

AMERICAN FINANCIAL GROUP INC

Form 10-Q

November 08, 2018

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

For the

Quarterly

Period

Ended

September

30, 2018

Commission

File No.

1-13653

AMERICAN FINANCIAL GROUP, INC.

Incorporated under the Laws of Ohio IRS Employer I.D. No. 31-1544320

301 East Fourth Street, Cincinnati, Ohio 45202

(513) 579-2121

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months. Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

Smaller reporting company Emerging growth company

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

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

Yes No

As of November 1, 2018, there were 89,253,183 shares of the Registrant's Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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PART I

ITEM I — FINANCIAL STATEMENTS

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET (UNAUDITED)

(Dollars in Millions)

	September 30, 2018	December 31, 2017
Assets:		
Cash and cash equivalents	\$ 2,009	\$ 2,338
Investments:		
Fixed maturities, available for sale at fair value (amortized cost — \$40,053 and \$37,038)	40,244	38,379
Fixed maturities, trading at fair value	103	348
Equity securities, at fair value	1,827	1,662
Investments accounted for using the equity method	1,289	999
Mortgage loans	1,152	1,125
Policy loans	176	184
Equity index call options	759	701
Real estate and other investments	282	312
Total cash and investments	47,841	46,048
Recoverables from reinsurers	3,352	3,369
Prepaid reinsurance premiums	717	600
Agents' balances and premiums receivable	1,299	1,146
Deferred policy acquisition costs	1,669	1,216
Assets of managed investment entities	4,998	4,902
Other receivables	1,633	1,030
Variable annuity assets (separate accounts)	650	644
Other assets	1,832	1,504
Goodwill	199	199
Total assets	\$ 64,190	\$ 60,658
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	\$ 9,670	\$ 9,678
Unearned premiums	2,740	2,410
Annuity benefits accumulated	35,958	33,316
Life, accident and health reserves	643	658
Payable to reinsurers	932	743
Liabilities of managed investment entities	4,807	4,687
Long-term debt	1,302	1,301
Variable annuity liabilities (separate accounts)	650	644
Other liabilities	2,324	1,887
Total liabilities	59,026	55,324
Redeemable noncontrolling interests	—	3
Shareholders' equity:		
Common Stock, no par value		
— 200,000,000 shares authorized	89	88
— 89,188,708 and 88,275,460 shares outstanding		

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

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

(In Millions, Except Per Share Data)

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Revenues:				
Property and casualty insurance net earned premiums	\$1,327	\$1,267	\$3,595	\$3,354
Life, accident and health net earned premiums	6	6	18	17
Net investment income	527	471	1,552	1,366
Realized gains (losses) on securities (*)	34	(12)	(28)	(1)
Income (loss) of managed investment entities:				
Investment income	65	54	187	155
Gain (loss) on change in fair value of assets/liabilities	(5)	1	(10)	12
Other income	54	48	146	154
Total revenues	2,008	1,835	5,460	5,057
Costs and Expenses:				
Property and casualty insurance:				
Losses and loss adjustment expenses	872	995	2,206	2,239
Commissions and other underwriting expenses	424	357	1,205	1,062
Annuity benefits	222	215	664	635
Life, accident and health benefits	10	6	32	21
Annuity and supplemental insurance acquisition expenses	71	55	203	156
Interest charges on borrowed money	15	21	46	65
Expenses of managed investment entities	52	45	154	137
Other expenses	98	112	272	285
Total costs and expenses	1,764	1,806	4,782	4,600
Earnings before income taxes	244	29	678	457
Provision for income taxes	41	18	126	146
Net earnings, including noncontrolling interests	203	11	552	311
Less: Net earnings (losses) attributable to noncontrolling interests	(1)	—	(7)	2
Net Earnings Attributable to Shareholders	\$204	\$11	\$559	\$309
Earnings Attributable to Shareholders per Common Share:				
Basic	\$2.30	\$0.13	\$6.29	\$3.52
Diluted	\$2.26	\$0.13	\$6.17	\$3.44
Average number of Common Shares:				
Basic	89.1	88.1	88.9	87.7
Diluted	90.7	90.0	90.6	89.7
Cash dividends per Common Share	\$0.35	\$0.3125	\$2.55	\$2.4375
<hr/>				
(*) Consists of the following:				
Realized gains (losses) before impairments	\$36	\$26	\$(25)	\$52
Losses on securities with impairment	(2)	(38)	(3)	(54)

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

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

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

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

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

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

(In Millions)

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

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

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

A. Accounting Policies

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

Certain reclassifications have been made to prior periods to conform to the current year's presentation. All significant intercompany balances and transactions have been eliminated. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements. Events or transactions occurring subsequent to September 30, 2018, and prior to the filing of this Form 10-Q, have been evaluated for potential recognition or disclosure herein.

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

Fair Value Measurements Accounting standards define fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. The standards establish a hierarchy of valuation techniques based on whether the assumptions that market participants would use in pricing the asset or liability ("inputs") are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect AFG's assumptions about the assumptions market participants would use in pricing the asset or liability. AFG did not have any significant nonrecurring fair value measurements in the first nine months of 2018.

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

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

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

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

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

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

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

To qualify for hedge accounting, at the inception of a derivative contract, AFG formally documents the relationship between the terms of the hedge and the hedged items and its risk management objective. This documentation includes

defining how hedge effectiveness and ineffectiveness will be measured on a retrospective and prospective basis.

Changes in the fair value of derivatives that are designated and qualify as highly effective cash flow hedges are recorded in AOCI and are reclassified into earnings when the variability of the cash flows from the hedged items impacts earnings. Any hedge ineffectiveness is immediately recorded in current period earnings. When the change in the fair value of a qualifying cash flow hedge is included in earnings, it is included in the same line item in the statement of earnings as the cash flows from the hedged item. AFG uses interest rate swaps that are designated and qualify as highly effective cash flow hedges to mitigate interest rate risk related to certain floating-rate securities included in AFG's portfolio of fixed maturity securities.

For derivatives that are designated and qualify as highly effective fair value hedges, changes in the fair value of the derivative, along with changes in the fair value of the hedged item attributable to the hedged risk, are recognized in current period earnings.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

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

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

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

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

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

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

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

AFG manages, and has investments in, collateralized loan obligations (“CLOs”) that are VIEs (see Note G — “Managed Investment Entities”). AFG has determined that it is the primary beneficiary of the CLOs because (i) its role as asset manager gives it the power to direct the activities that most significantly impact the economic performance of the CLOs and (ii) through its investment in the CLO debt tranches, it has exposure to CLO losses (limited to the amount AFG invested) and the right to receive CLO benefits that could potentially be significant to the CLOs.

Because AFG has no right to use the CLO assets and no obligation to pay the CLO liabilities, the assets and liabilities of the CLOs are shown separately in AFG’s Balance Sheet. AFG has elected the fair value option for reporting on the CLO assets and liabilities to improve the transparency of financial reporting related to the CLOs. The net gain or loss from accounting for the CLO assets and liabilities at fair value is presented separately in AFG’s Statement of Earnings.

The fair values of a CLO’s assets may differ from the separately measured fair values of its liabilities even though the CLO liabilities only have recourse to the CLO assets. AFG has set the carrying value of the CLO liabilities equal to the fair value of the CLO assets (which have more observable fair values) as an alternative to reporting those liabilities at a separately measured fair value. CLO earnings attributable to AFG’s shareholders are measured by the change in the fair value of AFG’s investments in the CLOs and management fees earned.

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

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

Annuity Benefits Accumulated Annuity receipts and benefit payments are recorded as increases or decreases in annuity benefits accumulated rather than as revenue and expense. Increases in this liability for interest credited are charged to annuity benefits expense and decreases for annuity policy charges are recorded in other income. For traditional fixed annuities, the liability for annuity benefits accumulated represents the account value that has accrued to the benefit of the policyholder as of the balance sheet date. For fixed-indexed annuities, the liability or annuity benefits accumulated includes an embedded derivative that represents the estimated fair value of the index participation with the remaining component representing the discounted value of the guaranteed minimum contract benefits.

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

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

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

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

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

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

Debt Issuance Costs Debt issuance costs related to AFG's outstanding debt are presented in its Balance Sheet as a direct reduction in the carrying value of long-term debt and are amortized over the life of the related debt using the effective interest method as a component of interest expense. Debt issuance costs related to AFG's revolving credit facilities are included in other assets in AFG's Balance Sheet.

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

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

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

Noncontrolling Interests For balance sheet purposes, noncontrolling interests represent the interests of shareholders other than AFG in consolidated entities. In the statement of earnings, net earnings and losses attributable to noncontrolling interests represents such shareholders' interest in the earnings and losses of those entities. Noncontrolling interests that are redeemable at the option of the holder are presented separately in the mezzanine section of the balance sheet (between liabilities and equity).

Income Taxes Deferred income taxes are calculated using the liability method. Under this method, deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases and are measured using enacted tax rates. A valuation allowance is established to reduce total deferred tax assets to an amount that will more likely than not be realized. The effect of a change in tax rates on deferred tax assets and liabilities is recorded in net earnings in the period that includes the enactment date.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

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

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

Earnings Per Share Although basic earnings per share only considers shares of common stock outstanding during the period, the calculation of diluted earnings per share includes the following adjustments to weighted average common shares related to stock-based compensation plans: third quarter of 2018 and 2017 — 1.6 million and 1.9 million; first nine months of 2018 and 2017 — 1.7 million and 2.0 million, respectively.

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

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

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

B. Segments of Operations

AFG manages its business as three segments: (i) Property and casualty insurance, (ii) Annuity and (iii) Other, which includes holding company costs, revenues and costs of AFG’s limited insurance operations outside of property and casualty insurance and annuities, and operations attributable to the noncontrolling interests of the managed investment entities.

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes physical damage and liability coverage for buses, trucks and recreational vehicles,

inland and ocean marine, agricultural-related products and other property coverages, (ii) Specialty casualty, which includes primarily excess and surplus, general liability, executive liability, professional liability, umbrella and excess liability, specialty coverage in targeted markets, customized programs for small to mid-sized businesses and workers' compensation insurance, and (iii) Specialty financial, which includes risk management insurance programs for leasing and financing institutions (including equipment leasing and collateral and lender-placed mortgage property insurance), surety and fidelity products and trade credit insurance. Premiums and underwriting profit included under Other specialty represent business assumed by AFG's internal reinsurance program from the operations that make up AFG's other Specialty sub-segments and amortization of deferred gains on retroactive reinsurance transactions related to the sales of businesses in prior years. AFG's annuity business markets traditional fixed, fixed-indexed and variable-indexed annuities in the retail, financial institutions, registered investment advisor and education markets. AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services. Effective January 1, 2018, the results of AFG's run-off long-term care and life

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

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

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

C. Fair Value Measurements

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

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

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

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

As discussed in Note A — "Accounting Policies — Managed Investment Entities," AFG has set the carrying value of its CLO liabilities equal to the fair value of the CLO assets (which have more observable fair values) as an alternative to reporting those liabilities at separately measured fair values. As a result, the CLO liabilities are categorized within the fair value hierarchy on the same basis (proportionally) as the related CLO assets. Since the portion of the CLO liabilities allocated to Level 3 is derived from the fair value of the CLO assets, these amounts are excluded from the progression of Level 3 financial instruments.

AFG's management is responsible for the valuation process and uses data from outside sources (including nationally recognized pricing services and broker/dealers) in establishing fair value. AFG's internal investment professionals are a group of approximately 25 analysts whose primary responsibility is to manage AFG's investment portfolio. These professionals monitor individual investments as well as overall industries and are active in the financial markets on a daily basis. The group is led by AFG's chief investment officer, who reports directly to one of AFG's Co-CEOs. Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by AFG's internal investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, these investment managers consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. In addition, the Company communicates directly with the pricing services regarding the methods and assumptions used in pricing, including

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

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

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

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

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

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

Approximately 7% of the total assets carried at fair value at September 30, 2018, were Level 3 assets. Approximately 68% (\$2.18 billion) of the Level 3 assets were priced using non-binding broker quotes, for which there is a lack of transparency as to the inputs used to determine fair value. Details as to the quantitative inputs are neither provided by the brokers nor otherwise reasonably obtainable by AFG. Since internally developed Level 3 asset fair values represent approximately 18% of AFG's Shareholders' Equity, any justifiable changes in unobservable inputs used to determine internally developed fair values would not be expected to have a material impact on AFG's financial position.

The only significant Level 3 assets or liabilities carried at fair value in the financial statements that were not measured using broker quotes are the derivatives embedded in AFG's fixed-indexed and variable-indexed annuity liabilities, which are measured using a discounted cash flow approach and had a fair value of \$3.11 billion at September 30, 2018. The following table presents information about the unobservable inputs used by management in determining fair value of these embedded derivatives. See Note E — "Derivatives."

Unobservable Input	Range
Adjustment for insurance subsidiary's credit risk	0.4% – 1.6% over the risk free rate
Risk margin for uncertainty in cash flows	0.70% reduction in the discount rate
Surrenders	3% – 23% of indexed account value
Partial surrenders	2% – 9% of indexed account value
Annuity payments	0.1% – 1% of indexed account value
Deaths	1.6% – 8.0% of indexed account value
Budgeted option costs	2.4% – 3.6% of indexed account value

The range of adjustments for insurance subsidiary's credit risk reflects credit spread variations across the yield curve. The range of projected surrender rates reflects the specific surrender charges and other features of AFG's individual fixed-indexed and variable-indexed annuity products with an expected range of 7% to 11% in the majority of future calendar years (3% to 23% over all periods). Increasing the budgeted option cost or risk margin for uncertainty in cash flow assumptions in the table above would increase the fair value of the fixed-indexed and variable-indexed annuity embedded derivatives, while increasing any of the other unobservable inputs in the table above would decrease the fair value of the embedded derivatives.

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

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

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

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

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

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

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

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

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

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

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

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

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

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D. Investments

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

	September 30, 2018				December 31, 2017					
	Amortized Cost	Gross Gains	Unrealized Losses	Net Unrealized Value	Fair Value	Amortized Cost	Gross Gains	Unrealized Losses	Net Unrealized Value	Fair Value
Fixed maturities:										
U.S. Government and government agencies	\$238	\$—	\$(4)	\$(4)	\$234	\$244	\$1	\$(3)	\$(2)	\$242
States, municipalities and political subdivisions	6,756	117	(98)	19	6,775	6,887	254	(18)	236	7,123
Foreign government	137	2	—	2	139	124	3	—	3	127
Residential MBS	2,408	310	(9)	301	2,709	2,884	349	(6)	343	3,227
Commercial MBS	913	14	(4)	10	923	927	36	(1)	35	962
Asset-backed securities	9,249	122	(64)	58	9,307	7,836	142	(16)	126	7,962
Corporate and other	20,352	169	(364)	(195)	20,157	18,136	638	(38)	600	18,736
Total fixed maturities	\$40,053	\$734	\$(543)	\$191	\$40,244	\$37,038	\$1,423	\$(82)	\$1,341	\$38,379

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, 2018 and December 31, 2017 were \$144 million and \$158 million, respectively. Gross unrealized gains on such securities at September 30, 2018 and December 31, 2017 were \$130 million and \$137 million, respectively. Gross unrealized losses on such securities at both September 30, 2018 and December 31, 2017 were \$4 million. These amounts represent the non-credit other-than-temporary impairment charges recorded in AOCI adjusted for subsequent changes in fair values and relate primarily to residential MBS.

As discussed in Note A — “Accounting Policies — Investments,” beginning on January 1, 2018, AFG implemented new accounting guidance, which required all equity securities previously classified as “available for sale” to be reported at fair value, with holding gains and losses recognized in net earnings. Equity securities reported at fair value consisted of the following at September 30, 2018 (in millions):

	Actual Cost	Fair Value	Fair Value in excess of Cost
Common stocks	\$1,040	\$1,151	\$111
Perpetual preferred stocks	683	676	(7)
Total equity securities carried at fair value	\$1,723	\$1,827	\$104

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The following tables show gross unrealized losses (dollars in millions) on available for sale fixed maturities and equity securities by investment category and length of time that individual securities have been in a continuous unrealized loss position at the following balance sheet dates.

	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, 2018								
Fixed maturities:								
U.S. Government and government agencies	\$(1)	\$ 113	99 %		\$(3)	\$ 100	97 %	
States, municipalities and political subdivisions	(63)	2,729	98 %		(35)	721	95 %	
Foreign government	—	105	100 %		—	—	— %	
Residential MBS	(3)	200	99 %		(6)	132	96 %	
Commercial MBS	(3)	178	98 %		(1)	51	98 %	
Asset-backed securities	(47)	4,775	99 %		(17)	353	95 %	
Corporate and other	(283)	10,984	97 %		(81)	1,346	94 %	
Total fixed maturities	\$(400)	\$ 19,084	98 %		\$(143)	\$ 2,703	95 %	
December 31, 2017								
Fixed maturities:								
U.S. Government and government agencies	\$—	\$ 55	100 %		\$(3)	\$ 123	98 %	
States, municipalities and political subdivisions	(8)	825	99 %		(10)	431	98 %	
Foreign government	—	4	100 %		—	—	— %	
Residential MBS	(1)	118	99 %		(5)	118	96 %	
Commercial MBS	(1)	67	99 %		—	—	— %	
Asset-backed securities	(7)	1,195	99 %		(9)	299	97 %	
Corporate and other	(20)	2,031	99 %		(18)	603	97 %	
Total fixed maturities	\$(37)	\$ 4,295	99 %		\$(45)	\$ 1,574	97 %	
Equity securities:								
Common stocks	\$(22)	\$ 117	84 %		\$—	\$—	— %	
Perpetual preferred stocks	—	41	100 %		(1)	13	93 %	
Total equity securities	\$(22)	\$ 158	88 %		\$(1)	\$ 13	93 %	

At September 30, 2018, the gross unrealized losses on fixed maturities of \$543 million relate to 2,392 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 95% of the gross unrealized loss and 96% 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 2018, AFG recorded \$1 million in other-than-temporary impairment charges related to its residential MBS.

In the first nine months of 2018, AFG recorded \$2 million in other-than-temporary impairment charges related to corporate bonds and other fixed maturities.

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, 2018. As discussed in Note A — “Accounting Policies — Investments,” effective January 1, 2018, all equity securities previously classified as “available for sale” are required to be carried at fair value through net earnings instead of accumulated other comprehensive income and therefore are no longer evaluated for other-than-temporary impairment.

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

	2018	2017
Balance at June 30	\$144	\$145
Additional credit impairments on:		
Previously impaired securities	—	—
Securities without prior impairments	—	3
Reductions due to sales or redemptions	(1)	(1)
Balance at September 30	\$143	\$147
Balance at January 1	\$145	\$153
Additional credit impairments on:		
Previously impaired securities	—	1
Securities without prior impairments	1	3
Reductions due to sales or redemptions	(3)	(10)
Balance at September 30	\$143	\$147

The table below sets forth the scheduled maturities of available for sale fixed maturities as of September 30, 2018 (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.

Maturity	Amortized Fair Value		
	Cost	Amount	%
One year or less	\$ 1,212	\$1,223	3 %
After one year through five years	8,150	8,184	20 %
After five years through ten years	13,372	13,211	33 %
After ten years	4,749	4,687	12 %
	27,483	27,305	68 %
ABS (average life of approximately 4-1/2 years)	9,249	9,307	23 %
MBS (average life of approximately 4-1/2 years)	3,321	3,632	9 %
Total	\$ 40,053	\$40,244	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, 2018 or December 31, 2017.

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Net Unrealized Gain on Marketable Securities In addition to adjusting fixed maturity securities and equity 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	Net
September 30, 2018			
Net unrealized gain on:			
Fixed maturities — annuity segment (a)	\$ 143	\$ (30)	\$ 113
Fixed maturities — all other	48	(10)	38
Total fixed maturities	191	(40)	151
Deferred policy acquisition costs — annuity segment	(56)	12	(44)
Annuity benefits accumulated	(18)	3	(15)
Unearned revenue	1	—	1
Total net unrealized gain on marketable securities	\$ 118	\$ (25)	\$ 93

December 31, 2017

Net unrealized gain on:			
Fixed maturities — annuity segment (a)	\$ 1,082	\$ (227)	\$ 855
Fixed maturities — all other	259	(55)	204
Total fixed maturities	1,341	(282)	1,059
Equity securities (b)	279	(58)	221
Total investments	1,620	(340)	1,280
Deferred policy acquisition costs — annuity segment	(433)	91	(342)
Annuity benefits accumulated	(137)	29	(108)
Unearned revenue	13	(3)	10
Total net unrealized gain on marketable securities	\$ 1,063	\$ (223)	\$ 840

(a) Net unrealized gains on fixed maturity investments supporting AFG’s annuity benefits accumulated.

(b) As discussed in Note A — “Accounting Policies — Investments,” effective January 1, 2018, all equity securities other than those accounted for under the equity method are carried at fair value through net earnings.

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Investment income:				
Fixed maturities	\$ 440	\$ 405	\$ 1,283	\$ 1,191
Equity securities:				
Dividends	19	17	59	53
Change in fair value (*)	2	—	16	4
Equity in earnings of partnerships and similar investments	41	20	128	51

Other	31	33	82	80
Gross investment income	533	475	1,568	1,379
Investment expenses	(6)	(4)	(16)	(13)
Net investment income	\$527	\$471	\$1,552	\$1,366

As discussed in Note A — “Accounting Policies — Investments,” AFG adopted guidance in January 2018 that requires all equity securities other than those accounted for under the equity method to be reported at fair value with holding (*) gains and losses recognized in net earnings. Although the change in the fair value of the majority of AFG’s equity securities is recorded in realized gains (losses) on securities, AFG records holding gains and losses in net investment income on equity

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

securities classified as “trading” under the previous guidance and on a small portfolio of limited partnership and similar investments that do not qualify for the equity method of accounting.

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

	Three months ended September 30, 2018				Three months ended September 30, 2017			
	Realized gains (losses)			Change in Unrealized	Realized gains (losses)			Change in Unrealized
	Before Impairments	Impairments	Total		Before Impairments	Impairments	Total	
Fixed maturities	\$—	\$ (2)	\$(2)	\$ (213)	\$9	\$ (15)	\$(6)	\$ 133
Equity securities	33	—	33	—	19	(29)	(10)	24
Mortgage loans and other investments	—	—	—	—	—	—	—	—
Other (*)	3	—	3	89	(2)	6	4	(53)
Total pretax	36	(2)	34	(124)	26	(38)	(12)	104
Tax effects	(8)	1	(7)	26	(9)	13	4	(37)
Net of tax	\$28	\$ (1)	\$27	\$ (98)	\$17	\$ (25)	\$(8)	\$ 67

	Nine months ended September 30, 2018				Nine months ended September 30, 2017			
	Realized gains (losses)			Change in Unrealized	Realized gains (losses)			Change in Unrealized
	Before Impairments	Impairments	Total		Before Impairments	Impairments	Total	
Fixed maturities	\$3	\$ (3)	\$—	\$ (1,150)	\$25	\$ (16)	\$ 9	\$ 597
Equity securities	(39)	—	(39)	—	29	(49)	(20)	116
Mortgage loans and other investments	—	—	—	—	3	—	3	—
Other (*)	11	—	11	484	(5)	12	7	(248)
Total pretax	(25)	(3)	(28)	(666)	52	(53)	(1)	465
Tax effects	5	1	6	140	(18)	18	—	(163)
Net of tax	\$(20)	\$ (2)	\$(22)	\$(526)	\$34	\$ (35)	\$(1)	\$ 302

(*) Primarily adjustments to deferred policy acquisition costs and reserves related to the annuity business.

As discussed in Note A — “Accounting Policies — Investments,” effective January 1, 2018, all equity securities other than those accounted for under the equity method are carried at fair value through net earnings. AFG recorded net holding gains (losses) on equity securities during the third quarter and first nine months of 2018 on securities that were still owned at September 30, 2018 as follows (in millions):

	Three months ended September 30, 2018	Nine months ended September 30, 2018
Included in realized gains (losses)	\$ 25	\$ (51)
Included in net investment income	2	16
	\$ 27	\$ (35)

Gross realized gains and losses (excluding impairment write-downs and mark-to-market of derivatives) on available for sale fixed maturity investment transactions consisted of the following (in millions):

Nine
months
ended
September
30,
2018 2017

Fixed maturities:

Gross gains	\$19	\$32
Gross losses	(8)	(4)

In the first nine months of 2017, AFG recorded gross gains of \$36 million and gross losses of \$6 million on available for sale equity securities.

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E. Derivatives

As discussed under “Derivatives” in Note A — “Accounting Policies,” AFG uses derivatives in certain areas of its operations.

Derivatives That Do Not Qualify for Hedge Accounting The following derivatives that do not qualify for hedge accounting under GAAP are included in AFG’s Balance Sheet at fair value (in millions):

Derivative	Balance Sheet Line	September 30, 2018		December 31, 2017	
		Asset	Liability	Asset	Liability
MBS with embedded derivatives	Fixed maturities	\$ 110	\$ —	\$ 105	\$ —
Public company warrants	Equity securities	3	—	4	—
Fixed-indexed and variable-indexed annuities (embedded derivative)	Annuity benefits accumulated	—	3,105	—	2,542
Equity index call options	Equity index call options	759	—	701	—
Equity index put options	Other liabilities	—	—	—	—
Reinsurance contracts (embedded derivative)	Other liabilities	—	2	—	4
		\$ 872	\$ 3,107	\$ 810	\$ 2,546

The MBS with embedded derivatives consist of interest-only and principal-only MBS. AFG records the entire change in the fair value of these securities in earnings. These investments are part of AFG’s overall investment strategy and represent a small component of AFG’s overall investment portfolio.

Warrants to purchase shares of publicly traded companies, which represent a small component of AFG’s overall investment portfolio, are considered to be derivatives that are required to be carried at fair value through earnings.

AFG’s fixed-indexed and variable-indexed annuities provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market or other financial index. AFG attempts to mitigate the risk in the index-based component of these products through the purchase and sale of call and put options on the appropriate index. AFG receives collateral from certain counterparties to support its purchased call option assets (net of collateral required under put option contracts with the same counterparties). This collateral (\$545 million at September 30, 2018 and \$389 million at December 31, 2017) is included in other assets in AFG’s Balance Sheet with an offsetting liability to return the collateral, which is included in other liabilities. AFG’s strategy is designed so that the change in the fair value of the call and put options will generally offset the economic change in the liabilities from the index participation. Both the index-based component of the annuities and the related call and put options are considered derivatives. Fluctuations in interest rates and the stock market, among other factors, can cause volatility in the periodic measurement of fair value of the embedded derivative that management believes can be inconsistent with the long-term economics of these products.

As discussed under “Reinsurance” in Note A, AFG has a reinsurance contract that is considered to contain an embedded derivative.

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The following table summarizes the gains (losses) included in AFG's Statement of Earnings for changes in the fair value of derivatives that do not qualify for hedge accounting for the third quarter and first nine months of 2018 and 2017 (in millions):

Derivative	Statement of Earnings Line	Three months ended		Nine months ended	
		September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
MBS with embedded derivatives	Realized gains (losses) on securities	\$(3)	\$—	\$(8)	\$(3)
Public company warrants	Realized gains (losses) on securities	1	(1)	—	(1)
Fixed-indexed and variable-indexed annuities (embedded derivative) (*)	Annuity benefits	(223)	(127)	(286)	(386)
Equity index call options	Annuity benefits	219	116	271	338
Equity index put options	Annuity benefits	—	—	—	—
Reinsurance contract (embedded derivative)	Net investment income	—	—	2	(2)
		\$(6)	\$(12)	\$(21)	\$(54)

(*) The change in fair value of the embedded derivative for the nine months ended September 30, 2018 includes a \$44 million charge in the second quarter of 2018 related to the unlocking of actuarial assumptions.

Derivatives Designated and Qualifying as Cash Flow Hedges As of September 30, 2018, AFG has entered into fourteen 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. The purpose of each of these swaps is to effectively convert a portion of AFG's floating-rate fixed maturity securities to fixed rates by offsetting the variability in cash flows attributable to changes in short-term LIBOR.

Under the terms of the swaps, AFG receives fixed-rate interest payments in exchange for variable interest payments based on short-term LIBOR. The notional amounts of the interest rate swaps generally decline over each swap's respective life (the swaps expire between August 2019 and June 2030) in anticipation of the expected decline in AFG's portfolio of fixed maturity securities with floating interest rates based on short-term LIBOR. The total outstanding notional amount of AFG's interest rate swaps was \$2.17 billion at September 30, 2018 compared to \$1.58 billion at December 31, 2017, reflecting four new swaps with an aggregate notional amount at issuance of \$697 million entered into in the first nine months of 2018, partially offset by the scheduled amortization discussed above. The fair value of the effective portion of the interest rate swaps in an asset position and included in other assets was zero at September 30, 2018 and less than \$1 million at December 31, 2017. The fair value of the effective portion of the interest rate swaps in a liability position and included in other liabilities was \$81 million at September 30, 2018 and \$31 million at December 31, 2017. The net unrealized gain or loss on cash flow hedges is included in AOCI, net of DPAC and deferred taxes. Amounts reclassified from AOCI (before DPAC and taxes) to net investment income were losses of \$1 million and \$2 million during the third quarter and first nine months of 2018 as compared to income of \$1 million and \$4 million in the third quarter and first nine months of 2017, respectively. There was no ineffectiveness recorded in net earnings during these periods. A collateral receivable supporting these swaps of \$126 million at September 30, 2018 and \$70 million at December 31, 2017 is included in other assets in AFG's Balance Sheet.

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F. Deferred Policy Acquisition Costs

A progression of deferred policy acquisition costs is presented below (in millions):

	P&C Deferred Costs	Annuity and Other Deferred Sales Costs	Inducements	PVFP	Subtotal	Unrealized (*)	Total	Consolidated Total
Balance at June 30, 2018	\$ 298	\$ 1,243	\$ 94	\$ 45	\$ 1,382	\$ (98)	\$ 1,284	\$ 1,582
Additions	181	65	1	—	66	—	66	247
Amortization:								
Periodic amortization	(171)	(58)	(5)	(2)	(65)	—	(65)	(236)
Included in realized gains	—	3	—	—	3	—	3	3
Foreign currency translation	—	—	—	—	—	—	—	—
Change in unrealized	—	—	—	—	—	73	73	73
Balance at September 30, 2018	\$ 308	\$ 1,253	\$ 90	\$ 43	\$ 1,386	\$ (25)	\$ 1,361	\$ 1,669
Balance at June 30, 2017	\$ 258	\$ 1,167	\$ 103	\$ 42	\$ 1,312	\$ (414)	\$ 898	\$ 1,156
Additions	149	44	1	—	45	—	45	194
Amortization:								
Periodic amortization	(142)	(44)	(4)	(2)	(50)	—	(50)	(192)
Included in realized gains	—	4	—	—	4	—	4	4
Foreign currency translation	1	—	—	—	—	—	—	1
Change in unrealized	—	—	—	—	—	(44)	(44)	(44)
Balance at September 30, 2017	\$ 266	\$ 1,171	\$ 100	\$ 40	\$ 1,311	\$ (458)	\$ 853	\$ 1,119
Balance at December 31, 2017	\$ 270	\$ 1,217	\$ 102	\$ 49	\$ 1,368	\$ (422)	\$ 946	\$ 1,216
Additions	524	192	2	—	194	—	194	718
Amortization:								
Periodic amortization	(485)	(193)	(15)	(6)	(214)	—	(214)	(699)
Annuity unlocking	—	28	1	—	29	—	29	29
Included in realized gains	—	9	—	—	9	—	9	9
Foreign currency translation	(1)	—	—	—	—	—	—	(1)
Change in unrealized	—	—	—	—	—	397	397	397
Balance at September 30, 2018	\$ 308	\$ 1,253	\$ 90	\$ 43	\$ 1,386	\$ (25)	\$ 1,361	\$ 1,669
Balance at December 31, 2016	\$ 238	\$ 1,110	\$ 110	\$ 46	\$ 1,266	\$ (265)	\$ 1,001	\$ 1,239
Additions	439	177	3	—	180	—	180	619
Amortization:								
Periodic amortization	(413)	(122)	(14)	(6)	(142)	—	(142)	(555)
Included in realized gains	—	6	1	—	7	—	7	7
Foreign currency translation	2	—	—	—	—	—	—	2
Change in unrealized	—	—	—	—	—	(193)	(193)	(193)
Balance at September 30, 2017	\$ 266	\$ 1,171	\$ 100	\$ 40	\$ 1,311	\$ (458)	\$ 853	\$ 1,119

(*) Unrealized adjustments to DPAC includes net unrealized gains/losses on securities and net unrealized gains/losses on cash flow hedges.

The present value of future profits (“PVFP”) amounts in the table above are net of \$147 million and \$141 million of accumulated amortization at September 30, 2018 and December 31, 2017, respectively.

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G. Managed Investment Entities

AFG is the investment manager and its subsidiaries have investments ranging from 15.0% to 60.9% of the most subordinate debt tranche of fifteen collateralized loan obligation entities or “CLOs,” which are considered variable interest entities. AFG’s subsidiaries also own portions of the senior debt tranches of certain of these CLOs. Upon formation between 2004 and 2018, these entities issued securities in various senior and subordinate classes and invested the proceeds primarily in secured bank loans, which serve as collateral for the debt securities issued by each particular CLO. None of the collateral was purchased from AFG. AFG’s investments in the subordinate debt tranches of these entities receive residual income from the CLOs only after the CLOs pay expenses (including management fees to AFG) and interest on and returns of capital to senior levels of debt securities. There are no contractual requirements for AFG to provide additional funding for these entities. AFG has not provided and does not intend to provide any financial support to these entities.

AFG’s maximum exposure to economic loss on its CLOs is limited to its investment in the CLOs, which had an aggregate fair value of \$191 million (including \$133 million invested in the most subordinate tranches) at September 30, 2018, and \$215 million at December 31, 2017.

In March 2018 and March 2017, AFG formed new CLOs, which issued \$463 million and \$408 million face amount of liabilities, respectively (including \$31 million and \$24 million face amount purchased by subsidiaries of AFG). During the first nine months of 2017, AFG subsidiaries also purchased \$58 million face amount of senior debt and subordinate tranches of existing CLOs for \$58 million. During the first nine months of 2018 and 2017, AFG subsidiaries received \$45 million and \$86 million, respectively, in sale and redemption proceeds from its CLO investments. During the first nine months of 2018 and 2017, one and two AFG CLOs, respectively, were substantially liquidated, as permitted by the CLO indentures.

The revenues and expenses of the CLOs are separately identified in AFG’s Statement of Earnings, after the elimination of management fees and earnings attributable to shareholders of AFG as measured by the change in the fair value of AFG’s investments in the CLOs. Selected financial information related to the CLOs is shown below (in millions):

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Investment in CLO tranches at end of period	\$191	\$261	\$191	\$261
Gains (losses) on change in fair value of assets/liabilities (a):				
Assets	20	(8)	5	(12)
Liabilities	(25)	9	(15)	24
Management fees paid to AFG	4	5	12	14
CLO earnings (losses) attributable to AFG shareholders (b)	4	5	11	16

(a) Included in revenues in AFG’s Statement of Earnings.

(b) Included in earnings before income taxes in AFG’s Statement of Earnings.

The aggregate unpaid principal balance of the CLOs’ fixed maturity investments exceeded the fair value of the investments by \$45 million and \$55 million at September 30, 2018 and December 31, 2017, respectively. The aggregate unpaid principal balance of the CLOs’ debt exceeded its carrying value by \$160 million and \$118 million at those dates. The CLO assets include loans with an aggregate fair value of \$1 million at both September 30, 2018 and

December 31, 2017, for which the CLOs are not accruing interest because the loans are in default (aggregate unpaid principal balance of \$8 million at both those dates).

H. Goodwill and Other Intangibles

There were no changes in the goodwill balance of \$199 million during the first nine months of 2018. Included in other assets in AFG's Balance Sheet is \$31 million at September 30, 2018 and \$26 million at December 31, 2017 in amortizable intangible assets related to property and casualty insurance acquisitions. These amounts are net of accumulated amortization of \$37 million and \$30 million, respectively. Amortization of intangibles was \$3 million and \$2 million in the third quarter of 2018 and 2017, respectively, and \$7 million and \$6 million in the first nine months of 2018 and 2017.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

I. Long-Term Debt

Long-term debt consisted of the following (in millions):

	September 30, 2018			December 31, 2017		
	Principal	Discount and Issue Costs	Carrying Value	Principal	Discount and Issue Costs	Carrying Value
Direct Senior Obligations of AFG:						
4.50% Senior Notes due June 2047	\$ 590	\$ (2)	\$ 588	\$ 590	\$ (2)	\$ 588
3.50% Senior Notes due August 2026	425	(4)	421	425	(5)	420
Other	3	—	3	3	—	3
	1,018	(6)	1,012	1,018	(7)	1,011
Direct Subordinated Obligations of AFG:						
6-1/4% Subordinated Debentures due September 2054	150	(5)	145	150	(5)	145
6% Subordinated Debentures due November 2055	150	(5)	145	150	(5)	145
	300	(10)	290	300	(10)	290
	\$1,318	\$ (16)	\$ 1,302	\$1,318	\$ (17)	\$ 1,301

AFG has no scheduled principal payments on its long-term debt for the balance of 2018 or in the subsequent five years.

AFG can borrow up to \$500 million under its revolving credit facility, which expires in June 2021. Amounts borrowed under this agreement bear interest at rates ranging from 1.00% to 1.875% (currently 1.375%) over LIBOR based on AFG's credit rating. No amounts were borrowed under this facility at September 30, 2018 or December 31, 2017.

J. Redeemable Noncontrolling Interests

Neon Lloyd's Business On December 29, 2017, AFG completed the sale of an indirect noncontrolling interest in Neon, its United Kingdom-based Lloyd's insurer, to certain Neon executives for cash equal to the fair value of the interest sold as determined by a third-party valuation firm. This noncontrolling interest is redeemable at the option of the holder and is presented separately in the mezzanine section of the balance sheet, as discussed in Note A — "Accounting Policies — Noncontrolling Interests."

K. Shareholders' Equity

AFG is authorized to issue 12.5 million shares of Voting Preferred Stock and 12.5 million shares of Nonvoting Preferred Stock, each without par value.

Accumulated Other Comprehensive Income, Net of Tax ("AOCI") Comprehensive income is defined as all changes in shareholders' equity except those arising from transactions with shareholders. Comprehensive income includes net earnings and other comprehensive income, which consists primarily of changes in net unrealized gains or losses on available for sale securities.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

The progression of the components of accumulated other comprehensive income follows (in millions):

	Other Comprehensive Income (Loss)							AOCI Ending Balance
	AOCI Beginning Balance	Pretax	Tax	Net of tax	Attributable to noncontrolling interests	Attributable to shareholders	Other (c)	
Quarter ended September 30, 2018								
Net unrealized gains (losses) on securities:								
Unrealized holding losses on securities arising during the period		\$(122)	\$26	\$(96)	\$	—	\$(96)	
Reclassification adjustment for realized (gains) losses included in net earnings (a)		(2)	—	(2)	—	(2)		
Total net unrealized gains (losses) on securities (b)	\$ 191	(124)	26	(98)	—	(98)	\$—	\$ 93
Net unrealized losses on cash flow hedges	(27)	(6)	1	(5)	—	(5)	—	(32)
Foreign currency translation adjustments	(9)	—	—	—	—	—	—	(9)
Pension and other postretirement plans adjustments	(8)	—	—	—	—	—	—	(8)
Total	\$ 147	\$(130)	\$27	\$(103)	\$	—	\$(103)	\$ 44
Quarter ended September 30, 2017								
Net unrealized gains on securities:								
Unrealized holding gains on securities arising during the period		\$92	\$(33)	\$59	\$	—	\$ 59	
Reclassification adjustment for realized (gains) losses included in net earnings (a)		12	(4)	8	—	8		
Total net unrealized gains on securities	\$ 639	104	(37)	67	—	67	\$—	\$ 706
Net unrealized losses on cash flow hedges	(6)	(1)	1	—	—	—	—	(6)
Foreign currency translation adjustments	(11)	5	2	7	—	7	—	(4)
Pension and other postretirement plans adjustments	(7)	—	—	—	—	—	—	(7)
Total	\$ 615	\$108	\$(34)	\$74	\$	—	\$ 74	\$ 689
Nine months ended September 30, 2018								
Net unrealized gains (losses) on securities:								
Unrealized holding losses on securities arising during the period		\$(662)	\$139	\$(523)	\$	—	\$(523)	
Reclassification adjustment for realized (gains) losses included in net earnings (a)		(4)	1	(3)	—	(3)		
Total net unrealized gains (losses) on securities (b)	\$ 840	(666)	140	(526)	—	(526)	\$(221)	\$ 93
Net unrealized losses on cash flow hedges	(13)	(24)	5	(19)	—	(19)	—	(32)
Foreign currency translation adjustments	(6)	(2)	(1)	(3)	—	(3)	—	(9)
Pension and other postretirement plans adjustments	(8)	—	—	—	—	—	—	(8)
Total	\$ 813	\$(692)	\$144	\$(548)	\$	—	\$(548)	\$(221) \$ 44

Nine months ended September 30, 2017

Net unrealized gains on securities:

Unrealized holding gains on securities arising during the period		\$461	\$(162)	\$299	\$	—	\$ 299	
Reclassification adjustment for realized (gains) losses included in net earnings (a)		4	(1)	3	—	3		
Total net unrealized gains on securities	\$ 404	465	(163)	302	—	302	\$—	\$ 706
Net unrealized gains (losses) on cash flow hedges	(7)	1	—	1	—	1	—	(6)
Foreign currency translation adjustments	(15)	8	3	11	—	11	—	(4)
Pension and other postretirement plans adjustments	(7)	—	—	—	—	—	—	(7)
Total	\$ 375	\$474	\$(160)	\$314	\$	—	\$ 314	\$— \$ 689

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

(a) The reclassification adjustment out of net unrealized gains (losses) on securities affected the following lines in AFG's Statement of Earnings:

OCI component Affected line in the statement of earnings

Pretax Realized gains (losses) on securities

Tax Provision for income taxes

Includes net unrealized gains of \$64 million at September 30, 2018 compared to \$67 million at June 30, 2018 and (b) \$68 million at December 31, 2017 related to securities for which only the credit portion of an other-than-temporary impairment has been recorded in earnings.

On January 1, 2018, AFG adopted new guidance that requires all equity securities other than those accounted for under the equity method to be reported at fair value with holding gains and losses recognized in net earnings. At (c) the date of adoption, the \$221 million net unrealized gain on equity securities classified as available for sale (with unrealized holding gains and losses reported in AOCI) under the prior guidance was reclassified from AOCI to retained earnings as the cumulative effect of an accounting change.

Stock Incentive Plans Under AFG's stock incentive plans, employees of AFG and its subsidiaries are eligible to receive equity awards in the form of stock options, stock appreciation rights, restricted stock awards, restricted stock units and stock awards. In the first nine months of 2018, AFG issued 200,625 shares of restricted Common Stock (fair value of \$112.86 per share) under the Stock Incentive Plan. In addition, AFG issued 45,804 shares of Common Stock (fair value of \$115.49 per share) in the first quarter of 2018 under the Equity Bonus Plan. AFG did not grant any stock options in the first nine months of 2018.

Total compensation expense related to stock incentive plans of AFG and its subsidiaries was \$6 million and \$7 million in the third quarters of 2018 and 2017 and \$17 million and \$24 million in the first nine months of 2018 and 2017, respectively.

L. Income Taxes

The following is a reconciliation of income taxes at the statutory rate (21% in 2018 and 35% in 2017) to the provision for income taxes as shown in AFG's Statement of Earnings (dollars in millions):

	Three months ended				Nine months ended			
	September 30, 2018		2017		September 30, 2018		2017	
	Amount	% of EBT	Amount	% of EBT	Amount	% of EBT	Amount	% of EBT
Earnings before income taxes ("EBT")	\$244		\$29		\$678		\$457	
Income taxes at statutory rate	\$51	21 %	\$10	35 %	\$142	21 %	\$160	35 %
Effect of:								
Adjustment to prior year taxes	(9)	(4 %)	(2)	(7 %)	(9)	(1 %)	(2)	(1 %)
Tax exempt interest	(3)	(1 %)	(5)	(17 %)	(10)	(1 %)	(17)	(4 %)
Dividends received deduction	(1)	— %	(2)	(7 %)	(3)	— %	(6)	(1 %)
Employee Stock Ownership Plan dividends paid deduction	(1)	— %	—	— %	(2)	— %	(2)	— %
Stock-based compensation	—	— %	(1)	(3 %)	(7)	(1 %)	(14)	(3 %)
Foreign operations	—	— %	1	3 %	3	— %	7	2 %
Nondeductible expenses	1	— %	2	7 %	5	1 %	5	1 %
Change in valuation allowance	1	— %	16	55 %	3	— %	16	4 %

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Other	2	1 %	(1)	(4 %)	4	—%	(1)	(1 %)
Provision for income taxes as shown in the statement of earnings	\$41	17%	\$18	62 %	\$126	19%	\$146	32%

AFG's effective tax rate for the three months ended September 30, 2017 reflects the impact of catastrophe losses in the Neon Lloyd's insurance business for which no tax benefit is recognized. AFG maintains a full valuation allowance against the deferred tax benefits associated with losses related to Neon. Excluding the \$53 million in catastrophe losses at Neon, AFG's effective tax rate for the three months ended September 30, 2017 was 22%, which reflects the impact of a typical level of tax-favored investment income on lower earnings before income taxes.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

The favorable impact of stock-based compensation on AFG's effective tax rate in the first nine months of 2018 and 2017 reflects the high volume of employee stock option exercises during that period and the increase in the market price of AFG Common Stock.

The Tax Cuts and Jobs Act of 2017 ("TCJA"), which was enacted on December 22, 2017, lowered the U.S corporate tax rate to 21% and made other widespread changes to the U.S. tax code effective in 2018. Because the TCJA was enacted in December 2017, AFG recorded the \$83 million decrease in its net deferred tax asset resulting from the changes in the tax code (primarily the lower corporate tax rate applicable to 2018 and future years) in the fourth quarter of 2017.

The TCJA is subject to further clarification and interpretation by the U.S. Treasury Department and the Internal Revenue Service. For example, the TCJA changes the way that companies calculate their insurance claims and reserves for tax purposes, including revaluing those tax basis liabilities as of January 1, 2018, based on a methodology and discount factors that have not been published. The resulting transitional deferred tax liability (taxes payable over eight years under the TCJA) and offsetting increase in AFG's insurance claims and reserves deferred tax assets, were recorded at December 31, 2017 using reasonable estimates based on available information and should be considered provisional in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 118 ("SAB 118"). Because the established transition liability was completely offset by an increase in related deferred tax assets, any adjustment to the provisional amount will not impact AFG's effective tax rate. In accordance with SAB 118, the insurance claims and reserves transitional deferred tax liability (and offsetting adjustment to the related deferred tax assets) and any other changes in deferred taxes resulting from clarification and interpretation of the TCJA provided during 2018 will be recorded in the period in which the guidance is published (none through September 30, 2018).

Approximately \$19 million of AFG's net operating loss carryforwards ("NOL") subject to separate return limitation year ("SRLY") tax rules will expire unutilized at December 31, 2018. Since AFG maintains a full valuation allowance against its SRLY NOLs, the expiration of these loss carryforwards will be offset by a corresponding reduction in the valuation allowance and will have no overall impact on AFG's income tax expense or results of operations.

M. Contingencies

There have been no significant changes to the matters discussed and referred to in Note M — "Contingencies" of AFG's 2017 Form 10-K, which covers property and casualty insurance reserves for claims related to environmental exposures, asbestos and other mass tort claims and environmental and occupational injury and disease claims of former subsidiary railroad and manufacturing operations, as well as contingencies related to the sale of substantially all of AFG's run-off long-term care insurance business.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

N. Insurance

Property and Casualty Insurance Reserves The following table provides an analysis of changes in the liability for losses and loss adjustment expenses during the first nine months of 2018 and 2017 (in millions):

	Nine months ended September 30,	
	2018	2017
Balance at beginning of year	\$9,678	\$8,563
Less reinsurance recoverables, net of allowance	2,957	2,302
Net liability at beginning of year	6,721	6,261
Provision for losses and LAE occurring in the current period	2,337	2,237
Net increase (decrease) in the provision for claims of prior years:		
Special A&E charges	18	89
Other	(149)	(87)
Total losses and LAE incurred	2,206	2,239
Payments for losses and LAE of:		
Current year	(569)	(530)
Prior years	(1,313)	(1,272)
Total payments	(1,882)	(1,802)
Reserves of business disposed (*)	(319)	—
Foreign currency translation and other	(4)	32
Net liability at end of period	6,722	6,730
Add back reinsurance recoverables, net of allowance	2,948	2,833
Gross unpaid losses and LAE included in the balance sheet at end of period	\$9,670	\$9,563

(*) Reflects the reinsurance to close transaction at Neon discussed below.

The net decrease in the provision for claims of prior years during the first nine months of 2018 reflects (i) lower than expected losses in the crop business and lower than expected severity in claims at National Interstate (within the Property and transportation sub-segment), (ii) lower than anticipated claim severity in the workers' compensation and executive liability businesses (within the Specialty casualty sub-segment), and (iii) lower than expected claim frequency and severity in the surety business and lower than expected claim severity in the fidelity business (within the Specialty financial sub-segment). This favorable development was partially offset by (i) the \$18 million special charge to increase asbestos and environmental reserves and (ii) higher than expected claim severity in the Singapore branch and aviation operations (within the Property and transportation sub-segment).

The net increase in the provision for claims of prior years during the first nine months of 2017 reflects (i) the \$89 million special charge to increase asbestos and environmental reserves, (ii) higher than expected claim severity in the ocean marine business (within the Property and transportation sub-segment), (iii) higher than anticipated claim severity in the targeted markets and general liability businesses (all within the Specialty casualty sub-segment) and (iv) an adjustment to the deferred gain on the retroactive reinsurance transaction entered into in connection with the sale of businesses in 1998 (included in Other specialty sub-segment). This adverse development was partially offset by (i) lower than expected losses in the crop and equine businesses and lower than expected claim severity in the property and inland marine and transportation businesses (all within the Property and transportation sub-segment), (ii) lower than anticipated claim severity in the workers' compensation businesses and at Neon (all within the Specialty

casualty sub-segment) and (iii) lower than anticipated claim severity in the fidelity business and lower than expected claim frequency and severity in the surety business (both within the Specialty financial sub-segment).

In December 2017, the Neon Lloyd's syndicate entered into a reinsurance to close transaction for the 2015 and prior years of account with StarStone Underwriting Limited, a subsidiary of Enstar Group Limited, which was effective as of December 31, 2017 (the transaction settled in early 2018). In the Lloyd's market, a reinsurance to close transaction transfers the responsibility for discharging all of the liabilities that attach to the transferred year of account plus the right to any income due to the closing year of account in return for a premium. This transaction provided Neon with finality on its legacy business.

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ITEM 2

Management's Discussion and Analysis of Financial Condition and Results of Operations

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FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Some of the forward-looking statements can be identified by the use of words such as “anticipates”, “believes”, “expects”, “projects”, “estimates”, “intends”, “plans”, “seeks”, “could”, “may”, “should”, “will” or the negative version of those words or other comparable terminology. Such forward-looking statements include statements relating to: expectations concerning market and other conditions and their effect on future premiums, revenues, earnings, investment activities, and the amount and timing of share repurchases; recoverability of asset values; expected losses and the adequacy of reserves for asbestos, environmental pollution and mass tort claims; rate changes; and improved loss experience.

Actual results and/or financial condition could differ materially from those contained in or implied by such forward-looking statements for a variety of reasons including but not limited to:

- changes in financial, political and economic conditions, including changes in interest and inflation rates, currency fluctuations and extended economic recessions or expansions in the U.S. and/or abroad;
- performance of securities markets, including the cost of equity index options;
- new legislation or declines in credit quality or credit ratings that could have a material impact on the valuation of securities in AFG's investment portfolio;
- the availability of capital;
- changes in insurance law or regulation, including changes in statutory accounting rules and changes in regulation of the Lloyd's market, including modifications to the establishment of capital requirements for and approval of business plans for syndicate participation;
- changes in the legal environment affecting AFG or its customers;
- tax law and accounting changes, including the impact of recent changes in U.S. corporate tax law;
- levels of natural catastrophes and severe weather, terrorist activities (including any nuclear, biological, chemical or radiological events), incidents of war or losses resulting from civil unrest and other major losses;
- disruption caused by cyber-attacks or other technology breaches or failures by AFG or its business partners and service providers, which could negatively impact AFG's business and/or expose AFG to litigation;
- development of insurance loss reserves and establishment of other reserves, particularly with respect to amounts associated with asbestos and environmental claims;
- availability of reinsurance and ability of reinsurers to pay their obligations;
- trends in persistency and mortality;

•competitive pressures;
•the ability to obtain adequate rates and policy terms;
•changes in AFG's credit ratings or the financial strength ratings assigned by major ratings agencies to AFG's operating subsidiaries; and
•the impact of the conditions in the international financial markets and the global economy (including those associated with the United Kingdom's expected withdrawal from the European Union, or "Brexit") relating to AFG's international operations.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

The forward-looking statements herein are made only as of the date of this report. The Company assumes no obligation to publicly update any forward-looking statements.

OVERVIEW

Financial Condition

AFG is organized as a holding company with almost all of its operations being conducted by subsidiaries. AFG, however, has continuing cash needs for administrative expenses, the payment of principal and interest on borrowings, shareholder dividends, and taxes. Therefore, certain analyses are most meaningfully presented on a parent only basis while others are best done on a total enterprise basis. In addition, because most of its businesses are financial in nature, AFG does not prepare its consolidated financial statements using a current-noncurrent format. Consequently, certain traditional ratios and financial analysis tests are not meaningful.

Results of Operations

Through the operations of its subsidiaries, AFG is engaged primarily in property and casualty insurance, focusing on specialized commercial products for businesses, and in the sale of traditional fixed, fixed-indexed and variable-indexed annuities in the retail, financial institutions, broker-dealer, registered investment advisor and education markets.

Net earnings attributable to AFG's shareholders for the third quarter and first nine months of 2018 were \$204 million (\$2.26 per share, diluted) and \$559 million (\$6.17 per share, diluted), respectively, compared to \$11 million (\$0.13 per share, diluted) and \$309 million (\$3.44 per share, diluted) reported in the same periods of 2017, reflecting:

- higher earnings in the annuity segment,
- higher underwriting profit in the property and casualty insurance segment due primarily to lower catastrophe losses and lower special charges to increase asbestos and environmental reserves,
- higher net investment income in the property and casualty insurance segment,
- lower interest charges on borrowed money,
- a lower corporate income tax rate,
- realized gains on securities in the third quarter of 2018 compared to realized losses in the third quarter of 2017 and higher realized losses on securities in the first nine months of 2018 compared to the first nine months of 2017. Both periods in 2018 reflect the change in the fair value of equity securities that are required to be carried at fair value through net earnings under new accounting guidance adopted on January 1, 2018,
- lower income from the sale of real estate in the first nine months of 2018 compared to the first nine months of 2017, and
- a loss on the retirement of debt in the third quarter and first nine months of 2017.

CRITICAL ACCOUNTING POLICIES

Significant accounting policies are summarized in Note A — “Accounting Policies” to the financial statements. The preparation of financial statements in conformity with U.S. generally accepted accounting principles (“GAAP”) requires management to make estimates and assumptions that can have a significant effect on amounts reported in the financial statements. As more information becomes known, these estimates and assumptions change and, thus, impact amounts reported in the future. The areas where management believes the degree of judgment required to determine amounts recorded in the financial statements is most significant are as follows:

- the establishment of insurance reserves, especially asbestos and environmental-related reserves,
- the recoverability of reinsurance,
- the recoverability of deferred acquisition costs,
- the establishment of asbestos and environmental reserves of former railroad and manufacturing operations, and
- the valuation of investments, including the determination of other-than-temporary impairments.

For a discussion of these policies, see Management's Discussion and Analysis — "Critical Accounting Policies" in AFG's 2017 Form 10-K.

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Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

LIQUIDITY AND CAPITAL RESOURCES

Ratios AFG's debt to total capital ratio on a consolidated basis is shown below (dollars in millions):

	September 30,		December 31,	
	2018	2017	2016	
Principal amount of long-term debt	\$ 1,318	\$1,318	\$1,308	
Total capital	6,389	6,033	5,921	
Ratio of debt to total capital:				
Including subordinated debt	20.6	% 21.8	% 22.1	%
Excluding subordinated debt	15.9	% 16.9	% 17.0	%

The ratio of debt to total capital is a non-GAAP measure that management believes is useful for investors, analysts and independent ratings agencies to evaluate AFG's financial strength and liquidity and to provide insight into how AFG finances its operations. In addition, maintaining a ratio of debt, excluding subordinated debt and debt secured by real estate (if any), to total capital of 35% or lower is a financial covenant in AFG's bank credit facility. The ratio is calculated by dividing the principal amount of AFG's long-term debt by its total capital, which includes long-term debt, noncontrolling interests and shareholders' equity (excluding unrealized gains (losses) on fixed maturity investments).

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 1.86 for the nine months ended September 30, 2018 and 1.72 for the year ended December 31, 2017. Excluding annuity benefits, this ratio was 10.87 and 7.67, respectively. Although the ratio excluding annuity benefits is not required or encouraged to be disclosed under Securities and Exchange Commission rules, it is presented because interest credited to annuity policyholder accounts is not always considered a borrowing cost for an insurance company.

Condensed Consolidated Cash Flows AFG's principal sources of cash include insurance premiums, income from its investment portfolio and proceeds from the maturities, redemptions and sales of investments. Insurance premiums in excess of acquisition expenses and operating costs are invested until they are needed to meet policyholder obligations or made available to the parent company through dividends to cover debt obligations and corporate expenses, and to provide returns to shareholders through share repurchases and dividends. Cash flows from operating, investing and financing activities as detailed in AFG's Consolidated Statement of Cash Flows are shown below (in millions):

	Nine months ended September 30,	
	2018	2017
Net cash provided by operating activities	\$1,277	\$993
Net cash used in investing activities	(3,375)	(2,230)
Net cash provided by financing activities	1,769	1,479
Net change in cash and cash equivalents	\$(329)	\$242

Net Cash Provided by Operating Activities AFG's property and casualty insurance operations typically produce positive net operating cash flows as premiums collected and investment income exceed policy acquisition costs, claims payments and operating expenses. AFG's net cash provided by operating activities is impacted by the level and timing of property and casualty premiums, claim and expense payments and recoveries from reinsurers. AFG's annuity operations typically produce positive net operating cash flows as investment income exceeds acquisition costs and operating expenses. Interest credited on annuity policyholder funds is a non-cash increase in AFG's annuity benefits

accumulated liability and annuity premiums, benefits and withdrawals are considered financing activities due to the deposit-type nature of annuities. Cash flows provided by operating activities also include the activity of AFG's managed investment entities (collateralized loan obligations) other than those activities included in investing or financing activities. The changes in the assets and liabilities of the managed investment entities included in operating activities increased cash flows from operating activities by \$104 million during the first nine months of 2018 and \$14 million in the first nine months of 2017, accounting for a \$90 million increase in cash flows from operating activities in the 2018 period compared to the 2017 period. As discussed in Note A — "Accounting Policies — Managed Investment Entities" to the financial statements, AFG has no right to use the CLO assets and no obligation to pay the CLO liabilities and such assets and liabilities are shown separately in AFG's Balance Sheet. Excluding the impact of the managed investment entities, net cash provided by operating activities was \$1.17 billion in the first nine months of 2018 compared to \$979 million in the first nine months of 2017, an increase of \$194 million.

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Net Cash Used in Investing Activities AFG's investing activities consist primarily of the investment of funds provided by its property and casualty and annuity businesses. Net cash used in investing activities was \$3.38 billion for the first nine months of 2018 compared to \$2.23 billion in the first nine months of 2017, an increase of \$1.15 billion. As discussed below (under net cash provided by financing activities), AFG's annuity group had net cash flows from annuity policyholders of \$1.86 billion in the first nine months of 2018 and \$1.75 billion in the first nine months of 2017, which is the primary source of AFG's cash used in investing activities. During the first nine months of 2018, AFG also invested a portion of its overall cash held at December 31, 2017. In addition to the investment of funds provided by the insurance operations, investing activities also include the purchase and disposal of managed investment entity investments, which are presented separately in AFG's Balance Sheet. Net investment activity in the managed investment entities was a \$189 million use of cash in the first nine months of 2018 compared to a \$13 million source of cash in the 2017 period, accounting for a \$202 million increase in net cash used in investing activities in the first nine months of 2018 compared to the same 2017 period. See Note A — "Accounting Policies — Managed Investment Entities" and Note G — "Managed Investment Entities" to the financial statements.

Net Cash Provided by Financing Activities AFG's financing activities consist primarily of transactions with annuity policyholders, issuances and retirements of long-term debt, repurchases of common stock and dividend payments. Net cash provided by financing activities was \$1.77 billion for the first nine months of 2018 compared to \$1.48 billion in the first nine months of 2017, an increase of \$290 million. Annuity receipts exceeded annuity surrenders, benefits, withdrawals and transfers by \$1.86 billion in the first nine months of 2018 compared to \$1.75 billion in the first nine months of 2017, accounting for a \$109 million increase in net cash provided by financing activities in the 2018 period compared to the 2017 period. In June 2017, AFG issued \$350 million of 4.50% Senior Notes due 2047, the net proceeds of which contributed \$345 million to net cash provided by financing activities in the first nine months of 2017. Redemptions of long-term debt were a \$355 million use of cash in the first nine months of 2017. Financing activities also include issuances and retirements of managed investment entity liabilities, which are nonrecourse to AFG and presented separately in AFG's Balance Sheet. Issuances of managed investment entity liabilities exceeded retirements by \$109 million in the first nine months of 2018 compared to retirements of managed investment liabilities exceeding issuances by \$72 million in the first nine months of 2017, accounting for a \$181 million increase in net cash provided by financing activities in the 2018 period compared to the 2017 period. See Note A — "Accounting Policies — Managed Investment Entities" and Note G — "Managed Investment Entities" to the financial statements.

Parent and Subsidiary Liquidity

Parent Holding Company Liquidity Management believes AFG has sufficient resources to meet its liquidity requirements. If funds generated from operations, including dividends, tax payments and borrowings from subsidiaries, are insufficient to meet fixed charges in any period, AFG would be required to utilize parent company cash and marketable securities or to generate cash through borrowings, sales of other assets, or similar transactions.

AFG can borrow up to \$500 million under its revolving credit facility which expires in June 2021. Amounts borrowed under this agreement bear interest at rates ranging from 1.00% to 1.875% (currently 1.375%) over LIBOR based on AFG's credit rating. There were no borrowings under this agreement, or under any other parent company short-term borrowing arrangements, during 2017 or the first nine months of 2018.

In November 2018, AFG declared a special cash dividend of \$1.50 per share of AFG Common Stock. The dividend is payable on November 26, 2018 to shareholders of record on November 16, 2018. The aggregate amount of this special dividend will be approximately \$134 million. In May 2018, AFG paid a special cash dividend of \$1.50 per share of AFG Common Stock totaling \$134 million. In 2017, AFG paid special cash dividends of \$3.50 per share of AFG

Common Stock (\$1.50 per share in May and \$2.00 per share in November) totaling approximately \$308 million.

In June 2017, AFG issued \$350 million of 4.50% Senior Notes due June 2047. Net proceeds from the offering were used to redeem AFG's \$230 million outstanding principal amount of 6-3/8% Senior Notes due June 2042, at par value in June 2017 and AFG's \$125 million outstanding principal amount of 5-3/4% Senior Notes due August 2042 at par value in August 2017.

In November 2017, AFG issued an additional \$240 million of 4.50% Senior Notes due in 2047 and \$125 million of 3.50% Senior Notes due in 2026. The net proceeds of the offering were used to redeem AFG's \$350 million outstanding principal amount of 9-7/8% Senior Notes due in June 2019 for \$388 million (including a make-whole premium of \$38 million) in December 2017.

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Under a tax allocation agreement with AFG, its 80%-owned U.S. subsidiaries generally pay taxes to (or recover taxes from) AFG based on each subsidiary's contribution to amounts due under AFG's consolidated tax return.

Subsidiary Liquidity Great American Life Insurance Company ("GALIC"), a wholly-owned annuity subsidiary, is a member of the Federal Home Loan Bank of Cincinnati ("FHLB"). The FHLB makes advances and provides other banking services to member institutions, which provides the annuity operations with an additional source of liquidity. At September 30, 2018, GALIC had \$871 million in outstanding advances from the FHLB (included in annuity benefits accumulated), bearing interest at rates ranging from 0.03% to 0.21% over LIBOR (average rate of 2.33% at September 30, 2018). While these advances must be repaid between 2018 and 2021 (\$40 million in 2018, \$345 million in 2019 and \$486 million in 2021), GALIC has the option to prepay all or a portion of the advances. GALIC has invested the proceeds from the advances in fixed maturity securities with similar expected lives as the advances for the purpose of earning a spread over the interest payments due to the FHLB. At September 30, 2018, GALIC estimated that it had additional borrowing capacity of approximately \$300 million from the FHLB.

The liquidity requirements of AFG's insurance subsidiaries relate primarily to the liabilities associated with their products as well as operating costs and expenses, payments of dividends and taxes to AFG and contributions of capital to their subsidiaries. Historically, cash flows from premiums and investment income have generally provided more than sufficient funds to meet these requirements. Funds received in excess of cash requirements are generally invested in additional marketable securities. In addition, the insurance subsidiaries generally hold a significant amount of highly liquid, short-term investments.

The excess cash flow of AFG's property and casualty group allows it to extend the duration of its investment portfolio somewhat beyond that of its claim reserves.

In the annuity business, where profitability is largely dependent on earning a spread between invested assets and annuity liabilities, the duration of investments is generally maintained close to that of liabilities. In a rising interest rate environment, significant protection from withdrawals exists in the form of temporary and permanent surrender charges on AFG's annuity products. With declining rates, AFG receives some protection (from spread compression) due to the ability to lower crediting rates, subject to contractually guaranteed minimum interest rates ("GMIRs"). AFG began selling policies with GMIRs below 2% in 2003; almost all new business since late 2010 has been issued with a 1% GMIR. At September 30, 2018, AFG could reduce the average crediting rate on approximately \$27 billion of traditional fixed annuities and fixed-indexed and variable-indexed annuities without guaranteed withdrawal benefits by approximately 116 basis points (on a weighted average basis). Annuity policies are subject to GMIRs at policy issuance. The table below shows the breakdown of annuity reserves by GMIR. The current interest crediting rates on substantially all of AFG's annuities with a GMIR of 3% or higher are at their minimum.

GMIR	% of Reserves		
	September 30, 2018	December 31, 2017	2016
1 — 1.99%	78%	76%	72%
2 — 2.99%	4%	5%	6%
3 — 3.99%	9%	10%	12%
4.00% and above	9%	9%	10%
Annuity benefits accumulated (in millions)	\$35,958	\$33,316	\$29,907

AFG believes its insurance subsidiaries maintain sufficient liquidity to pay claims and benefits and operating expenses. In addition, these subsidiaries have sufficient capital to meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies. Nonetheless, changes in statutory accounting rules, significant declines in the fair value of the insurance subsidiaries' investment portfolios or significant ratings downgrades on these investments, could create a need for additional capital.

Investments AFG's investment portfolio at September 30, 2018, includes \$40.24 billion in fixed maturity securities classified as available for sale and carried at fair value with unrealized gains and losses included in a separate component of shareholders' equity on an after-tax basis and \$103 million in fixed maturities classified as trading with changes in unrealized holding gains or losses included in net investment income. In addition, AFG's investment portfolio includes \$1.65 billion in equity securities carried at fair value with holding gains and losses included in realized gains (losses) on securities and \$176 million in equity securities carried at fair value with unrealized holding gains and losses included in net investment income.

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Fair values for AFG's portfolio are determined by AFG's internal investment professionals using data from nationally recognized pricing services as well as non-binding broker quotes. Fair values of equity securities are generally based on published closing prices. For mortgage-backed securities ("MBS"), which comprise approximately 9% of AFG's fixed maturities, prices for each security are generally obtained from both pricing services and broker quotes. For the remainder of AFG's fixed maturity portfolio, approximately 72% are priced using pricing services and the balance is priced primarily by using non-binding broker quotes. When prices obtained for the same security vary, AFG's internal investment professionals select the price they believe is most indicative of an exit price.

The pricing services use a variety of observable inputs to estimate fair value of fixed maturities that do not trade on a daily basis. Based upon information provided by the pricing services, these inputs include, but are not limited to, recent reported trades, benchmark yields, issuer spreads, bids or offers, reference data, and measures of volatility. Included in the pricing of MBS are estimates of the rate of future prepayments and defaults of principal over the remaining life of the underlying collateral. Due to the lack of transparency in the process that brokers use to develop prices, valuations that are based on brokers' prices are classified as Level 3 in the GAAP hierarchy unless the price can be corroborated, for example, by comparison to similar securities priced using observable inputs.

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, AFG communicates directly with pricing services regarding the methods and assumptions used in pricing, including verifying, on a test basis, the inputs used by the services to value specific securities.

In general, the fair value of AFG's fixed maturity investments is inversely correlated to changes in interest rates. The following table demonstrates the sensitivity of such fair values to reasonably likely changes in interest rates by illustrating the estimated effect on AFG's fixed maturity portfolio and accumulated other comprehensive income that an immediate increase of 100 basis points in the interest rate yield curve would have at September 30, 2018 (dollars in millions). Effects of increases or decreases from the 100 basis points illustrated would be approximately proportional.

Fair value of fixed maturity portfolio	\$40,347
Percentage impact on fair value of 100 bps increase in interest rates	(4.5 %)
Pretax impact on fair value of fixed maturity portfolio	\$(1,816)
Offsetting adjustments to deferred policy acquisition costs and other balance sheet amounts	750
Estimated pretax impact on accumulated other comprehensive income	(1,066)
Deferred income tax	224
Estimated after-tax impact on accumulated other comprehensive income	\$(842)

Approximately 90% of the fixed maturities held by AFG at September 30, 2018, were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated and non-investment grade. Management believes that the high quality investment portfolio should generate a stable and predictable investment return.

MBS are subject to significant prepayment risk due to the fact that, in periods of declining interest rates, mortgages may be repaid more rapidly than scheduled as borrowers refinance higher rate mortgages to take advantage of lower rates. Although interest rates have been low in recent years, tighter lending standards have resulted in fewer buyers

being able to refinance the mortgages underlying much of AFG's non-agency residential MBS portfolio.

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Summarized information for AFG's MBS (including those classified as trading) at September 30, 2018, is shown in the table below (dollars in millions). Agency-backed securities are those issued by a U.S. government-backed agency; Alt-A mortgages are those with risk profiles between prime and subprime. The average life of the residential and commercial MBS is approximately 4-1/2 years and 5 years, respectively.

Collateral type	Amortized Cost	Fair Value	Fair Value as % of Cost	Unrealized Gain (Loss)	% Rated Investment Grade
Residential:					
Agency-backed	\$ 177	\$ 173	98 %	\$ (4)	100 %
Non-agency prime	1,009	1,154	114 %	145	27 %
Alt-A	837	953	114 %	116	15 %
Subprime	387	431	111 %	44	28 %
Commercial	913	923	101 %	10	94 %
	\$ 3,323	\$ 3,634	109 %	\$ 311	44 %

The National Association of Insurance Commissioners ("NAIC") assigns creditworthiness designations on a scale of 1 to 6 with 1 being the highest quality and 6 being the lowest quality. The NAIC retains third-party investment management firms to assist in the determination of appropriate NAIC designations for MBS based not only on the probability of loss (which is the primary basis of ratings by the major ratings firms), but also on the severity of loss and statutory carrying value. At September 30, 2018, 97% (based on statutory carrying value of \$3.28 billion) of AFG's MBS had an NAIC designation of 1.

Municipal bonds represented approximately 17% of AFG's fixed maturity portfolio at September 30, 2018. AFG's municipal bond portfolio is high quality, with 99% of the securities rated investment grade at that date. The portfolio is well diversified across the states of issuance and individual issuers. At September 30, 2018, approximately 77% of the municipal bond portfolio was held in revenue bonds, with the remaining 23% held in general obligation bonds. AFG does not own general obligation bonds issued by Puerto Rico.

Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at September 30, 2018, is shown in the following table (dollars in millions). Approximately \$563 million of available for sale fixed maturity securities had no unrealized gains or losses at September 30, 2018.

	Securities With Unrealized Gains	Securities With Unrealized Losses
Available for Sale Fixed Maturities		
Fair value of securities	\$17,894	\$21,787
Amortized cost of securities	\$17,160	\$22,330
Gross unrealized gain (loss)	\$734	\$(543)
Fair value as % of amortized cost	104 %	98 %
Number of security positions	2,876	2,392
Number individually exceeding \$2 million gain or loss	50	10
Concentration of gains (losses) by type or industry (exceeding 5% of unrealized):		
Mortgage-backed securities	\$324	\$(13)
Asset-backed securities	122	(64)

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States and municipalities	117	(98)
Banks, savings and credit institutions	32	(100)
Manufacturing	29	(57)
Insurance companies	15	(47)
Percentage rated investment grade	84	% 96	%

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The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at September 30, 2018, based on their fair values. 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.

Maturity	Securities With Unrealized Gains	%	Securities With Unrealized Losses	%
One year or less	5	%	1	%
After one year through five years	25	%	17	%
After five years through ten years	24	%	41	%
After ten years	9	%	14	%
	63	%	73	%
Asset-backed securities (average life of approximately 4-1/2 years)	21	%	24	%
Mortgage-backed securities (average life of approximately 4-1/2 years)	16	%	3	%
	100	%	100	%

The table below (dollars in millions) summarizes the unrealized gains and losses on fixed maturity securities by dollar amount:

	Aggregate Fair Value	Aggregate Unrealized Gain (Loss)	Fair Value as % of Cost
Fixed Maturities at September 30, 2018			
Securities with unrealized gains:			
Exceeding \$500,000 (376 securities)	\$ 4,334	\$ 460	112 %
\$500,000 or less (2,500 securities)	13,560	274	102 %
	\$ 17,894	\$ 734	104 %
Securities with unrealized losses:			
Exceeding \$500,000 (307 securities)	\$ 6,001	\$ (275)	