisted of the following (in millions):

	September 30, 2014				December 31, 2013			
	Amortized	Fair	Gross Unrealized		Amortized	Fair	Gross Unrealized	
	Cost	Value	Gains	Losses	Cost	Value	Gains	Losses
Fixed maturities:								
U.S. Government and government agencies	$360	$365	$7	$(2)	$310	$314	$7	$(3)
States, municipalities and political subdivisions	6,103	6,370	294	(27)	5,360	5,372	156	(144)
Foreign government	195	204	9	—	198	208	10	—
Residential MBS	4,189	4,589	416	(16)	3,947	4,310	391	(28)
Commercial MBS	2,328	2,491	163	—	2,535	2,724	192	(3)
Asset-backed securities	3,601	3,619	37	(19)	2,477	2,493	35	(19)
Corporate and other	11,633	12,327	725	(31)	10,539	11,035	604	(108)
Total fixed maturities	$28,409	$29,965	$1,651	$(95)	$25,366	$26,456	$1,395	$(305)
Common stocks	$908	$1,088	$216	$(36)	$721	$914	$209	$(16)
Perpetual preferred stocks	$371	$386	$19	$(4)	$266	$265	$9	$(10)

The non-credit related portion of other-than-temporary impairment charges is included in other comprehensive income. Cumulative non-credit charges taken for securities still owned at September 30, 2014 and December 31, 2013, respectively, were $222 million and $229 million. Gross unrealized gains on such securities at September 30, 2014 and December 31, 2013 were $154 million and $150 million, respectively. Gross unrealized losses on such securities at September 30, 2014 and December 31, 2013 were $7 million and $13 million, respectively. These amounts represent the non-credit other-than-temporary impairment charges recorded in AOCI adjusted for subsequent changes in fair values and nearly all relate to residential MBS.

The following tables show gross unrealized losses (in millions) on fixed maturities and equity securities by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2014 and December 31, 2013.

	Less Than Twelve Months			Twelve Months or More		
	Unrealized Loss	Fair Value	Fair Value as % of Cost	Unrealized Loss	Fair Value	Fair Value as % of Cost
September 30, 2014						
Fixed maturities:						
U.S. Government and government agencies	$—	$22	100 %	$(2)	$15	88 %
States, municipalities and political subdivisions	(7)	617	99 %	(20)	566	97 %
Foreign government	—	84	100 %	—	—	— %
Residential MBS	(4)	330	99 %	(12)	225	95 %
Commercial MBS	—	44	100 %	—	11	100 %
Asset-backed securities	(10)	1,490	99 %	(9)	485	98 %
Corporate and other	(13)	1,277	99 %	(18)	580	97 %
Total fixed maturities	$(34)	$3,864	99 %	$(61)	$1,882	97 %
Common stocks	$(36)	$278	89 %	$—	$—	— %
Perpetual preferred stocks	$(1)	$61	98 %	$(3)	$57	95 %
December 31, 2013						
Fixed maturities:						
U.S. Government and government agencies	$(3)	$60	95 %	$—	$—	— %
States, municipalities and political subdivisions	(135)	2,219	94 %	(9)	73	89 %
Residential MBS	(9)	553	98 %	(19)	212	92 %
Commercial MBS	(3)	106	97 %	—	2	100 %
Asset-backed securities	(18)	1,310	99 %	(1)	28	97 %
Corporate and other	(101)	2,634	96 %	(7)	85	92 %
Total fixed maturities	$(269)	$6,882	96 %	$(36)	$400	92 %
Common stocks	$(16)	$158	91 %	$—	$—	— %
Perpetual preferred stocks	$(6)	$91	94 %	$(4)	$20	83 %

At September 30, 2014, the gross unrealized losses on fixed maturities of $95 million relate to 824 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 80% of the gross unrealized loss and 89% of the fair value.

AFG analyzes its MBS securities for other-than-temporary impairment each quarter based upon expected future cash flows. Management estimates expected future cash flows based upon its knowledge of the MBS market, cash flow projections (which reflect loan to collateral values, subordination, vintage and geographic concentration) received from independent sources, implied cash flows inherent in security ratings and analysis of historical payment data. In the first nine months of 2014, AFG recorded less than $1 million in other-than-temporary impairment charges related to its residential MBS.

Management believes AFG will recover its cost basis in the securities with unrealized losses and that AFG has the ability to hold the securities until they recover in value and had no intent to sell them at September 30, 2014.

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A progression of the credit portion of other-than-temporary impairments on fixed maturity securities for which the non-credit portion of an impairment has been recognized in other comprehensive income is shown below (in millions).

	2014	2013
Balance at June 30	$175	$191
Additional credit impairments on:		
Previously impaired securities	—	—
Securities without prior impairments	—	—
Reductions due to sales or redemptions	(2)	—
Balance at September 30	$173	$191
Balance at January 1	$194	$192
Additional credit impairments on:		
Previously impaired securities	—	—
Securities without prior impairments	—	—
Reductions due to sales or redemptions	(21)	(1)
Balance at September 30	$173	$191

The table below sets forth the scheduled maturities of available for sale fixed maturities as of September 30, 2014 (in millions). Securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

	Amortized Cost	Fair Value Amount	%
Maturity			
One year or less	$812	$826	3%
After one year through five years	4,144	4,483	15%
After five years through ten years	7,910	8,277	27%
After ten years	5,425	5,680	19%
	18,291	19,266	64%
ABS (average life of approximately 3-1/2 years)	3,601	3,619	12%
MBS (average life of approximately 4-1/2 years)	6,517	7,080	24%
Total	$28,409	$29,965	100%

Certain risks are inherent in connection with fixed maturity securities, including loss upon default, price volatility in reaction to changes in interest rates, and general market factors and risks associated with reinvestment of proceeds due to prepayments or redemptions in a period of declining interest rates.
There were no investments in individual issuers that exceeded 10% of Shareholders’ Equity at September 30, 2014 or December 31, 2013.

Net Unrealized Gain on Marketable Securities In addition to adjusting equity securities and fixed maturity securities classified as "available for sale" to fair value, GAAP requires that deferred policy acquisition costs and certain other balance sheet amounts related to annuity, long-term care and life businesses be adjusted to the extent that unrealized gains and losses from securities would result in adjustments to those balances had the unrealized gains or losses actually been realized. The following table shows (in millions) the components of the net unrealized gain on securities that is included in AOCI in AFG's Balance Sheet.

	Pretax	Deferred Tax and Amounts Attributable to Noncontrolling Interests	Net
September 30, 2014			
Unrealized gain on:			
Fixed maturities — annuity segment (*)	$1,077	$ (377)	$700
Fixed maturities — all other	479	(177)	302
Equity securities	195	(71)	124
Deferred policy acquisition costs — annuity segment	(496)	174	(322)
Annuity benefits accumulated	(108)	38	(70)
Life, accident and health reserves	(41)	13	(28)
Unearned revenue	30	(10)	20
	$1,136	$ (410)	$726
December 31, 2013			
Unrealized gain on:			
Fixed maturities — annuity segment (*)	$729	$ (255)	$474
Fixed maturities — all other	361	(133)	228
Equity securities	192	(70)	122
Deferred policy acquisition costs — annuity segment	(345)	121	(224)
Annuity benefits accumulated	(71)	25	(46)
Life, accident and health reserves	(8)	3	(5)
Unearned revenue	22	(8)	14
	$880	$ (317)	$563

(*) Unrealized gains on fixed maturity investments supporting AFG's annuity benefits accumulated.

Net Investment Income The following table shows (in millions) investment income earned and investment expenses incurred.

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Investment income:				
Fixed maturities	$342	$310	$1,007	$920
Equity securities	16	15	48	36
Equity in earnings of partnerships and similar investments	2	—	15	—
Other	20	17	56	52
Gross investment income	380	342	1,126	1,008

Investment expenses	(3)	(4)	(9)	(12)
Net investment income	$377	$338	$1,117	$996

Equity in the earnings of partnerships has not been material and was included in realized gains (losses) on securities prior to 2014.

Realized gains (losses) and changes in unrealized appreciation (depreciation) related to fixed maturity and equity security investments are summarized as follows (in millions):

	Fixed Maturities	Equity Securities	Mortgage Loans and Other Investments	Other (a)	Tax Effects	Noncon-trolling Interests	Total
Quarter ended September 30, 2014							
Realized before impairments	$ 10	$ 16	$ (1)	$ (1)	$ (10)	$ —	$ 14
Realized — impairments	(9)	(5)	—	3	5	—	(6)
Change in unrealized	(145)	(40)	—	60	44	2	(79)
Quarter ended September 30, 2013							
Realized before impairments	$ 6	$ 54	$ —	$ 1	$ (22)	$ (1)	$ 38
Realized — impairments	—	(5)	—	—	2	—	(3)
Change in unrealized	(57)	(28)	—				