AMERICAN FINANCIAL GROUP INC
Form 10-Q
November 04, 2016

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, 2016

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, 2016, there were 86,845,988 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, 2016	December 31, 2015
Assets:		
Cash and cash equivalents	$ 1,639	$ 1,220
Investments:		
Fixed maturities, available for sale at fair value (amortized cost — $33,586 and $31,565)	35,394	32,284
Fixed maturities, trading at fair value	348	254
Equity securities, available for sale at fair value (cost — $1,392 and $1,469)	1,553	1,553
Equity securities, trading at fair value	86	166
Mortgage loans	1,180	1,067
Policy loans	194	201
Real estate and other investments	1,411	991
Total cash and investments	41,805	37,736
Recoverables from reinsurers	2,814	2,636
Prepaid reinsurance premiums	634	480
Agents’ balances and premiums receivable	1,029	937
Deferred policy acquisition costs	867	1,184
Assets of managed investment entities	4,312	4,047
Other receivables	1,391	820
Variable annuity assets (separate accounts)	606	608
Other assets	1,188	1,190
Goodwill	199	199
Total assets	$ 54,845	$ 49,837
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	$ 8,661	$ 8,127
Unearned premiums	2,328	2,060
Annuity benefits accumulated	29,222	26,622
Life, accident and health reserves	700	705
Payable to reinsurers	835	591
Liabilities of managed investment entities	4,067	3,781
Long-term debt	1,300	998
Variable annuity liabilities (separate accounts)	606	608
Other liabilities	1,768	1,575
Total liabilities	49,487	45,067
Shareholders’ equity:		
Common Stock, no par value		
— 200,000,000 shares authorized	87	87
— 86,812,651 and 87,474,452 shares outstanding		
Capital surplus	1,242	1,214
Retained earnings	3,079	2,987
Accumulated other comprehensive income, net of tax	753	304
Total shareholders’ equity	5,161	4,592

Noncontrolling interests	197	178
Total equity	5,358	4,770
Total liabilities and equity	$ 54,845	$ 49,837

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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,	
	2016	2015	2016	2015
Revenues:				
Property and casualty insurance net earned premiums	$1,159	$1,173	$3,184	$3,104
Life, accident and health net earned premiums	6	28	18	80
Net investment income	433	425	1,267	1,217
Realized gains (losses) on:				
Securities (*)	2	(16)	(32)	2
Subsidiaries	—	5	2	(157)
Income (loss) of managed investment entities:				
Investment income	48	40	141	112
Gain (loss) on change in fair value of assets/liabilities	11	(11)	9	(16)
Other income	46	43	172	185
Total revenues	1,705	1,687	4,761	4,527
Costs and Expenses:				
Property and casualty insurance:				
Losses and loss adjustment expenses	765	825	2,033	2,002
Commissions and other underwriting expenses	356	336	1,038	987
Annuity benefits	189	208	640	543
Life, accident and health benefits	8	31	26	96
Annuity and supplemental insurance acquisition expenses	54	49	131	156
Interest charges on borrowed money	19	18	56	58
Expenses of managed investment entities	38	28	109	80
Other expenses	98	93	258	250
Total costs and expenses	1,527	1,588	4,291	4,172
Earnings before income taxes	178	99	470	355
Provision for income taxes	65	33	190	115
Net earnings, including noncontrolling interests	113	66	280	240
Less: Net earnings attributable to noncontrolling interests	4	3	16	17
Net Earnings Attributable to Shareholders	$109	$63	$264	$223
Earnings Attributable to Shareholders per Common Share:				
Basic	$1.25	$0.72	$3.04	$2.54
Diluted	$1.23	$0.71	$2.98	$2.49
Average number of Common Shares:				
Basic	86.9	87.5	86.8	87.6
Diluted	88.5	89.3	88.4	89.4
Cash dividends per Common Share	$0.28	$0.25	$0.84	$0.75

(*) Consists of the following:				
Realized gains before impairments	$18	$19	$75	$71

Losses on securities with impairment	(16)	(35)	(106)	(69)
Non-credit portion recognized in other comprehensive income (loss)	—	—	(1)	—
Impairment charges recognized in earnings	(16)	(35)	(107)	(69)
Total realized gains (losses) on securities	$2	$(16)	$(32)	$2

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

	Three months ended September 30, 2016	Three months ended September 30, 2015	Nine months ended September 30, 2016	Nine months ended September 30, 2015
Net earnings, including noncontrolling interests	$113	$66	$280	$240
Other comprehensive income (loss), net of tax:				
Net unrealized gains (losses) on securities:				
Unrealized holding gains (losses) on securities arising during the period	89	(110)	427	(255)
Reclassification adjustment for realized (gains) losses included in net earnings	(1)	10	20	(3)
Total net unrealized gains (losses) on securities	88	(100)	447	(258)
Net unrealized gains on cash flow hedges	—	2	4	2
Foreign currency translation adjustments	(3)	(7)	4	(15)
Pension and other postretirement plans adjustments	—	1	1	1
Other comprehensive income (loss), net of tax	85	(104)	456	(270)
Total comprehensive income (loss), net of tax	198	(38)	736	(30)
Less: Comprehensive income attributable to noncontrolling interests	5	1	23	13
Comprehensive income (loss) attributable to shareholders	$193	$(39)	$713	$(43)

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

	Shareholders' Equity							
	Common	Common Stock and Capital	Retained Earnings		Accumulated Other Comp.		Noncon- trolling	Total
	Shares	Surplus	Approp.	Unapprop.	Income	Total	Interests	Equity
Balance at December 31, 2015	87,474,452	$1,301	$ —	$ 2,987	$ 304	$4,592	$ 178	$4,770
Net earnings	—	—	—	264	—	264	16	280
Other comprehensive income	—	—	—	—	449	449	7	456
Dividends on Common Stock	—	—	—	(73)	—	(73)	—	(73)
Shares issued:								
Exercise of stock options	753,095	26	—	—	—	26	—	26
Restricted stock awards	318,940	—	—	—	—	—	—	—
Other benefit plans	82,087	6	—	—	—	6	—	6
Dividend reinvestment plan	10,930	1	—	—	—	1	—	1
Stock-based compensation:								
Expense	—	15	—	—	—	15	—	15
Excess tax benefits	—	7	—	—	—	7	—	7
Shares acquired and retired	(1,796,009)	(27)	—	(97)	—	(124)	—	(124)
Shares exchanged — benefit plans	(28,059)	—	—	(2)	—	(2)	—	(2)
Forfeitures of restricted stock	(2,785)	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	(4)	(4)
Balance at September 30, 2016	86,812,651	$1,329	$ —	$ 3,079	$ 753	$5,161	$ 197	$5,358
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	37	—	—	—	37	—	37
Restricted stock awards	171,130	—	—	—	—	—	—	—
Other benefit plans	97,817	6	—	—	—	6	—	6
Dividend reinvestment plan	10,359	1	—	—	—	1	—	1
Stock-based compensation:								
Expense	—	14	—	—	—	14	—	14
Excess tax benefits	—	9	—	—	—	9	—	9
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

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

	Nine months ended September 30,	
	2016	2015
Operating Activities:		
Net earnings, including noncontrolling interests	$280	$240
Adjustments:		
Depreciation and amortization	91	118
Annuity benefits	640	543
Realized (gains) losses on investing activities	(6)	90
Net (purchases) sales of trading securities	73	(9)
Deferred annuity and life policy acquisition costs	(172)	(164)
Change in:		
Reinsurance and other receivables	(972)	(468)
Other assets	(257)	68
Insurance claims and reserves	796	491
Payable to reinsurers	244	79
Other liabilities	230	(45)
Managed investment entities’ assets/liabilities	(235)	(53)
Other operating activities, net	(39)	17
Net cash provided by operating activities	673	907
Investing Activities:		
Purchases of:		
Fixed maturities	(5,604)	(5,395)
Equity securities	(143)	(449)
Mortgage loans	(310)	(105)
Real estate, property and equipment	(37)	(65)
Proceeds from:		
Maturities and redemptions of fixed maturities	3,111	2,426
Repayments of mortgage loans	197	231
Sales of fixed maturities	496	235
Sales of equity securities	193	193
Sales of real estate, property and equipment	45	96
Managed investment entities:		
Purchases of investments	(1,405)	(1,167)
Proceeds from sales and redemptions of investments	1,381	685
Other investing activities, net	(370)	(100)
Net cash used in investing activities	(2,446)	(3,415)
Financing Activities:		
Annuity receipts	3,474	3,333
Annuity surrenders, benefits and withdrawals	(1,726)	(1,487)
Net transfers from variable annuity assets	29	32
Additional long-term borrowings	302	—

Reductions of long-term debt	—	(182)
Issuances of managed investment entities' liabilities	1,028	693
Retirements of managed investment entities' liabilities	(747)	(192)
Issuances of Common Stock	34	47
Repurchases of Common Stock	(124)	(113)
Cash dividends paid on Common Stock	(72)	(65)
Other financing activities, net	(6)	(7)
Net cash provided by financing activities	2,192	2,059
Net Change in Cash and Cash Equivalents	419	(449)
Cash and cash equivalents at beginning of period	1,220	1,343
Cash and cash equivalents at end of period	$1,639	$894

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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, 2016, 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 2016.

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 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 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 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.

On January 1, 2016, AFG adopted ASU 2015-02, which amended certain consolidation accounting guidance, including the VIE guidance that applies to collateralized financing entities such as CLOs. The new guidance affects how fee arrangements with CLO asset managers impact the determination of the primary beneficiary of those entities. Due to the significance of AFG's investments in the CLOs that it manages, the new guidance did not impact the consolidation of AFG's currently outstanding CLOs. The new guidance also impacted the consolidation analysis that applies to limited partnerships and similar entities, but did not result in a change to 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 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 ASU 2014-13, 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. This difference was recorded as "appropriated retained earnings — managed investment entities" in AFG's Balance Sheet. In accordance with the guidance adopted in 2015, 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.

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 (included in other income) 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.

Debt Issuance Costs   Debt issuance costs related to AFG's outstanding debt are amortized over the life of the related debt using the effective interest method. Effective January 1, 2016, AFG adopted (on a retrospective basis) ASU 2015-03, which requires debt issuance costs to be presented in the balance sheet as a direct reduction in the carrying value of long-term debt (consistent with the treatment of debt discounts) with the periodic amortization of such costs included in interest expense. Debt issuance costs related to AFG's revolving credit facilities will continue to be included in other assets in AFG's Balance Sheet. Prior to AFG's adoption of ASU 2015-03, AFG reported unamortized debt issuance costs as a deferred charge asset (included in other assets) in AFG's Balance Sheet and the periodic amortization was included in other expenses in AFG's Statement of Earnings. The updated guidance did not affect the overall recognition and measurement guidance for debt issuance costs. Accordingly, the guidance did not have an overall impact on AFG's Shareholders' Equity or results of operations.

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.

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 2016 and 2015 — 1.6 million and 1.8 million; first nine months of 2016 and 2015 — 1.6 million and 1.8 million, respectively.

AFG's weighted average diluted shares outstanding excludes the following anti-dilutive potential common shares related to stock compensation plans: third quarter of 2016 and 2015 — 0.2 million and 0.9 million; first nine months of 2016 and 2015 — 0.6 million and 1.2 million, respectively. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2016 and 2015 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. Acquisition and Sale of Businesses

Proposed Acquisition of Noncontrolling Interest in National Interstate Corporation On July 25, 2016, AFG announced that it reached an agreement with the Special Committee of the Board of Directors of National Interstate Corporation ("NATL") to acquire all shares of NATL that it does not currently own. NATL is currently a 51%-owned subsidiary of AFG's wholly-owned subsidiary, Great American Insurance Company ("GAI"). Shareholders of NATL, other than GAI, will receive $32.00 per share in cash in the transaction. In addition, NATL will pay a one-time special dividend to its shareholders of $0.50 per NATL share in cash immediately prior to the closing of the merger. The transaction remains subject to the approval of shareholders holding a majority of the shares of NATL not owned by AFG or its affiliates. On November 10, 2016, a special meeting will be held for NATL shareholders to vote on the proposed transaction. GAI has entered into a voting agreement with certain shareholders of NATL under which the shareholders agreed, among other things, to vote all common shares of NATL owned by such shareholders, totaling approximately 10% of the outstanding NATL common shares (and representing approximately 20% of the shares not owned by GAI), in favor of the transaction. Based on a $32.00 per share purchase price plus $0.50 special dividend, the purchase price to acquire the NATL shares not currently owned by GAI will be approximately $320 million. Because NATL is already a consolidated subsidiary of AFG, the acquisition will be accounted for as an equity transaction with the excess of the consideration paid over the carrying value of the noncontrolling interest acquired recorded as a direct reduction in AFG's Capital Surplus (approximately $140 million based on balances as of September 30, 2016). In addition, the proposed transaction will allow NATL and its subsidiaries to become members of the AFG consolidated tax group, which will result in a tax benefit of approximately $66 million to AFG at the time the transaction is consummated, which is expected to be during the fourth quarter of 2016.

Sale of Long-term Care Business   On December 24, 2015, AFG completed the sale of substantially all of its run-off long-term care insurance business (which was included in the run-off long-term care and life segment) to HC2 Holdings, Inc. ("HC2") for an initial payment of $7 million in cash and HC2 securities with a fair value of $11 million (subject to post-closing adjustments). AFG may also receive up to $13 million of additional proceeds from HC2 in the future contingent upon the release of certain statutory-basis liabilities of the legal entities sold by AFG. In connection with obtaining regulatory approval for the transaction, AFG agreed to provide up to an aggregate of $35 million of capital support for the insurance companies, on an as-needed basis to maintain specified surplus levels, subject to immediate reimbursement by HC2 through a five-year capital maintenance agreement. The legal entities involved in the transaction, United Teacher Associates Insurance Company ("UTA") and Continental General Insurance Company ("CGIC"), contained substantially all of AFG's long-term care insurance reserves (96% as measured by net statutory reserves as of November 30, 2015), as well as smaller blocks of annuity and life insurance business. Following the sale of these subsidiaries, AFG has only a small block of long-term care insurance (1,600 policies) with approximately $38 million of reserves at September 30, 2016. AFG had ceased new sales of long-term care insurance in January 2010, but continued to service and accept renewal premiums on its outstanding policies, which are guaranteed renewable.

In addition to the $18 million in cash and securities received at closing and the $13 million of potential additional proceeds in the future from the release of statutory liabilities, AFG received a total of $97 million in tax benefits related to the sale. AFG received these tax benefits in the first nine months of 2016 through reduced estimated tax payments and a tax refund resulting from the carryback of the tax-basis capital loss. The receivables for these tax benefits were reflected in AFG's financial statements at December 31, 2015.

Based on the status of ongoing negotiations at the end of the first quarter of 2015, management determined that the potential sale of the run-off long-term care insurance business met the GAAP "held for sale" criteria as of March 31, 2015. Accordingly, AFG recorded a $162 million pretax loss ($105 million loss after tax) in the first quarter of 2015 to establish a liability equal to the excess of the net carrying value of the assets and liabilities to be disposed over the estimated net sale proceeds. At the closing date, the loss was adjusted to $166 million ($108 million loss after tax) based on the actual proceeds received and the final carrying value of the net assets disposed. In the second quarter of 2016, AFG received additional proceeds based on the final closing balance sheet and adjusted certain accrued expense estimates associated with the sale, resulting in a $2 million pretax gain. At March 31, 2015 and at the sale date, the carrying value of the assets and liabilities disposed represented approximately 4% of both AFG's assets and liabilities.

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

	Three months ended September 30, 2015	Nine months ended September 30, 2015
Life, accident and health net earned premiums:		
Long-term care	$ 19	$ 56
Life operations	3	8
Net investment income	19	56
Realized gains (losses) on securities and other income	(4)	(6)
Total revenues	37	114
Annuity benefits	2	6
Life, accident and health benefits:		
Long-term care	21	67
Life operations	3	8
Annuity and supplemental insurance acquisition expenses	3	9
Other expenses	4	13
Total costs and expenses	33	103
Earnings before income taxes	$ 4	$ 11

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.

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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,	
	2016	2015	2016	2015
Revenues				
Property and casualty insurance:				
Premiums earned:				
Specialty				
Property and transportation	$493	$517	$1,197	$1,157
Specialty casualty	497	503	1,496	1,496
Specialty financial	145	131	416	380
Other specialty	24	22	75	71
Total premiums earned	1,159	1,173	3,184	3,104
Net investment income	93	83	265	245
Other income (a)	3	2	46	61
Total property and casualty insurance	1,255	1,258	3,495	3,410
Annuity:				
Net investment income	351	317	1,010	915
Other income	26	24	76	75
Total annuity	377	341	1,086	990
Run-off long-term care and life (b)	13	50	37	145
Other	58	49	173	137
Total revenues before realized gains (losses)	1,703	1,698	4,791	4,682
Realized gains (losses) on securities	2	(16)	(32)	2
Realized gains (losses) on subsidiaries	—	5	2	(157)
Total revenues	$1,705	$1,687	$4,761	$4,527
Earnings Before Income Taxes				
Property and casualty insurance:				
Underwriting:				
Specialty				
Property and transportation	$44	$20	$91	$14
Specialty casualty	13	31	65	96
Specialty financial	19	26	64	72
Other specialty	2	7	7	13
Other lines (c)	(36)	(69)	(101)	(70)
Total underwriting	42	15	126	125
Investment and other income, net (a)	79	75	269	272
Total property and casualty insurance	121	90	395	397
Annuity	107	67	236	230
Run-off long-term care and life (b)	1	6	—	14
Other (d)	(53)	(53)	(131)	(131)
Total earnings before realized gains (losses) and income taxes	176	110	500	510
Realized gains (losses) on securities	2	(16)	(32)	2
Realized gains (losses) on subsidiaries	—	5	2	(157)

Total earnings before income taxes	$178	$99	$470	$355

(a) Includes pretax income of $32 million (before noncontrolling interest) from the sale of an apartment property in the second quarter of 2016 and $51 million (before noncontrolling interest) from the sale of the Le Pavillon Hotel in the second quarter of 2015.

(b) AFG sold substantially all of its run-off long-term care insurance business in December 2015.

(c) Includes a special charge of $65 million related to the exit of certain lines of business within AFG's Lloyd's-based insurer, Neon, in the second quarter of 2016 and special charges of $36 million and $67 million in the third quarter of 2016 and 2015, respectively, to increase asbestos and environmental ("A&E") reserves.

(d) Includes holding company interest and expenses, including a $4 million loss on retirement of debt in the third quarter of 2015, and special charges of $5 million and $12 million in the third quarter of 2016 and 2015, respectively, to increase A&E reserves related to AFG's former railroad and manufacturing operations.

D. Fair Value Measurements

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

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

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

Level 3 — Valuations derived from market valuation techniques generally consistent with those used to estimate the fair values of Level 2 financial instruments in which one or more significant inputs are unobservable or when the market for a security exhibits significantly less liquidity relative to markets supporting Level 2 fair value measurements. The unobservable inputs may include management's own assumptions about the assumptions market participants would use based on the best information available in the circumstances. AFG's Level 3 is comprised of financial instruments 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, 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 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 December 2015, AFG completed the sale of substantially all of its run-off long-term care insurance business. Based on the status of ongoing negotiations at the end of the first quarter of 2015, management determined that the potential sale of the run-off long-term care insurance business met GAAP “held for sale” criteria as of March 31, 2015. Accordingly, 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 used to determine that loss 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, 2016				
Assets:				
Available for sale ("AFS") fixed maturities:				
U.S. Government and government agencies	$133	$191	$8	$332
States, municipalities and political subdivisions	—	6,956	91	7,047
Foreign government	—	141	—	141
Residential MBS	—	3,597	219	3,816
Commercial MBS	—	1,815	34	1,849
Asset-backed securities ("ABS")	—	5,422	467	5,889
Corporate and other	35	15,576	709	16,320
Total AFS fixed maturities	168	33,698	1,528	35,394
Trading fixed maturities	12	336	—	348
Equity securities — AFS and trading	1,373	101	165	1,639
Assets of managed investment entities ("MIE")	328	3,960	24	4,312
Variable annuity assets (separate accounts) (*)	—	606	—	606
Other investments — equity index call options	—	447	—	447
Other assets — derivatives	—	14	—	14
Total assets accounted for at fair value	$1,881	$39,162	$1,717	$42,760
Liabilities:				
Liabilities of managed investment entities	$310	$3,734	$23	$4,067
Derivatives in annuity benefits accumulated	—	—	1,688	1,688
Derivatives in long-term debt	—	(6)	—	(6)
Other liabilities — derivatives	—	13	—	13
Total liabilities accounted for at fair value	$310	$3,741	$1,711	$5,762
December 31, 2015				
Assets:				
Available for sale fixed maturities:				
U.S. Government and government agencies	$100	$192	$15	$307
States, municipalities and political subdivisions	—	6,767	89	6,856
Foreign government	—	154	—	154
Residential MBS	—	3,305	224	3,529
Commercial MBS	—	2,148	39	2,187
Asset-backed securities	—	4,464	470	4,934
Corporate and other	50	13,634	633	14,317
Total AFS fixed maturities	150	30,664	1,470	32,284
Trading fixed maturities	13	241	—	254
Equity securities — AFS and trading	1,362	217	140	1,719
Assets of managed investment entities	309	3,712	26	4,047
Variable annuity assets (separate accounts) (*)	—	608	—	608
Other investments — equity index call options	—	241	—	241
Other assets — derivatives	—	2	—	2
Total assets accounted for at fair value	$1,834	$35,685	$1,636	$39,155

Liabilities:				
Liabilities of managed investment entities	$289	$3,468	$24	$3,781
Derivatives in annuity benefits accumulated	—	—	1,369	1,369
Derivatives in long-term debt	—	(2)	—	(2)
Other liabilities — derivatives	—	8	—	8
Total liabilities accounted for at fair value	$289	$3,474	$1,393	$5,156

(*) 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 of 2016, there was one common stock with a fair value of less than $1 million that transferred from Level 1 to Level 2. During the first nine months of 2016, there were six perpetual preferred stocks with a fair value of $35 million that transferred from Level 2 to Level 1 and five perpetual preferred stocks and one common stock with aggregate fair values of $12 million and less than $1 million, respectively, that transferred from Level 1 to Level 2. 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, 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.

Approximately 4% of the total assets carried at fair value on September 30, 2016, were Level 3 assets. Approximately 76% ($1.31 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 less than 10% of AFG's shareholders' equity, any justifiable 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 $1.69 billion at September 30, 2016. 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	0.4% – 2.9% over the risk free rate
Risk margin for uncertainty in cash flows	0.58% reduction in the discount rate
Surrenders	3% – 21% of indexed account value
Partial surrenders	2% – 10% of indexed account value
Annuitizations	0.25% – 1% of indexed account value
Deaths	1.5% – 4.0% of indexed account value
Budgeted option costs	1.75% – 3.5% 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 10% in the majority of future calendar years (3% to 21% over all periods). Increasing the budgeted option cost or risk margin for uncertainty in cash flows assumptions in the table above would increase the fair value of the fixed-indexed annuity embedded derivatives, while increasing any of the other unobservable inputs in the table above would decrease the fair value of the embedded derivatives.

Changes in balances of Level 3 financial assets and liabilities carried at fair value during the third quarter and first nine months of 2016 and 2015 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, 2016	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, 2016
AFS fixed maturities:								
U.S. government agency	$8	$ —	$ —	$ —	$ —	$ —	$ —	$ 8
State and municipal	91	—	1	—	(1)	—	—	91
Residential MBS	231	(2)	—	—	(8)	—	(2)	219
Commercial MBS	36	—	—	—	(2)	—	—	34
Asset-backed securities	478	(1)	4	—	(5)	—	(9)	467
Corporate and other	689	—	(3)	37	(14)	—	—	709
Total AFS fixed maturities	1,533	(3)	2	37	(30)	—	(11)	1,528
Equity securities	166	5	5	10	(21)	—	—	165
Assets of MIE	26	(2)	—	—	—	—	—	24
Total Level 3 assets	$1,725	$ —	$ 7	$ 47	$ (51)	$ —	$ (11)	$ 1,717
Embedded derivatives	$(1,557)	$ (109)	$ —	$ (53)	$ 31	$ —	$ —	$ (1,688)
Total Level 3 liabilities (*)	$(1,557)	$ (109)	$ —	$ (53)	$ 31	$ —	$ —	$ (1,688)

	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
Total AFS fixed maturities	1,372	(3)	6	143	(26)	61	(11)	1,542
Equity securities	118	—	(2)	7	—	—	—	123
Assets of MIE	29	(3)	—	—	—	—	—	26
Total Level 3 assets	$1,519	$ (6)	$ 4	$ 150	$ (26)	$ 61	$ (11)	$ 1,691
Embedded derivatives	$(1,258)	$ 130	$ —	$ (88)	$ 18	$ —	$ —	$ (1,198)
Total Level 3 liabilities (*)	$(1,258)	$ 130	$ —	$ (88)	$ 18	$ —	$ —	$ (1,198)

(*) As discussed previously, 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, 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, 2016
AFS fixed maturities:								
U.S. government agency	$ 15	$ (8)	$ 1	$ —	$ —	$ —	$ —	$ 8
State and municipal	89	—	4	—	(2)	—	—	91
Residential MBS	224	—	1	—	(21)	33	(18)	219
Commercial MBS	39	(1)	—	—	(4)	—	—	34
Asset-backed securities	470	(1)	1	15	(24)	41	(35)	467
Corporate and other	633	—	24	131	(89)	15	(5)	709
Total AFS fixed maturities	1,470	(10)	31	146	(140)	89	(58)	1,528
Equity securities	140	(12)	21	22	(21)	15	—	165
Assets of MIE	26	(6)	—	4	—	—	—	24
Total Level 3 assets	$ 1,636	$ (28)	$ 52	$ 172	$ (161)	$ 104	$ (58)	$ 1,717
Embedded derivatives	$ (1,369)	$ (188)	$ —	$ (207)	$ 76	$ —	$ —	$ (1,688)
Total Level 3 liabilities (a)	$ (1,369)	$ (188)	$ —	$ (207)	$ 76	$ —	$ —	$ (1,688)

	Balance at December 31, 2014	Impact of accounting change (b)	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
Total AFS fixed maturities	1,231	—	(7)	(6)	367	(114)	165	(94)	1,542
Equity securities	93	—	(4)	(1)	52	—	—	(17)	123
Assets of MIE	31	—	(9)	—	4	—	—	—	26
Total Level 3 assets	$ 1,355	$ —	$ (20)	$ (7)	$ 423	$ (114)	$ 165	$ (111)	$ 1,691

Liabilities of MIE	$ (2,701)	$ 2,701	$ —	$ —	$ —	$ —	$ —	$ —	$ —
Embedded derivatives	(1,160)	—	99	—	(183)	46	—	—	(1,198)
Total Level 3 liabilities (a)	$ (3,861)	$ 2,701	$ 99	$ —	$ (183)	$ 46	$ —	$ —	$ (1,198)

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

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

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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 Total	Level 1	Level 2	Level 3
September 30, 2016					
Financial assets:					
Cash and cash equivalents	$1,639	$1,639	$1,639	$—	$—
Mortgage loans	1,180	1,193	—	—	1,193
Policy loans	194	194	—	—	194
Total financial assets not accounted for at fair value	$3,013	$3,026	$1,639	$—	$1,387
Financial liabilities:					
Annuity benefits accumulated (*)	$29,018	$29,020	$—	$—	$29,020
Long-term debt	1,306	1,438	—	1,417	21
Total financial liabilities not accounted for at fair value	$30,324	$30,458	$—	$1,417	$29,041
December 31, 2015					
Financial assets:					
Cash and cash equivalents	$1,220	$1,220	$1,220	$—	$—
Mortgage loans	1,067	1,074	—	—	1,074
Policy loans	201	201	—	—	201
Total financial assets not accounted for at fair value	$2,488	$2,495	$1,220	$—	$1,275
Financial liabilities:					
Annuity benefits accumulated (*)	$26,422	$25,488	$—	$—	$25,488
Long-term debt	1,000	1,120	—	1,105	15
Total financial liabilities not accounted for at fair value	$27,422	$26,608	$—	$1,105	$25,503

(*) Excludes $204 million and $200 million of life contingent annuities in the payout phase at September 30, 2016 and December 31, 2015, 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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E. Investments

Available for sale fixed maturities and equity securities at September 30, 2016 and December 31, 2015, consisted of the following (in millions):

	September 30, 2016					December 31, 2015				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Net Unrealized	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Net Unrealized	Fair Value
Fixed maturities:										
U.S. Government and government agencies	$328	$6	$(2)	$4	$332	$305	$5	$(3)	$2	$307
States, municipalities and political subdivisions	6,597	455	(5)	450	7,047	6,642	249	(35)	214	6,856
Foreign government	134	7	—	7	141	147	7	—	7	154
Residential MBS	3,530	300	(14)	286	3,816	3,236	308	(15)	293	3,529
Commercial MBS	1,764	85	—	85	1,849	2,111	77	(1)	76	2,187
Asset-backed securities	5,844	70	(25)	45	5,889	4,961	25	(52)	(27)	4,934
Corporate and other	15,389	962	(31)	931	16,320	14,163	422	(268)	154	14,317
Total fixed maturities	$33,586	$1,885	$(77)	$1,808	$35,394	$31,565	$1,093	$(374)	$719	$32,284
Equity Securities:										
Common stocks	$939	$157	$(27)	$130	$1,069	$1,051	$146	$(79)	$67	$1,118
Perpetual preferred stocks	453	34	(3)	31	484	418	23	(6)	17	435
Total equity securities	$1,392	$191	$(30)	$161	$1,553	$1,469	$169	$(85)	$84	$1,553

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, 2016 and December 31, 2015, respectively, were $192 million and $205 million. Gross unrealized gains on such securities at September 30, 2016 and December 31, 2015 were $131 million and $134 million, respectively. Gross unrealized losses on such securities at September 30, 2016 and December 31, 2015 were $5 million and $6 million, respectively. These amounts represent the non-credit other-than-temporary impairment charges recorded in AOCI adjusted for subsequent changes in fair values and nearly all relate to residential MBS.

The following tables show gross unrealized losses (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, 2016 and December 31, 2015.

	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, 2016						
Fixed maturities:						
U.S. Government and government agencies	$ —	$ 51	100 %	$ (2)	$ 8	80 %
States, municipalities and political subdivisions	(2)	191	99 %	(3)	50	94 %
Residential MBS	(7)	490	99 %	(7)	158	96 %
Commercial MBS	—	23	100 %	—	4	100 %
Asset-backed securities	(13)	924	99 %	(12)	535	98 %
Corporate and other	(8)	470	98 %	(23)	336	94 %
Total fixed maturities	$ (30)	$ 2,149	99 %	$ (47)	$ 1,091	96 %
Equity securities:						
Common stocks	$ (27)	$ 233	90 %	$ —	$ —	— %
Perpetual preferred stocks	(2)	89	98 %	(1)	6	86 %
Total equity securities	$ (29)	$ 322	92 %	$ (1)	$ 6	86 %
December 31, 2015						
Fixed maturities:						
U.S. Government and government agencies	$ (1)	$ 112	99 %	$ (2)	$ 15	88 %
States, municipalities and political subdivisions	(33)	1,419	98 %	(2)	50	96 %
Residential MBS	(7)	438	98 %	(8)	201	96 %
Commercial MBS	—	95	100 %	(1)	28	97 %
Asset-backed securities	(42)	2,706	98 %	(10)	455	98 %
Corporate and other	(229)	4,661	95 %	(39)	165	81 %
Total fixed maturities	$ (312)	$ 9,431	97 %	$ (62)	$ 914	94 %
Equity securities:						
Common stocks	$ (79)	$ 509	87 %	$ —	$ —	— %
Perpetual preferred stocks	(3)	91	97 %	(3)	22	88 %
Total equity securities	$ (82)	$ 600	88 %	$ (3)	$ 22	88 %

At September 30, 2016, the gross unrealized losses on fixed maturities of $77 million relate to approximately 475 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 49% of the gross unrealized loss and 74% of the fair value.

AFG analyzes its MBS securities for other-than-temporary impairment each quarter based upon expected future cash flows. Management estimates expected future cash flows based upon its knowledge of the MBS market, cash flow projections (which reflect loan to collateral values, subordination, vintage and geographic concentration) received from independent sources, implied cash flows inherent in security ratings and analysis of historical payment data. In the first nine months of 2016, AFG recorded $2 million in other-than-temporary impairment charges related to its residential MBS.

In the first nine months of 2016, AFG recorded approximately $34 million in other-than-temporary impairment charges related to corporate bonds and other fixed maturities.

AFG recorded $79 million in other-than-temporary impairment charges on common stocks in the first nine months of 2016. At September 30, 2016, the gross unrealized losses on common stocks of $27 million relate to 32 securities, none of which has been in an unrealized loss position for more than 12 months.

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AFG recorded $4 million in other-than-temporary impairment charges on preferred stocks in the first nine months of 2016. At September 30, 2016, the gross unrealized losses on preferred stocks of $3 million relate to 14 securities. All of the preferred stocks that have been in an unrealized loss position for 12 months or more (1 security), have investment grade ratings.

Management believes AFG will recover its cost basis in the securities with unrealized losses and that AFG has the ability to hold the securities until they recover in value and had no intent to sell them at September 30, 2016.

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

	2016	2015
Balance at June 30	$157	$166
Additional credit impairments on:		
Previously impaired securities	—	—
Securities without prior impairments	—	2
Reductions due to sales or redemptions	(2)	(2)
Balance at September 30	$155	$166
Balance at January 1	$160	$170
Additional credit impairments on:		
Previously impaired securities	2	1
Securities without prior impairments	—	2
Reductions due to sales or redemptions	(7)	(7)
Balance at September 30	$155	$166

The table below sets forth the scheduled maturities of available for sale fixed maturities as of September 30, 2016 (dollars in millions). Securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

	Amortized Cost	Fair Value Amount	%
Maturity			
One year or less	$ 1,036	$1,053	3 %
After one year through five years	5,686	6,047	17 %
After five years through ten years	11,767	12,467	35 %
After ten years	3,959	4,273	12 %
	22,448	23,840	67 %
ABS (average life of approximately 5 years)	5,844	5,889	17 %
MBS (average life of approximately 4 years)	5,294	5,665	16 %
Total	$ 33,586	$35,394	100%

Certain risks are inherent in fixed maturity securities, including loss upon default, price volatility in reaction to changes in interest rates, and general market factors and risks associated with reinvestment of proceeds due to prepayments or redemptions in a period of declining interest rates.

There were no investments in individual issuers that exceeded 10% of shareholders’ equity at September 30, 2016 or December 31, 2015.

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

	Pretax	Deferred Tax and Amounts Attributable to Noncontrolling Interests	Net
September 30, 2016			
Unrealized gain on:			
Fixed maturities — annuity segment (*)	$1,420	$ (497)	$923
Fixed maturities — all other	388	(145)	243
Total fixed maturities	1,808	(642)	1,166
Equity securities	161	(58)	103
Total investments	1,969	(700)	1,269
Deferred policy acquisition costs — annuity segment	(614)	215	(399)
Annuity benefits accumulated	(179)	63	(116)
Life, accident and health reserves	(1)	—	(1)
Unearned revenue	30	(11)	19
Total net unrealized gain on marketable securities	$1,205	$ (433)	$772

December 31, 2015
Unrealized gain on: