

AMERICAN FINANCIAL GROUP INC

Form 10-Q

November 08, 2018

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, 2018

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 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. Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

Smaller reporting company Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of November 1, 2018, there were 89,253,183 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, 2018	December 31, 2017
Assets:		
Cash and cash equivalents	\$ 2,009	\$ 2,338
Investments:		
Fixed maturities, available for sale at fair value (amortized cost — \$40,053 and \$37,038)	40,244	38,379
Fixed maturities, trading at fair value	103	348
Equity securities, at fair value	1,827	1,662
Investments accounted for using the equity method	1,289	999
Mortgage loans	1,152	1,125
Policy loans	176	184
Equity index call options	759	701
Real estate and other investments	282	312
Total cash and investments	47,841	46,048
Recoverables from reinsurers	3,352	3,369
Prepaid reinsurance premiums	717	600
Agents' balances and premiums receivable	1,299	1,146
Deferred policy acquisition costs	1,669	1,216
Assets of managed investment entities	4,998	4,902
Other receivables	1,633	1,030
Variable annuity assets (separate accounts)	650	644
Other assets	1,832	1,504
Goodwill	199	199
Total assets	\$ 64,190	\$ 60,658
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	\$ 9,670	\$ 9,678
Unearned premiums	2,740	2,410
Annuity benefits accumulated	35,958	33,316
Life, accident and health reserves	643	658
Payable to reinsurers	932	743
Liabilities of managed investment entities	4,807	4,687
Long-term debt	1,302	1,301
Variable annuity liabilities (separate accounts)	650	644
Other liabilities	2,324	1,887
Total liabilities	59,026	55,324
Redeemable noncontrolling interests	—	3
Shareholders' equity:		
Common Stock, no par value		
— 200,000,000 shares authorized	89	88
— 89,188,708 and 88,275,460 shares outstanding		

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Capital surplus	1,231	1,181
Retained earnings	3,800	3,248
Accumulated other comprehensive income, net of tax	44	813
Total shareholders' equity	5,164	5,330
Noncontrolling interests	—	1
Total equity	5,164	5,331
Total liabilities and equity	\$ 64,190	\$ 60,658

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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,	
	2018	2017	2018	2017
Revenues:				
Property and casualty insurance net earned premiums	\$1,327	\$1,267	\$3,595	\$3,354
Life, accident and health net earned premiums	6	6	18	17
Net investment income	527	471	1,552	1,366
Realized gains (losses) on securities (*)	34	(12)	(28)	(1)
Income (loss) of managed investment entities:				
Investment income	65	54	187	155
Gain (loss) on change in fair value of assets/liabilities	(5)	1	(10)	12
Other income	54	48	146	154
Total revenues	2,008	1,835	5,460	5,057
Costs and Expenses:				
Property and casualty insurance:				
Losses and loss adjustment expenses	872	995	2,206	2,239
Commissions and other underwriting expenses	424	357	1,205	1,062
Annuity benefits	222	215	664	635
Life, accident and health benefits	10	6	32	21
Annuity and supplemental insurance acquisition expenses	71	55	203	156
Interest charges on borrowed money	15	21	46	65
Expenses of managed investment entities	52	45	154	137
Other expenses	98	112	272	285
Total costs and expenses	1,764	1,806	4,782	4,600
Earnings before income taxes	244	29	678	457
Provision for income taxes	41	18	126	146
Net earnings, including noncontrolling interests	203	11	552	311
Less: Net earnings (losses) attributable to noncontrolling interests	(1)	—	(7)	2
Net Earnings Attributable to Shareholders	\$204	\$11	\$559	\$309
Earnings Attributable to Shareholders per Common Share:				
Basic	\$2.30	\$0.13	\$6.29	\$3.52
Diluted	\$2.26	\$0.13	\$6.17	\$3.44
Average number of Common Shares:				
Basic	89.1	88.1	88.9	87.7
Diluted	90.7	90.0	90.6	89.7
Cash dividends per Common Share	\$0.35	\$0.3125	\$2.55	\$2.4375
<hr/>				
(*) Consists of the following:				
Realized gains (losses) before impairments	\$36	\$26	\$(25)	\$52
Losses on securities with impairment	(2)	(38)	(3)	(54)

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Non-credit portion recognized in other comprehensive income (loss)	—	—	—	1	
Impairment charges recognized in earnings	(2) (38) (3) (53)
Total realized gains (losses) on securities	\$34	\$(12) \$(28) \$(1)

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

	Three months ended September 30, 2018		Nine months ended September 30, 2017	
Net earnings, including noncontrolling interests	\$203	\$ 11	\$552	\$311
Other comprehensive income (loss), net of tax:				
Net unrealized gains (losses) on securities:				
Unrealized holding gains (losses) on securities arising during the period	(96)	59	(523)	299
Reclassification adjustment for realized (gains) losses included in net earnings	(2)	8	(3)	3
Total net unrealized gains (losses) on securities	(98)	67	(526)	302
Net unrealized gains (losses) on cash flow hedges	(5)	—	(19)	1
Foreign currency translation adjustments	—	7	(3)	11
Other comprehensive income (loss), net of tax	(103)	74	(548)	314
Total comprehensive income, net of tax	100	85	4	625
Less: Comprehensive income (loss) attributable to noncontrolling interests	(1)	—	(7)	2
Comprehensive income attributable to shareholders	\$101	\$ 85	\$11	\$623

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

	Common Shares	Shareholders' Equity			Total	Noncontrolling Interests	Total Equity	Redeemable
		Common Stock and Capital Surplus	Retained Earnings	Accumulated Other Comp. Income (Loss)				Noncontrolling Interests
Balance at December 31, 2017	88,275,460	\$ 1,269	\$ 3,248	\$ 813	\$ 5,330	\$ 1	\$ 5,331	\$ 3
Cumulative effect of accounting change	—	—	225	(221)	4	—	4	—
Net earnings (losses)	—	—	559	—	559	(1)	558	(6)
Other comprehensive loss	—	—	—	(548)	(548)	—	(548)	—
Dividends on Common Stock	—	—	(227)	—	(227)	—	(227)	—
Shares issued:								
Exercise of stock options	635,364	23	—	—	23	—	23	—
Restricted stock awards	200,625	—	—	—	—	—	—	—
Other benefit plans	86,229	10	—	—	10	—	10	—
Dividend reinvestment plan	21,072	2	—	—	2	—	2	—
Stock-based compensation expense	—	17	—	—	17	—	17	—
Shares exchanged — benefit plans	(26,520)	(1)	(2)	—	(3)	—	(3)	—
Forfeitures of restricted stock	(3,522)	—	—	—	—	—	—	—
Other	—	—	(3)	—	(3)	—	(3)	3
Balance at September 30, 2018	89,188,708	\$ 1,320	\$ 3,800	\$ 44	\$ 5,164	\$ —	\$ 5,164	\$ —
Balance at December 31, 2016	86,924,399	\$ 1,198	\$ 3,343	\$ 375	\$ 4,916	\$ 3	\$ 4,919	\$ —
Net earnings	—	—	309	—	309	2	311	—
Other comprehensive income	—	—	—	314	314	—	314	—
Dividends on Common Stock	—	—	(214)	—	(214)	—	(214)	—
Shares issued:								
Exercise of stock options	870,022	29	—	—	29	—	29	—
Restricted stock awards	232,250	—	—	—	—	—	—	—
Other benefit plans	85,190	8	—	—	8	—	8	—
Dividend reinvestment plan	22,243	2	—	—	2	—	2	—
Stock-based compensation expense	—	18	—	—	18	—	18	—
Shares exchanged — benefit plans	(34,922)	—	(3)	—	(3)	—	(3)	—
Forfeitures of restricted stock	(6,388)	—	—	—	—	—	—	—
Other	—	—	—	—	—	(5)	(5)	—
Balance at September 30, 2017	88,092,794	\$ 1,255	\$ 3,435	\$ 689	\$ 5,379	\$ —	\$ 5,379	\$ —

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

(In Millions)

	Nine months ended September 30,	
	2018	2017
Operating Activities:		
Net earnings, including noncontrolling interests	\$552	\$311
Adjustments:		
Depreciation and amortization	163	105
Annuity benefits	664	635
Realized (gains) losses on investing activities	28	(18)
Net sales of trading securities	116	5
Deferred annuity and life policy acquisition costs	(192)	(177)
Change in:		
Reinsurance and other receivables	(868)	(1,467)
Other assets	(257)	(59)
Insurance claims and reserves	507	1,372
Payable to reinsurers	189	272
Other liabilities	346	—
Managed investment entities' assets/liabilities	104	14
Other operating activities, net	(75)	—
Net cash provided by operating activities	1,277	993
Investing Activities:		
Purchases of:		
Fixed maturities	(6,700)	(7,163)
Equity securities	(342)	(73)
Mortgage loans	(112)	(149)
Equity index options and other investments	(695)	(594)
Real estate, property and equipment	(60)	(46)
Proceeds from:		
Maturities and redemptions of fixed maturities	3,516	4,690
Repayments of mortgage loans	87	191
Sales of fixed maturities	275	179
Sales of equity securities	150	97
Sales and settlements of equity index options and other investments	688	565
Sales of real estate, property and equipment	3	54
Managed investment entities:		
Purchases of investments	(1,674)	(2,330)
Proceeds from sales and redemptions of investments	1,485	2,343
Other investing activities, net	4	6
Net cash used in investing activities	(3,375)	(2,230)
Financing Activities:		
Annuity receipts	3,925	3,432
Annuity surrenders, benefits and withdrawals	(2,101)	(1,725)

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Net transfers from variable annuity assets	35	43
Additional long-term borrowings	—	345
Reductions of long-term debt	—	(355)
Issuances of managed investment entities' liabilities	1,572	1,926
Retirements of managed investment entities' liabilities	(1,463)	(1,998)
Issuances of Common Stock	26	30
Cash dividends paid on Common Stock	(225)	(212)
Other financing activities, net	—	(7)
Net cash provided by financing activities	1,769	1,479
Net Change in Cash and Cash Equivalents	(329)	242
Cash and cash equivalents at beginning of period	2,338	2,107
Cash and cash equivalents at end of period	\$2,009	\$2,349

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B. Segments of Operations	I. Long-Term Debt
C. Fair Value Measurements	J. Redeemable Noncontrolling Interests
D. Investments	K. Shareholders' Equity
E. Derivatives	L. Income Taxes
F. Deferred Policy Acquisition Costs	M. Contingencies
G. Managed Investment Entities	N. Insurance

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, 2018, 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. AFG did not have any significant nonrecurring fair value measurements in the first nine months of 2018.

Investments On January 1, 2018, AFG adopted Accounting Standards Update ("ASU") 2016-01, which requires all equity securities other than those accounted for under the equity method to be reported at fair value with holding gains and losses recognized in net earnings. At December 31, 2017, AFG had \$1.60 billion in equity securities classified as "available for sale" under the prior guidance with holding gains and losses included in accumulated other comprehensive income ("AOCI") instead of net earnings. At the date of adoption, the \$221 million net unrealized gain on equity securities included in AOCI was reclassified to retained earnings as the cumulative effect of an accounting change. The cumulative effect of the accounting change also includes the net unrealized gain on AFG's small number of limited partnerships and similar investments carried at cost under the prior guidance that are carried at fair value

through net earnings under the new guidance (\$4 million net of tax at the date of adoption).

Holding gains and losses on equity securities carried at fair value under ASU 2016-01 are generally recorded in realized gains (losses) on securities. However, prior to the adoption of the new guidance, AFG classified a small portion of its equity securities as “trading” and reported those investments at fair value with holding gains and losses recognized in net investment income. These investments consisted primarily of equity securities held to offset the impact of changes in the stock market on employee benefit plans that are impacted by stock market performance and totaled \$62 million at December 31, 2017. Following the adoption of the new guidance, AFG continues to record holding gains and losses on these securities, as well as its small portfolio of limited partnerships and similar investments carried at fair value under the new guidance and certain other securities classified at purchase as “fair value through net investment income” in net investment income.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

Under the new guidance, AFG recorded holding losses of \$35 million on equity securities in net earnings during the first nine months of 2018 on securities that were still owned at September 30, 2018. Under the prior guidance, these holding losses would have been recorded in AOCI (with the exception of any impairment charge that may have been recorded). Because almost all of the equity securities impacted by the new guidance were carried at fair value through AOCI under the prior guidance, the adoption of the new guidance did not have a material impact on AFG's financial position.

Fixed maturity securities classified as "available for sale" are reported at fair value with unrealized gains and losses included in AOCI in AFG's Balance Sheet. Fixed maturity 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 effective 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.

Limited partnerships and similar investments are generally accounted for using the equity method of accounting. Under the equity method, AFG records its share of the earnings or losses of the investee based on when they are reported by the investee in its financial statements rather than in the period in which the investee declares a dividend. AFG's share of the earnings or losses from equity method investments is generally recorded on a quarter lag due to the timing of the receipt of the investee's financial statements. AFG's equity in the earnings (losses) of limited partnerships and similar investments is included in net investment income.

Gains or losses on fixed maturity 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 equity index options 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 statement of earnings as the cash flows from the hedged item. AFG uses interest rate swaps that are designated and 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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.

An AFG 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 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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 G — “Managed Investment Entities”). 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) through its investment in the CLO debt tranches, it has exposure to CLO losses (limited to the amount AFG invested) and the right to receive CLO benefits that 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. 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.

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. AFG has 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 are measured by the change in the fair value of AFG’s investments in the CLOs and management fees earned.

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 annuity benefits expense and decreases for annuity policy charges are recorded in other income. For traditional fixed annuities, the liability for annuity benefits accumulated represents the account value that has accrued to the benefit of the policyholder as of the balance sheet date. For fixed-indexed annuities, the liability or annuity benefits accumulated includes an embedded derivative that represents the estimated fair value of the index participation with the remaining component representing the discounted value of the guaranteed minimum contract benefits.

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 (included in other income) using the same assumptions and estimated gross profits used to amortize DPAC.

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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 (losses) 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.

Debt Issuance Costs Debt issuance costs related to AFG's outstanding debt are presented in its Balance Sheet as a direct reduction in the carrying value of long-term debt and are amortized over the life of the related debt using the effective interest method as a component of interest expense. Debt issuance costs related to AFG's revolving credit facilities are included in other assets 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 represent 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. Noncontrolling interests that are redeemable at the option of the holder are presented separately in the mezzanine section of the balance sheet (between liabilities and equity).

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. The effect of a change in tax rates on deferred tax assets and liabilities is recorded in net earnings in the period that includes the enactment date.

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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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.

AFG records excess tax benefits or deficiencies for share-based payments through income tax expense in the statement of earnings. In addition, AFG accounts for forfeitures of awards when they occur.

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 2018 and 2017 — 1.6 million and 1.9 million; first nine months of 2018 and 2017 — 1.7 million and 2.0 million, respectively.

There were no anti-dilutive potential common shares in the third quarter or first nine months of 2018 or 2017.

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.

Revenue Recognition Guidance Effective in 2018 On January 1, 2018, AFG adopted ASU 2014-09, which provides guidance on recognizing revenue when (or as) performance obligations under the contract are satisfied. The new guidance also updates the accounting for certain costs associated with obtaining and fulfilling contracts with customers and requires certain new disclosures. Because revenue recognition for insurance contracts and financial instruments (AFG’s primary sources of revenue) were excluded from the scope of the new guidance, the adoption of ASU 2014-09 did not have a material impact on AFG’s results of operations or financial position.

B. Segments of Operations

AFG manages its business as three segments: (i) Property and casualty insurance, (ii) Annuity and (iii) Other, which includes holding company costs, revenues and costs of AFG’s limited insurance operations outside of property and casualty insurance and annuities, and 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 equipment leasing and 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, fixed-indexed and variable-indexed annuities in the retail, financial institutions, registered investment advisor and education markets. AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services. Effective January 1, 2018, the results of AFG's run-off long-term care and life

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

businesses are included in the “Other” segment instead of as a separate reportable segment based on the immaterial size of the remaining operations. Prior period amounts were reclassified for consistent presentation.

The following tables (in millions) show AFG’s revenues and earnings before income taxes by segment and sub-segment.

	Three months ended September 30, 2018		Nine months ended September 30, 2017			
Revenues						
Property and casualty insurance:						
Premiums earned:						
Specialty						
Property and transportation	\$526	\$527	\$1,250	\$1,226		
Specialty casualty	616	568	1,790	1,613		
Specialty financial	149	142	457	435		
Other specialty	36	30	98	80		
Total premiums earned	1,327	1,267	3,595	3,354		
Net investment income	108	94	323	276		
Other income (a)	4	1	8	21		
Total property and casualty insurance	1,439	1,362	3,926	3,651		
Annuity:						
Net investment income	413	375	1,219	1,082		
Other income	27	26	80	79		
Total annuity	440	401	1,299	1,161		
Other	95	84	263	246		
Total revenues before realized gains (losses)	1,974	1,847	5,488	5,058		
Realized gains (losses) on securities	34	(12)	(28)	(1)		
Total revenues	\$2,008	\$1,835	\$5,460	\$5,057		
Earnings Before Income Taxes						
Property and casualty insurance:						
Underwriting:						
Specialty						
Property and transportation			\$—	\$6	\$56	\$70
Specialty casualty			49	2	119	46
Specialty financial			9	(3)	46	42
Other specialty			(3)	4	(1)	3
Other lines (b)			(17)	(90)	(19)	(92)
Total underwriting			38	(81)	201	69
Investment and other income, net (a)			101	87	300	271
Total property and casualty insurance			139	6	501	340
Annuity						
Other (c)			(46)	(67)	(136)	(165)
Total earnings before realized gains (losses) and income taxes			210	41	706	458
Realized gains (losses) on securities			34	(12)	(28)	(1)
Total earnings before income taxes			\$244	\$29	\$678	\$457

- (a) Includes income of \$13 million (before noncontrolling interest) from the sale of a hotel in the first quarter of 2017.
- (b) Includes special charges of \$18 million and \$89 million in the third quarter of 2018 and 2017, respectively, to increase asbestos and environmental (“A&E”) reserves.
Includes holding company interest and expenses, including losses on retirement of debt of \$4 million in the third quarter of 2017 and \$7 million in the second quarter of 2017, and special charges of \$9 million and \$24 million in the third quarter of 2018 and 2017, respectively, to increase A&E reserves related to AFG’s former railroad and manufacturing operations.
- (c)

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

C. 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, 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, asset-backed securities ("ABS"), mortgage-backed securities ("MBS"), non-affiliated common stocks, equity index call options 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 at the valuation date. 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.

As discussed in Note A — "Accounting Policies — Managed Investment Entities," AFG has set the carrying value of its 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. As a result, 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, 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 25 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 services regarding the methods and assumptions used in pricing, including

verifying, on a test basis, the inputs used by the service to value specific securities.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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, 2018				
Assets:				
Available for sale (“AFS”) fixed maturities:				
U.S. Government and government agencies	\$ 142	\$ 84	\$ 8	\$ 234
States, municipalities and political subdivisions	—	6,715	60	6,775
Foreign government	—	139	—	139
Residential MBS	—	2,564	145	2,709
Commercial MBS	—	866	57	923
Asset-backed securities	—	8,316	991	9,307
Corporate and other	29	18,482	1,646	20,157
Total AFS fixed maturities	171	37,166	2,907	40,244
Trading fixed maturities	9	94	—	103
Equity securities	1,462	76	289	1,827
Equity index call options	—	759	—	759
Assets of managed investment entities (“MIE”)	258	4,718	22	4,998
Variable annuity assets (separate accounts) (*)	—	650	—	650
Total assets accounted for at fair value	\$ 1,900	\$ 43,463	\$ 3,218	\$ 48,581
Liabilities:				
Liabilities of managed investment entities	\$ 248	\$ 4,537	\$ 22	\$ 4,807
Derivatives in annuity benefits accumulated	—	—	3,105	3,105
Other liabilities — derivatives	—	83	—	83
Total liabilities accounted for at fair value	\$ 248	\$ 4,620	\$ 3,127	\$ 7,995
December 31, 2017				
Assets:				
Available for sale fixed maturities:				
U.S. Government and government agencies	\$ 122	\$ 112	\$ 8	\$ 242
States, municipalities and political subdivisions	—	6,975	148	7,123
Foreign government	—	127	—	127
Residential MBS	—	3,105	122	3,227
Commercial MBS	—	926	36	962
Asset-backed securities	—	7,218	744	7,962
Corporate and other	30	17,662	1,044	18,736
Total AFS fixed maturities	152	36,125	2,102	38,379
Trading fixed maturities	44	304	—	348
Equity securities	1,411	86	165	1,662
Equity index call options	—	701	—	701
Assets of managed investment entities	307	4,572	23	4,902
Variable annuity assets (separate accounts) (*)	—	644	—	644
Total assets accounted for at fair value	\$ 1,914	\$ 42,432	\$ 2,290	\$ 46,636
Liabilities:				
Liabilities of managed investment entities	\$ 293	\$ 4,372	\$ 22	\$ 4,687
Derivatives in annuity benefits accumulated	—	—	2,542	2,542

Other liabilities — derivatives	—	35	—	35
Total liabilities accounted for at fair value	\$ 293	\$ 4,407	\$ 2,564	\$ 7,264

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

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

During the third quarter there were no transfers between Level 1 and Level 2. During the first nine months of 2018, there were two preferred stocks with an aggregate fair value of \$6 million that transferred from Level 1 to Level 2. During the third quarter of 2017, there was one preferred stock with an aggregate fair value of \$1 million that transferred from Level 2 to Level 1. During the first nine months of 2017, there were three preferred stocks with an aggregate fair value of \$17 million that transferred from Level 2 to Level 1.

Approximately 7% of the total assets carried at fair value at September 30, 2018, were Level 3 assets. Approximately 68% (\$2.18 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 18% of AFG's Shareholders' Equity, any justifiable changes in unobservable inputs used to determine internally developed fair values would not be expected to 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 and variable-indexed annuity liabilities, which are measured using a discounted cash flow approach and had a fair value of \$3.11 billion at September 30, 2018. The following table presents information about the unobservable inputs used by management in determining fair value of these embedded derivatives. See Note E — "Derivatives."

Unobservable Input	Range
Adjustment for insurance subsidiary's credit risk	0.4% – 1.6% over the risk free rate
Risk margin for uncertainty in cash flows	0.70% reduction in the discount rate
Surrenders	3% – 23% of indexed account value
Partial surrenders	2% – 9% of indexed account value
Annuity payments	0.1% – 1% of indexed account value
Deaths	1.6% – 8.0% of indexed account value
Budgeted option costs	2.4% – 3.6% 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 and variable-indexed annuity products with an expected range of 7% to 11% in the majority of future calendar years (3% to 23% over all periods). Increasing the budgeted option cost or risk margin for uncertainty in cash flow assumptions in the table above would increase the fair value of the fixed-indexed and variable-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.

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Changes in balances of Level 3 financial assets and liabilities carried at fair value during the third quarter and first nine months of 2018 and 2017 are presented below (in millions). The transfers into and out of Level 3 were due to changes in the availability of market observable inputs and \$29 million of equity securities transferred into Level 3 in the first quarter of 2018 related to a small number of limited partnerships and similar investments carried at cost under the prior guidance that are carried at fair value through net earnings under new guidance adopted on January 1, 2018, as discussed in Note A — “Accounting Policies — Investments.” All transfers are reflected in the table at fair value as of the end of the reporting period.

	Balance at June 30, 2018	Net earnings	Other comprehensive income (loss)	Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at September 30, 2018
Total realized/unrealized gains (losses) included in								
AFS fixed maturities:								
U.S. government agency	\$8	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 8
State and municipal	61	—	—	—	(1)	—	—	60
Residential MBS	147	(2)	(2)	—	(6)	13	(5)	145
Commercial MBS	56	2	—	(1)	—	—	—	57
Asset-backed securities	1,004	—	(3)	13	(23)	—	—	991
Corporate and other	1,408	—	(3)	312	(59)	—	(12)	1,646
Total AFS fixed maturities	2,684	—	(8)	324	(89)	13	(17)	2,907
Equity securities	230	(5)	—	81	—	—	(17)	289
Assets of MIE	23	(1)	—	—	—	—	—	22
Total Level 3 assets	\$2,937	\$ (6)	\$ (8)	\$ 405	\$ (89)	\$ 13	\$ (34)	\$ 3,218
Embedded derivatives	\$(2,776)	\$(223)	\$ —	\$(151)	\$ 45	\$ —	\$ —	\$(3,105)
Total Level 3 liabilities (*)	\$(2,776)	\$(223)	\$ —	\$(151)	\$ 45	\$ —	\$ —	\$(3,105)

	Balance at June 30, 2017	Net earnings	Other comprehensive income (loss)	Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at September 30, 2017
Total realized/unrealized gains (losses) included in								
AFS fixed maturities:								
U.S. government agency	\$8	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 8
State and municipal	143	—	—	—	(1)	10	—	152
Residential MBS	153	2	1	—	(6)	15	(21)	144
Commercial MBS	45	1	—	—	(10)	—	—	36
Asset-backed securities	498	(2)	1	13	(26)	163	(111)	536
Corporate and other	953	(9)	—	172	(59)	—	(7)	1,050
Total AFS fixed maturities	1,800	(8)	2	185	(102)	188	(139)	1,926
Equity securities	168	(3)	(4)	2	—	—	—	163
Assets of MIE	23	(4)	—	2	—	—	—	21
Total Level 3 assets	\$1,991	\$ (15)	\$ (2)	\$ 189	\$ (102)	\$ 188	\$(139)	\$ 2,110
Embedded derivatives	\$(2,129)	\$(127)	\$ —	\$(65)	\$ 28	\$ —	\$ —	\$(2,293)

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Total Level 3 liabilities (*) \$(2,129) \$ (127) \$ — \$ (65) \$ 28 \$ — \$— \$ (2,293)

(*) As previously discussed, these tables exclude the portion of MIE liabilities allocated to Level 3, which are derived from the fair value of the MIE assets.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

	Balance at December 31, 2017	Total realized/unrealized gains (losses) included in						Balance at September 30, 2018
		Net earnings	Other comprehensive income (loss)	Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	
AFS fixed maturities:								
U.S. government agency	\$ 8	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 8
State and municipal	148	—	(2)	—	(2)	—	(84)	60
Residential MBS	122	(9)	(2)	—	(17)	70	(19)	145
Commercial MBS	36	1	—	20	—	—	—	57
Asset-backed securities	744	(2)	(6)	353	(80)	—	(18)	991
Corporate and other	1,044	2	(21)	784	(138)	—	(25)	1,646
Total AFS fixed maturities	2,102	(8)	(31)	1,157	(237)	70	(146)	2,907
Equity securities	165	9	—	106	(4)	30	(17)	289
Assets of MIE	23	(6)	—	5	—	—	—	22
Total Level 3 assets	\$ 2,290	\$ (5)	\$ (31)	\$ 1,268	\$ (241)	\$ 100	\$ (163)	\$ 3,218
Embedded derivatives (a)	\$ (2,542)	\$ (286)	\$ —	\$ (395)	\$ 118	\$ —	\$ —	\$ (3,105)
Total Level 3 liabilities (b)	\$ (2,542)	\$ (286)	\$ —	\$ (395)	\$ 118	\$ —	\$ —	\$ (3,105)

	Balance at December 31, 2016	Total realized/unrealized gains (losses) included in						Balance at September 30, 2017
		Net earnings	Other comprehensive income (loss)	Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	
AFS fixed maturities:								
U.S. government agency	\$ 8	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 8
State and municipal	140	—	4	—	(2)	10	—	152
Residential MBS	190	—	3	1	(37)	35	(48)	144
Commercial MBS	25	2	—	15	(10)	4	—	36
Asset-backed securities	484	(2)	3	117	(62)	199	(203)	536
Corporate and other	712	(4)	8	460	(124)	29	(31)	1,050
Total AFS fixed maturities	1,559	(4)	18	593	(235)	277	(282)	1,926
Equity securities	174	(19)	9	22	(3)	—	(20)	163
Assets of MIE	29	(10)	—	6	—	—	(4)	21
Total Level 3 assets	\$ 1,762	\$ (33)	\$ 27	\$ 621	\$ (238)	\$ 277	\$ (306)	\$ 2,110
Embedded derivatives	\$ (1,759)	\$ (386)	\$ —	\$ (224)	\$ 76	\$ —	\$ —	\$ (2,293)
Total Level 3 liabilities (b)	\$ (1,759)	\$ (386)	\$ —	\$ (224)	\$ 76	\$ —	\$ —	\$ (2,293)

(a) Total realized/unrealized gains (losses) included in net earnings for the embedded derivatives reflects losses related to the unlocking of actuarial assumptions of \$44 million in the first nine months of 2018.

(b) As previously discussed, these tables exclude the portion of MIE liabilities allocated to Level 3, which are derived from the fair value of the MIE assets.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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 Fair Value				
	Value	Total	Level 1	Level 2	Level 3
September 30, 2018					
Financial assets:					
Cash and cash equivalents	\$2,009	\$2,009	\$2,009	\$—	\$—
Mortgage loans	1,152	1,130	—	—	1,130
Policy loans	176	176	—	—	176
Total financial assets not accounted for at fair value	\$3,337	\$3,315	\$2,009	\$—	\$1,306
Financial liabilities:					
Annuity benefits accumulated (*)	\$35,729	\$33,923	\$—	\$—	\$33,923
Long-term debt	1,302	1,260	—	1,257	3
Total financial liabilities not accounted for at fair value	\$37,031	\$35,183	\$—	\$1,257	\$33,926
December 31, 2017					
Financial assets:					
Cash and cash equivalents	\$2,338	\$2,338	\$2,338	\$—	\$—
Mortgage loans	1,125	1,119	—	—	1,119
Policy loans	184	184	—	—	184
Total financial assets not accounted for at fair value	\$3,647	\$3,641	\$2,338	\$—	\$1,303
Financial liabilities:					
Annuity benefits accumulated (*)	\$33,110	\$32,461	\$—	\$—	\$32,461
Long-term debt	1,301	1,354	—	1,351	3
Total financial liabilities not accounted for at fair value	\$34,411	\$33,815	\$—	\$1,351	\$32,464

(*) Excludes \$229 million and \$206 million of life contingent annuities in the payout phase at September 30, 2018 and December 31, 2017, 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.

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D. Investments

Available for sale fixed maturities at September 30, 2018 and December 31, 2017, consisted of the following (in millions):

	September 30, 2018				December 31, 2017					
	Amortized Cost	Gross Gains	Unrealized Losses	Net Unrealized Value	Fair Value	Amortized Cost	Gross Gains	Unrealized Losses	Net Unrealized Value	Fair Value
Fixed maturities:										
U.S. Government and government agencies	\$238	\$ —	\$(4)	\$(4)	\$234	\$244	\$1	\$(3)	\$(2)	\$242
States, municipalities and political subdivisions	6,756	117	(98)	19	6,775	6,887	254	(18)	236	7,123
Foreign government	137									