AMERICAN FINANCIAL GROUP INC
Form 10-Q
November 06, 2015

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, 2015 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, 2015, there were 87,349,107 shares of the Registrant’s Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

TABLE OF CONTENTS

	Page
Part I — Financial Information	
Item 1 — Financial Statements:	
Consolidated Balance Sheet	2
Consolidated Statement of Earnings	3
Consolidated Statement of Comprehensive Income	4
Consolidated Statement of Changes in Equity	5
Consolidated Statement of Cash Flows	6
Notes to Consolidated Financial Statements	7
Item 2 — Management's Discussion and Analysis of Financial Condition and Results of Operations	36
Item 3 — Quantitative and Qualitative Disclosure about Market Risk	87
Item 4 — Controls and Procedures	87
Part II — Other Information	
Item 2 — Unregistered Sales of Equity Securities and Use of Proceeds	87
Item 6 — Exhibits	88
Signature	88

Table of Contents
AMERICAN FINANCIAL GROUP, INC. 10-Q

PART I
ITEM I — FINANCIAL STATEMENTS
AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET (UNAUDITED)
(Dollars in Millions)

	September 30, 2015	December 31, 2014
Assets:		
Cash and cash equivalents	$ 894	$ 1,343
Investments:		
Fixed maturities, available for sale at fair value (amortized cost — $31,868 and $29,074)	33,114	30,734
Fixed maturities, trading at fair value	269	266
Equity securities, available for sale at fair value (cost — $1,590 and $1,283)	1,658	1,501
Equity securities, trading at fair value	173	195
Mortgage loans	994	1,117
Policy loans	221	228
Real estate and other investments	809	826
Total cash and investments	38,132	36,210
Recoverables from reinsurers	3,151	3,238
Prepaid reinsurance premiums	604	469
Agents' balances and premiums receivable	976	889
Deferred policy acquisition costs	993	821
Assets of managed investment entities	3,613	3,108
Other receivables	1,241	910
Variable annuity assets (separate accounts)	595	662
Other assets	1,051	1,027
Goodwill	201	201
Total assets	$ 50,557	$ 47,535
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	$ 8,061	$ 7,872
Unearned premiums	2,238	1,956
Annuity benefits accumulated	26,026	23,764
Life, accident and health reserves	2,159	2,175
Payable to reinsurers	724	645
Liabilities of managed investment entities	3,287	2,819
Long-term debt	880	1,061
Variable annuity liabilities (separate accounts)	595	662
Other liabilities	1,681	1,527
Total liabilities	45,651	42,481
Shareholders' equity:		
Common Stock, no par value		
— 200,000,000 shares authorized	87	88
— 87,327,172 and 87,708,793 shares outstanding		
Capital surplus	1,195	1,152
Retained earnings:		
Appropriated — managed investment entities	—	(2)
Unappropriated	2,981	2,914

Accumulated other comprehensive income, net of tax	461	727
Total shareholders’ equity	4,724	4,879
Noncontrolling interests	182	175
Total equity	4,906	5,054
Total liabilities and equity	$ 50,557	$ 47,535

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,	
	2015	2014	2015	2014
Revenues:				
Property and casualty insurance net earned premiums	$1,173	$1,132	$3,104	$2,817
Life, accident and health net earned premiums	28	27	80	82
Net investment income	425	377	1,217	1,117
Realized gains (losses) on:				
Securities (*)	(16)	13	2	44
Subsidiaries	5	—	(157)	—
Income (loss) of managed investment entities:				
Investment income	40	29	112	84
Loss on change in fair value of assets/liabilities	(11)	(25)	(16)	(35)
Other income	40	28	177	75
Total revenues	1,684	1,581	4,519	4,184
Costs and Expenses:				
Property and casualty insurance:				
Losses and loss adjustment expenses	825	784	2,002	1,815
Commissions and other underwriting expenses	336	302	987	869
Annuity benefits	208	157	543	491
Life, accident and health benefits	31	37	96	119
Annuity and supplemental insurance acquisition expenses	46	46	148	122
Interest charges on borrowed money	18	18	57	53
Expenses of managed investment entities	28	19	80	60
Other expenses	93	73	251	219
Total costs and expenses	1,585	1,436	4,164	3,748
Earnings before income taxes	99	145	355	436
Provision for income taxes	33	54	115	155
Net earnings, including noncontrolling interests	66	91	240	281
Less: Net earnings (loss) attributable to noncontrolling interests	3	(25)	17	(44)
Net Earnings Attributable to Shareholders	$63	$116	$223	$325
Earnings Attributable to Shareholders per Common Share:				
Basic	$0.72	$1.30	$2.54	$3.64
Diluted	$0.71	$1.28	$2.49	$3.56
Average number of Common Shares:				
Basic	87.5	89.0	87.6	89.4
Diluted	89.3	90.9	89.4	91.4
Cash dividends per Common Share	$0.25	$0.22	$0.75	$0.66

(*) Consists of the following:				
Realized gains before impairments	$19	$24	$71	$57

Losses on securities with impairment	(35)	(11)	(69)	(13)
Non-credit portion recognized in other comprehensive income (loss)	—	—	—	—
Impairment charges recognized in earnings	(35)	(11)	(69)	(13)
Total realized gains (losses) on securities	$(16)	$13	$2	$44

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

	Three months ended September 30,		Nine months ended September 30,	
	2015	2014	2015	2014
Net earnings, including noncontrolling interests	$66	$91	$240	$281
Other comprehensive income (loss), net of tax:				
Net unrealized gains (losses) on securities:				
Unrealized holding gains (losses) on securities arising during the period	(110)	(73)	(255)	194
Reclassification adjustment for realized (gains) losses included in net earnings	10	(8)	(3)	(28)
Total net unrealized gains (losses) on securities	(100)	(81)	(258)	166
Net unrealized gains on cash flow hedges	2	—	2	—
Foreign currency translation adjustments	(7)	(2)	(15)	(5)
Pension and other postretirement plans adjustments	1	—	1	—
Other comprehensive income (loss), net of tax	(104)	(83)	(270)	161
Total comprehensive income (loss), net of tax	(38)	8	(30)	442
Less: Comprehensive income (loss) attributable to noncontrolling interests	1	(27)	13	(41)
Comprehensive income (loss) attributable to shareholders	$(39)	$35	$(43)	$483

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

	Shareholders' Equity							
	Common Shares	Common Stock and Capital Surplus	Retained Earnings Approp.	Retained Earnings Unapprop.	Accumulated Other Comp Inc. (Loss)	Total	Noncon-trolling Interests	Total Equity
Balance at December 31, 2014	87,708,793	$ 1,240	$ (2)	$ 2,914	$ 727	$ 4,879	$ 175	$ 5,054
Cumulative effect of accounting change	—	—	2	—	—	2	—	2
Net earnings	—	—	—	223	—	223	17	240
Other comprehensive loss	—	—	—	—	(266)	(266)	(4)	(270)
Dividends on Common Stock	—	—	—	(66)	—	(66)	—	(66)
Shares issued:								
Exercise of stock options	1,157,288	46	—	—	—	46	—	46
Other benefit plans	268,947	6	—	—	—	6	—	6
Dividend reinvestment plan	10,359	1	—	—	—	1	—	1
Stock-based compensation expense	—	14	—	—	—	14	—	14
Shares acquired and retired	(1,767,240)	(25)	—	(88)	—	(113)	—	(113)
Shares exchanged — benefit plans	(33,795)	—	—	(2)	—	(2)	—	(2)
Forfeitures of restricted stock	(17,180)	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	(6)	(6)
Balance at September 30, 2015	87,327,172	$ 1,282	$ —	$ 2,981	$ 461	$ 4,724	$ 182	$ 4,906
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
	—	14	—	—	—	14	—	14

Stock-based compensation expense								
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

5

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

	Nine months ended September 30,	
	2015	2014
Operating Activities:		
Net earnings, including noncontrolling interests	$240	$281
Adjustments:		
Depreciation and amortization	118	95
Annuity benefits	543	491
Realized (gains) losses on investing activities	90	(48)
Net purchases of trading securities	(9)	(39)
Deferred annuity and life policy acquisition costs	(164)	(144)
Change in:		
Reinsurance and other receivables	(468)	(459)
Other assets	68	(38)
Insurance claims and reserves	491	505
Payable to reinsurers	79	162
Other liabilities	(45)	(92)
Managed investment entities' assets/liabilities	(53)	(44)
Other operating activities, net	17	4
Net cash provided by operating activities	907	674
Investing Activities:		
Purchases of:		
Fixed maturities	(5,395)	(5,358)
Equity securities	(449)	(356)
Mortgage loans	(105)	(355)
Real estate, property and equipment	(65)	(34)
Businesses	—	(267)
Proceeds from:		
Maturities and redemptions of fixed maturities	2,426	2,252
Repayments of mortgage loans	231	74
Sales of fixed maturities	235	262
Sales of equity securities	193	97
Sales of real estate, property and equipment	96	11
Cash and cash equivalents of businesses acquired	—	1,078
Managed investment entities:		
Purchases of investments	(1,167)	(1,075)
Proceeds from sales and redemptions of investments	685	1,153
Other investing activities, net	(100)	83
Net cash used in investing activities	(3,415)	(2,435)
Financing Activities:		
Annuity receipts	3,333	2,725
Annuity surrenders, benefits and withdrawals	(1,487)	(1,289)
Net transfers from variable annuity assets	32	36

Additional long-term borrowings	—	145
Reductions of long-term debt	(182)	(1)
Issuances of managed investment entities’ liabilities	693	538
Retirements of managed investment entities’ liabilities	(192)	(571)
Issuances of Common Stock	47	35
Repurchases of Common Stock	(113)	(127)
Cash dividends paid on Common Stock	(65)	(59)
Other financing activities, net	(7)	—
Net cash provided by financing activities	2,059	1,432
Net Change in Cash and Cash Equivalents	(449)	(329)
Cash and cash equivalents at beginning of period	1,343	1,639
Cash and cash equivalents at end of period	$894	$1,310

INDEX TO NOTES

A. Accounting Policies
B. Acquisitions and Sale of Businesses
C. Segments of Operations
D. Fair Value Measurements
E. Investments
F. Derivatives
G. Deferred Policy Acquisition Costs
H. Managed Investment Entities
I. Goodwill and Other Intangibles
J. Long-Term Debt
K. Shareholders' Equity
L. Income Taxes
M. Contingencies

A. Accounting Policies

Basis of Presentation The accompanying consolidated financial statements for American Financial Group, Inc. and its subsidiaries ("AFG") 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 ("GAAP").

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, 2015, 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 recording an estimated loss on the pending sale of its long-term care business (see Note B — "Acquisitions and Sale of Businesses"), AFG did not have any significant nonrecurring fair value measurements in the first nine months of 2015.

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 and qualify as highly effective 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 impacts 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. AFG uses interest rate swaps that qualify as highly effective cash flow hedges to mitigate interest rate risk related to certain floating-rate securities included in AFG's portfolio of fixed maturity securities.

For derivatives that are designated and qualify as highly effective fair value hedges, changes in the fair value of the derivative, along with changes in the fair value of the hedged item attributable to the hedged risk, are recognized in current period earnings. AFG has entered into an interest rate swap that qualifies as a highly effective fair value hedge to mitigate the interest rate risk associated with fixed-rate long-term debt by economically converting certain fixed-rate debt obligations to floating-rate obligations. Since the terms of the swap match the terms of the hedged debt, changes in the fair value of the swap are offset by changes in the fair value of the hedged debt attributable to changes in interest rates. Accordingly, the net impact on AFG's current period earnings is that the interest expense associated with the hedged debt is effectively recorded at the floating rate.

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.

In February 2015, the Financial Accounting Standards Board issued Accounting Standards Update (“ASU”) 2015-02, which amends certain consolidation accounting guidance, including the VIE guidance that applies to collateralized financing entities such as CLOs. The new guidance, which AFG intends to adopt effective January 1, 2016, will affect how fee arrangements with CLO asset managers impact the determination of the primary beneficiary of these entities. Due to the significance of AFG’s investments in the CLOs that it manages, management does not expect the new guidance to impact the consolidation of its currently outstanding CLOs. The new guidance also impacts the consolidation analysis that applies to limited partnerships and similar entities. Management does not expect this guidance to impact the accounting for AFG’s existing investments in those entities.

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. 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 net gain or loss from accounting for the CLO assets and liabilities at fair value is presented separately in AFG’s Statement of Earnings.

Effective January 1, 2015, AFG adopted (on a modified retrospective basis) ASU 2014-13, which addresses 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. The fair values of a CLO's assets may differ from the separately measured fair values of its liabilities even though the CLO liabilities only have recourse to the CLO assets. Under the new guidance, AFG has elected 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 a separately measured fair value. CLO earnings attributable to AFG's shareholders continue to be measured by the change in the fair value of AFG's investments in the CLOs and management fees earned.

Prior to the adoption of this guidance, measuring both the CLO assets and CLO liabilities at separately determined fair values resulted in a difference between the carrying value of the CLO assets and the carrying value of the CLO liabilities that was not attributable to AFG's ownership interest in the CLOs and CLO earnings (losses) that were not attributable to AFG's shareholders. Accordingly, in periods prior to 2015, the difference between the fair value of the CLO assets and the fair value of the CLO liabilities was recorded as "appropriated retained earnings — managed investment entities" in AFG's Balance Sheet and the earnings (losses) that were not attributable to AFG's shareholders were included in net earnings (loss) attributable to noncontrolling interests in AFG's Statement of Earnings.

Under the guidance adopted in 2015, there is no longer 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. In accordance with the guidance, the amount reported as "appropriated retained earnings — managed investment entities" at December 31, 2014 was reclassified to "liabilities of managed investment entities" on January 1, 2015 as the cumulative effect of an accounting change. While the new guidance impacted the presentation of individual CLO-related line items in AFG's Statement of Earnings, it had no overall impact on AFG's Net Earnings Attributable to Shareholders.

At September 30, 2015, assets and liabilities of managed investment entities included $92 million in assets and $77 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 first quarter of 2016. Upon closing, all warehoused assets are expected to be transferred to the new CLO and the liabilities will be repaid.

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 2015 and 2014 — 1.8 million and 1.9 million; first nine months of 2015 and 2014 — 1.8 million and 2.0 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 2015 and 2014 — 0.9 million and 1.2 million; first nine months of 2015 and 2014 — 1.2 million and 1.0 million, respectively. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2015 and 2014 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 and Sale of Businesses

Acquisition of Summit Holding Southeast, Inc. 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, which is based in Lakeland, Florida and is a leading provider of specialty workers' compensation solutions in the southeastern United States, generated $539 million in net written premiums in 2014, including $410 million after the acquisition date. 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 $128 million and $386 million in net earned premiums in the third quarter and first nine months of 2015, respectively.

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) AFG's net deferred tax assets are included in Other assets in AFG's Consolidated Balance Sheet at September 30, 2015.
(b) Included in Other assets in AFG's Consolidated Balance Sheet.

Acquisition of Renewal Rights 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. The acquired business generated $33 million of gross written premiums and $23 million of net written premiums in 2014.

Sale of Long-term Care Business AFG ceased new sales of long-term care insurance, which is included in the run-off long-term care and life segment, in January 2010. AFG has continued to service and accept renewal premiums on its outstanding policies, which are guaranteed renewable. On April 13, 2015, AFG reached an agreement to sell substantially all of its run-off long-term care insurance business to HC2 Holdings, Inc. ("HC2") for an initial payment of $7 million in cash and HC2 securities (subject to adjustment based on certain items, including operating results through the closing date). AFG may also receive up to $13 million of additional proceeds from HC2 in the future based on the release of certain statutory liabilities of the legal entities sold by AFG. The legal entities involved in the

transaction, United Teacher Associates Insurance Company and Continental General Insurance Company, contain substantially all of AFG’s long-term care insurance reserves, as well as smaller blocks of annuity and life insurance business. The transaction is expected to close before the end of 2015, subject to customary conditions, including receipt of required regulatory approvals.

Including the significant tax benefit from the sale, AFG expects to receive after-tax proceeds of between $105 million and $115 million from the transaction (based on final proceeds received and final net assets at closing), excluding any potential additional proceeds from the release of statutory liabilities.

Based on the status of ongoing negotiations at the end of the first quarter, management determined that the potential sale of the run-off long-term care business met the GAAP “held for sale” criteria as of March 31, 2015. Accordingly, AFG recorded a loss

in the first quarter of 2015 to establish a liability (included in other liabilities in AFG's Balance Sheet) equal to the excess of the net carrying value of the assets and liabilities to be disposed over the estimated net sale proceeds. The loss may be adjusted at the closing date based on the final proceeds received and final net assets disposed. At March 31, 2015, and September 30, 2015, the carrying value of the assets and liabilities to be disposed represented approximately 4% of both AFG's assets and liabilities and are detailed in the table below.

Under accounting guidance effective on January 1, 2015, only disposals of components of an entity that represent a strategic shift and that have a major effect on a reporting entity's operations and financial results are reported as discontinued operations. Due to the run-off nature of the business and the immaterial expected impact on AFG's results of operations, the pending sale of AFG's long-term care insurance business has not been reported as a discontinued operation.

The estimated impact of the pending sale of the run-off long-term care insurance business, which was recorded in AFG's financial statements as of March 31, 2015, is shown below (in millions):

Estimated sale proceeds (*)	$14
Assets of businesses sold:	
Cash and investments	$1,397
Recoverables from reinsurers	603
Deferred policy acquisition costs	15
Other receivables	14
Other assets	7
Goodwill	2
Total assets	2,038
Liabilities of businesses sold:	
Annuity benefits accumulated	270
Life, accident and health reserves	1,537
Other liabilities	27
Total liabilities	1,834
Reclassify net unrealized gain on marketable securities	28
Net assets of businesses sold	$176
Pretax loss on subsidiaries recorded in the first quarter of 2015	$(162)

(*) Includes fair value of the potential additional consideration and is shown net of estimated expenses.

Revenues, costs and expenses, and earnings before income taxes for the subsidiaries to be sold were (in millions):

	Three months ended September 30,		Nine months ended September 30,	
	2015	2014	2015	2014
Life, accident and health net earned premiums:				
Long-term care	$19	$18	$56	$56
Life operations	3	3	8	8
Net investment income	19	18	56	57
Realized gains (losses) on securities and other income	(4)	(1)	(6)	1

Total revenues	37	38	114	122
Annuity benefits	2	2	6	6
Life, accident and health benefits:				
Long-term care	21	27	67	84
Life operations	3	3	8	9
Annuity and supplemental insurance acquisition expenses	3	3	9	10
Other expenses	4	3	13	10
Total costs and expenses	33	38	103	119
Earnings before income taxes	$4	$—	$11	$3

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,	
	2015	2014	2015	2014
Revenues				
Property and casualty insurance:				
Premiums earned:				
Specialty				
Property and transportation	$517	$504	$1,157	$1,129
Specialty casualty	503	486	1,496	1,266
Specialty financial	131	115	380	348
Other specialty	22	27	71	74
Total premiums earned	1,173	1,132	3,104	2,817
Net investment income	83	76	245	219
Other income (*)	2	4	61	8
Total property and casualty insurance	1,258	1,212	3,410	3,044
Annuity:				
Net investment income	317	287	915	851
Other income	22	20	68	57
Total annuity	339	307	983	908
Run-off long-term care and life	49	48	144	147
Other	49	1	137	41
Total revenues before realized gains (losses)	1,695	1,568	4,674	4,140
Realized gains (losses) on securities	(16)	13	2	44

Realized gain (loss) on subsidiaries	5	—	(157)	—
Total revenues	$1,684	$1,581	$4,519	$4,184

(*) Includes pretax income of $51 million (before noncontrolling interest) from the sale of the Le Pavillon Hotel in the second quarter of 2015.

15

Table of Contents

	Three months ended September 30,		Nine months ended September 30,	
	2015	2014	2015	2014
Earnings Before Income Taxes				
Property and casualty insurance:				
Underwriting:				
Specialty				
Property and transportation	$20	$11	$14	$(1)
Specialty casualty	31	32	96	100
Specialty financial	26	21	72	46
Other specialty	7	6	13	13
Other lines (a)	(69)	(24)	(70)	(25)
Total underwriting	15	46	125	133
Investment and other income, net (b)	75	64	272	180
Total property and casualty insurance	90	110	397	313
Annuity	67	86	230	243
Run-off long-term care and life	6	1	14	(3)
Other (c)	(53)	(65)	(131)	(161)
Total earnings before realized gains (losses) and income taxes	110	132	510	392
Realized gains (losses) on securities	(16)	13	2	44
Realized gain (loss) on subsidiaries	5	—	(157)	—
Total earnings before income taxes	$99	$145	$355	$436

(a) Includes special charges of $67 million and $24 million in the third quarter of 2015 and 2014, respectively, to increase asbestos and environmental (“A&E”) reserves.

(b) Includes pretax income of $51 million (before noncontrolling interest) from the sale of the Le Pavillon Hotel in the second quarter of 2015.

(c) Primarily holding company expenses, including a $4 million loss on retirement of debt in the third quarter of 2015 and special charges of $12 million and $6 million in the third quarters of 2015 and 2014, respectively, to increase A&E reserves related to AFG’s former railroad and manufacturing operations. Also includes losses of managed investment entities attributable to noncontrolling interest of $29 million for the third quarter and $47 million for the first nine months of 2014. Following the adoption of new guidance in the first quarter of 2015, there are no longer earnings (losses) of managed investment entities that are attributable to noncontrolling interests. See Note A — “Accounting Policies — Managed Investment Entities.”

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 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, and prior to 2015 certain liabilities of the CLOs.

Under new guidance adopted in the first quarter of 2015, discussed in Note A — "Accounting Policies — Managed Investment Entities," AFG has elected 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 separately measured fair values. Following the adoption of the new guidance, the CLO liabilities are categorized within the fair value hierarchy on the same basis (proportionally) as the related CLO assets. Since the portion of the CLO liabilities allocated to Level 3 is derived from the fair value of the CLO assets, beginning with the first quarter of 2015, these amounts are excluded from the progression of Level 3 financial instruments.

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.

In April 2015, AFG reached an agreement to sell all of its run-off long-term care insurance business. As discussed in Note B — "Acquisitions and Sale of Businesses," AFG recorded a loss in the first quarter of 2015 to write down the net carrying value of the assets and liabilities to be disposed to the estimated net sale proceeds of $14 million (estimated fair value less costs to sell). The estimate of fair value was derived using significant unobservable inputs (Level 3).

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, 2015				
Assets:				
Available for sale (“AFS”) fixed maturities:				
U.S. Government and government agencies	$115	$205	$15	$335
States, municipalities and political subdivisions	—	7,073	93	7,166
Foreign government	—	166	—	166
Residential MBS	—	3,585	294	3,879
Commercial MBS	—	2,252	45	2,297
Asset-backed securities (“ABS”)	—	4,252	449	4,701
Corporate and other	48	13,876	646	14,570
Total AFS fixed maturities	163	31,409	1,542	33,114
Trading fixed maturities	13	256	—	269
Equity securities	1,473	235	123	1,831
Assets of managed investment entities (“MIE”)	155	3,432	26	3,613
Variable annuity assets (separate accounts) (*)	—	595	—	595
Other investments — derivatives	—	122	—	122
Other assets — derivatives	—	8	—	8
Total assets accounted for at fair value	$1,804	$36,057	$1,691	$39,552
Liabilities:				
Liabilities of managed investment entities	$141	$3,123	$23	$3,287
Derivatives in annuity benefits accumulated	—	—	1,198	1,198
Derivatives in long-term debt	—	(7)	—	(7)
Other liabilities — derivatives	—	9	—	9
Total liabilities accounted for at fair value	$141	$3,125	$1,221	$4,487
December 31, 2014				
Assets:				
Available for sale fixed maturities:				
U.S. Government and government agencies	$164	$174	$15	$353
States, municipalities and political subdivisions	—	6,647	100	6,747
Foreign government	—	194	—	194
Residential MBS	—	4,142	300	4,442
Commercial MBS	—	2,407	44	2,451
Asset-backed securities	—	3,661	226	3,887
Corporate and other	36	12,078	546	12,660
Total AFS fixed maturities	200	29,303	1,231	30,734
Trading fixed maturities	12	254	—	266
Equity securities	1,306	297	93	1,696
Assets of managed investment entities	174	2,903	31	3,108
Variable annuity assets (separate accounts) (*)	—	662	—	662
Other investments — derivatives	—	322	—	322
Total assets accounted for at fair value	$1,692	$33,741	$1,355	$36,788
Liabilities:				

Liabilities of managed investment entities	$118	$—	$2,701	$2,819
Derivatives in annuity benefits accumulated	—	—	1,160	1,160
Other liabilities — derivatives	—	13	—	13
Total liabilities accounted for at fair value	$118	$13	$3,861	$3,992

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

Transfers between Level 1 and Level 2 for all periods presented were a result of increases or decreases in trade frequency.

During the third quarter of 2015, there was one common stock with a fair value of less than $1 million transferred from Level 2 to Level 1. During the first nine months of 2015, there were seven common stocks, four perpetual preferred stocks and one mandatory redeemable preferred stock with aggregate fair values of $80 million, $19 million and $10 million, respectively, that transferred from Level 2 to 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.

During the third quarter and first nine months of 2015, seven perpetual preferred stocks with a fair value of $31 million were transferred from Level 1 to Level 2. 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.

Approximately 4% of the total assets carried at fair value on September 30, 2015, were Level 3 assets. Approximately 71% ($1.20 billion) 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 approximately 1% of the total assets measured at fair value and approximately 8% 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 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 $1.20 billion at September 30, 2015. 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% – 2.60% over the risk free rate
Risk margin for uncertainty in cash flows	0.52% reduction in the discount rate
Surrenders	4% – 16% of indexed account value
Partial surrenders	2% – 10% of indexed account value
Annuitizations	1% – 1.5% of indexed account value
Deaths	1.5% – 3.0% of indexed account value
Budgeted option costs	2.25% – 3.50% 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 5% to 11% 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.

19

Changes in balances of Level 3 financial assets and liabilities carried at fair value during the third quarter and first nine months of 2015 and 2014 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, 2015	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, 2015
AFS fixed maturities:								
U.S. government agency	$15	$—	$ —	$—	$ —	$—	$—	$15
State and municipal	84	—	1	9	(1)	—	—	93
Residential MBS	296	(3)	(1)	—	(8)	10	—	294
Commercial MBS	48	—	(1)	—	(1)	—	(1)	45
Asset-backed securities	332	—	—	110	(3)	20	(10)	449
Corporate and other	597	—	7	24	(13)	31	—	646
Equity securities	118	—	(2)	7	—	—	—	123
Assets of MIE	29	(3)	—	—	—	—	—	26
Embedded derivatives	(1,258)	130	—	(88)	18	—	—	(1,198)

	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.”

20

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

	Balance at December 31, 2014	Impact of accounting change (*)	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, 2015
AFS fixed maturities:									
U.S. government agency	$15	$—	$—	$ —	$—	$ —	$—	$—	$15
State and municipal	100	—	—	(1)	34	(1)	—	(39)	93
Residential MBS	300	—	(5)	—	—	(24)	67	(44)	294
Commercial MBS	44	—	—	(1)	—	(1)	4	(1)	45
Asset-backed securities	226	—	1	—	230	(51)	53	(10)	449
Corporate and other	546	—	(3)	(4)	103	(37)	41	—	646
Equity securities	93	—	(4)	(1)	52	—	—	(17)	123
Assets of MIE	31	—	(9)	—	4	—	—	—	26
Liabilities of MIE	(2,701)	2,701	—	—	—	—	—	—	—
Embedded derivatives	(1,160)	—	99	—	(183)	46	—	—	(1,198)

(*) The impact of implementing new guidance adopted in 2015, as discussed above and in Note A — “Accounting Policies — Managed Investment Entities.”

	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.”

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, 2015					
Financial assets:					
Cash and cash equivalents	$894	$894	$894	$—	$—
Mortgage loans	994	1,005	—	—	1,005
Policy loans	221	221	—	—	221
Total financial assets not accounted for at fair value	$2,109	$2,120	$894	$—	$1,226
Financial liabilities:					
Annuity benefits accumulated (*)	$25,825	$25,083	$—	$—	$25,083
Long-term debt	887	987	—	962	25
Total financial liabilities not accounted for at fair value	$26,712	$26,070	$—	$962	$25,108
December 31, 2014					
Financial assets:					
Cash and cash equivalents	$1,343	$1,343	$1,343	$—	$—
Mortgage loans	1,117	1,124	—	—	1,124
Policy loans	228	228	—	—	228
Total financial assets not accounted for at fair value	$2,688	$2,695	$1,343	$—	$1,352
Financial liabilities:					
Annuity benefits accumulated (*)	$23,561	$23,187	$—	$—	$23,187
Long-term debt	1,061	1,180	—	1,106	74
Total financial liabilities not accounted for at fair value	$24,622	$24,367	$—	$1,106	$23,261

(*) Excludes $201 million and $203 million of life contingent annuities in the payout phase at September 30, 2015 and December 31, 2014, respectively.

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.

E. Investments

Available for sale fixed maturities and equity securities at September 30, 2015 and December 31, 2014, consisted of the following (in millions):

	September 30, 2015				December 31, 2014			
	Amortized	Fair	Gross Unrealized		Amortized	Fair	Gross Unrealized	
	Cost	Value	Gains	Losses	Cost	Value	Gains	Losses
Fixed maturities:								
U.S. Government and government agencies	$329	$335	$8	$(2)	$347	$353	$8	$(2)
States, municipalities and political subdivisions	6,874	7,166	321	(29)	6,393	6,747	364	(10)
Foreign government	157	166	9	—	184	194	10	—
Residential MBS	3,540	3,879	354	(15)	4,046	4,442	411	(15)
Commercial MBS	2,185	2,297	112	—	2,294	2,451	158	(1)
Asset-backed securities	4,673	4,701	47	(19)	3,872	3,887	37	(22)
Corporate and other	14,110	14,570	606	(146)	11,938	12,660	751	(29)
Total fixed maturities	$31,868	$33,114	$1,457	$(211)	$29,074	$30,734	$1,739	$(79)
Common stocks	$1,147	$1,204	$151	$(94)	$885	$1,087	$227	$(25)
Perpetual preferred stocks	$443	$454	$18	$(7)	$398	$414	$21	$(5)

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, 2015 and December 31, 2014, respectively, were $213 million and $220 million. Gross unrealized gains on such securities at September 30, 2015 and December 31, 2014 were $143 million and $151 million, respectively. Gross unrealized losses on such securities at both September 30, 2015 and December 31, 2014 were $8 million. 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 (dollars 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, 2015 and December 31, 2014.

	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, 2015						
Fixed maturities:						
U.S. Government and government agencies	$—	$2	100 %	$(2)	$15	88 %
States, municipalities and political subdivisions	(27)	1,197	98 %	(2)	58	97 %
Residential MBS	(6)	347	98 %	(9)	223	96 %
Commercial MBS	—	23	100 %	—	31	100 %
Asset-backed securities	(12)	1,315	99 %	(7)	414	98 %
Corporate and other	(124)	3,197	96 %	(22)	132	86 %
Total fixed maturities	$(169)	$6,081	97 %	$(42)	$873	95 %
Common stocks	$(94)	$590	86 %	$		