

AMERICAN FINANCIAL GROUP INC

Form 10-Q

August 04, 2017

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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 June

30, 2017

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 (or for such shorter period that the Registrant was required to submit and post such files). 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 August 1, 2017, there were 88,022,623 shares of the Registrant's Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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## 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)

	June 30, 2017	December 31, 2016
Assets:		
Cash and cash equivalents	\$2,207	\$ 2,107
Investments:		
Fixed maturities, available for sale at fair value (amortized cost — \$36,231 and \$33,735)	37,504	34,544
Fixed maturities, trading at fair value	339	359
Equity securities, available for sale at fair value (cost — \$1,338 and \$1,351)	1,581	1,502
Equity securities, trading at fair value	59	56
Mortgage loans	1,184	1,147
Policy loans	188	192
Equity index call options	589	492
Real estate and other investments	1,128	1,034
Total cash and investments	44,779	41,433
Recoverables from reinsurers	2,839	2,737
Prepaid reinsurance premiums	587	539
Agents' balances and premiums receivable	1,124	997
Deferred policy acquisition costs	1,156	1,239
Assets of managed investment entities	4,873	4,765
Other receivables	923	908
Variable annuity assets (separate accounts)	620	600
Other assets	1,518	1,655
Goodwill	199	199
Total assets	\$58,618	\$ 55,072
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	\$8,730	\$ 8,563
Unearned premiums	2,294	2,171
Annuity benefits accumulated	32,014	29,907
Life, accident and health reserves	676	691
Payable to reinsurers	681	634
Liabilities of managed investment entities	4,685	4,549
Long-term debt	1,405	1,283
Variable annuity liabilities (separate accounts)	620	600
Other liabilities	2,201	1,755
Total liabilities	53,306	50,153
Shareholders' equity:		
Common Stock, no par value		
— 200,000,000 shares authorized	88	87
— 88,007,252 and 86,924,399 shares outstanding		
Capital surplus	1,158	1,111
Retained earnings	3,451	3,343
Accumulated other comprehensive income, net of tax	615	375

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Total shareholders' equity	5,312	4,916
Noncontrolling interests	—	3
Total equity	5,312	4,919
Total liabilities and equity	\$58,618	\$ 55,072

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

(In Millions, Except Per Share Data)

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Revenues:				
Property and casualty insurance net earned premiums	\$1,065	\$1,027	\$2,087	\$2,025
Life, accident and health net earned premiums	5	6	11	12
Net investment income	460	423	895	834
Realized gains (losses) on:				
Securities (*)	8	(16)	11	(34)
Subsidiaries	—	2	—	2
Income (loss) of managed investment entities:				
Investment income	50	48	101	93
Gain (loss) on change in fair value of assets/liabilities	11	11	11	(2)
Other income	47	80	106	126
Total revenues	1,646	1,581	3,222	3,056
Costs and Expenses:				
Property and casualty insurance:				
Losses and loss adjustment expenses	635	687	1,244	1,268
Commissions and other underwriting expenses	366	348	705	682
Annuity benefits	224	223	420	451
Life, accident and health benefits	6	9	15	18
Annuity and supplemental insurance acquisition expenses	48	42	101	77
Interest charges on borrowed money	23	19	44	37
Expenses of managed investment entities	51	36	92	71
Other expenses	88	81	173	160
Total costs and expenses	1,441	1,445	2,794	2,764
Earnings before income taxes	205	136	428	292
Provision for income taxes	60	73	128	125
Net earnings, including noncontrolling interests	145	63	300	167
Less: Net earnings attributable to noncontrolling interests	—	9	2	12
Net Earnings Attributable to Shareholders	\$145	\$54	\$298	\$155
Earnings Attributable to Shareholders per Common Share:				
Basic	\$1.64	\$0.63	\$3.40	\$1.79
Diluted	\$1.61	\$0.62	\$3.32	\$1.76
Average number of Common Shares:				
Basic	87.8	86.8	87.5	86.8
Diluted	89.8	88.4	89.6	88.4
Cash dividends per Common Share	\$1.8125	\$0.28	\$2.125	\$0.56
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(*) Consists of the following:				
Realized gains before impairments	\$17	\$23	\$26	\$57

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Losses on securities with impairment	(10	)	(39	)	(16	)	(90	)
Non-credit portion recognized in other comprehensive income (loss)	1		—		1		(1	)
Impairment charges recognized in earnings	(9	)	(39	)	(15	)	(91	)
Total realized gains (losses) on securities	\$8		\$(16	)	\$11		\$(34	)

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## AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (UNAUDITED)

(In Millions)

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Net earnings, including noncontrolling interests	\$145	\$63	\$300	\$167
Other comprehensive income, net of tax:				
Net unrealized gains on securities:				
Unrealized holding gains on securities arising during the period	115	213	240	338
Reclassification adjustment for realized (gains) losses included in net earnings	(5 )	10	(5 )	21
Total net unrealized gains on securities	110	223	235	359
Net unrealized gains on cash flow hedges	2	1	1	4
Foreign currency translation adjustments	4	1	4	7
Pension and other postretirement plans adjustments	—	—	—	1
Other comprehensive income, net of tax	116	225	240	371
Total comprehensive income, net of tax	261	288	540	538
Less: Comprehensive income attributable to noncontrolling interests	—	13	2	18
Comprehensive income attributable to shareholders	\$261	\$275	\$538	\$520

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## 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	Accumulated Other Comprehensive Income	Total	Noncontrolling Interests	Total Equity
Balance at December 31, 2016	86,924,399	\$1,198	\$3,343	\$ 375	\$4,916	\$ 3	\$4,919
Net earnings	—	—	298	—	298	2	300
Other comprehensive income	—	—	—	240	240	—	240
Dividends on Common Stock	—	—	(187 )	—	(187 )	—	(187 )
Shares issued:							
Exercise of stock options	792,288	26	—	—	26	—	26
Restricted stock awards	232,250	—	—	—	—	—	—
Other benefit plans	75,381	7	—	—	7	—	7
Dividend reinvestment plan	19,516	2	—	—	2	—	2
Stock-based compensation expense	—	13	—	—	13	—	13
Shares exchanged — benefit plans	(32,509 )	—	(3 )	—	(3 )	—	(3 )
Forfeitures of restricted stock	(4,073 )	—	—	—	—	—	—
Other	—	—	—	—	—	(5 )	(5 )
Balance at June 30, 2017	88,007,252	\$1,246	\$3,451	\$ 615	\$5,312	\$ —	\$5,312
Balance at December 31, 2015	87,474,452	\$1,301	\$2,987	\$ 304	\$4,592	\$ 178	\$4,770
Net earnings	—	—	155	—	155	12	167
Other comprehensive income	—	—	—	365	365	6	371
Dividends on Common Stock	—	—	(48 )	—	(48 )	—	(48 )
Shares issued:							
Exercise of stock options	448,136	16	—	—	16	—	16
Restricted stock awards	317,230	—	—	—	—	—	—
Other benefit plans	72,050	5	—	—	5	—	5
Dividend reinvestment plan	7,427	1	—	—	1	—	1
Stock-based compensation expense	—	14	—	—	14	—	14
Shares acquired and retired	(1,438,142 )	(22 )	(76 )	—	(98 )	—	(98 )
Shares exchanged — benefit plans	(28,044 )	—	(2 )	—	(2 )	—	(2 )
Forfeitures of restricted stock	(2,650 )	—	—	—	—	—	—
Other	—	—	—	—	—	(3 )	(3 )
Balance at June 30, 2016	86,850,459	\$1,315	\$3,016	\$ 669	\$5,000	\$ 193	\$5,193



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

(In Millions)

	Six months ended June 30,	
	2017	2016
Operating Activities:		
Net earnings, including noncontrolling interests	\$ 300	\$ 167
Adjustments:		
Depreciation and amortization	69	53
Annuity benefits	420	451
Realized gains on investing activities	(28 )	(3 )
Net sales of trading securities	31	85
Deferred annuity and life policy acquisition costs	(133 )	(124 )
Change in:		
Reinsurance and other receivables	(291 )	42
Other assets	(8 )	(86 )
Insurance claims and reserves	275	121
Payable to reinsurers	47	(3 )
Other liabilities	(32 )	12
Managed investment entities' assets/liabilities	(72 )	(199 )
Other operating activities, net	(4 )	(20 )
Net cash provided by operating activities	574	496
Investing Activities:		
Purchases of:		
Fixed maturities	(5,387 )	(3,776 )
Equity securities	(44 )	(101 )
Mortgage loans	(146 )	(255 )
Equity index call options and other investments	(360 )	(304 )
Real estate, property and equipment	(30 )	(26 )
Proceeds from:		
Maturities and redemptions of fixed maturities	3,285	2,073
Repayments of mortgage loans	110	163
Sales of fixed maturities	150	373
Sales of equity securities	50	139
Sales and settlements of equity index call options and other investments	360	13
Sales of real estate, property and equipment	53	43
Managed investment entities:		
Purchases of investments	(1,780 )	(869 )
Proceeds from sales and redemptions of investments	1,738	771
Other investing activities, net	7	(61 )
Net cash used in investing activities	(1,994 )	(1,817 )
Financing Activities:		
Annuity receipts	2,556	2,533
Annuity surrenders, benefits and withdrawals	(1,161 )	(1,118 )
Net transfers from variable annuity assets	30	17

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Additional long-term borrowings	345	—
Reductions of long-term debt	(230	) —
Issuances of managed investment entities' liabilities	977	1,028
Retirements of managed investment entities' liabilities	(835	) (682 )
Issuances of Common Stock	27	20
Repurchases of Common Stock	—	(98 )
Cash dividends paid on Common Stock	(185	) (48 )
Other financing activities, net	(4	) (3 )
Net cash provided by financing activities	1,520	1,649
Net Change in Cash and Cash Equivalents	100	328
Cash and cash equivalents at beginning of period	2,107	1,220
Cash and cash equivalents at end of period	\$2,207	\$1,548

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C. Segments of Operations	J. Long-Term Debt
D. Fair Value Measurements	K. Shareholders' Equity
E. Investments	L. Income Taxes
F. Derivatives	M. Contingencies
G. Deferred Policy Acquisition Costs	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 June 30, 2017, 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 six months of 2017.

**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.

In January 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-01, which, among other things, will require all equity securities currently classified as "available for sale" to be

reported at fair value, with holding gains and losses recognized in net income, instead of AOCI. AFG will be required to adopt this guidance effective January 1, 2018.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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 call 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. 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.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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”). 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