CINCINNATI FINANCIAL CORP
Form 10-Q
October 27, 2011
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

(Mark one)

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the quarterly period ended September 30, 2011.

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the transition period from ____________________ to ____________________.
Commission file number 0-4604

CINCINNATI FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Ohio (State or other jurisdiction of incorporation or organization)	31-0746871 (I.R.S. Employer Identification No.)
6200 S. Gilmore Road, Fairfield, Ohio (Address of principal executive offices)	45014-5141 (Zip code)

Registrant's telephone number, including area code: (513) 870-2000

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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

þ Yes ¨ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

þ Yes ¨ No

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

þ Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company

(Do not check if a smaller reporting company)

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

¨ Yes þ No

As of October 24, 2011, there were 162,078,694 shares of common stock outstanding.

CINCINNATI FINANCIAL CORPORATION

FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2011

TABLE OF CONTENTS

Part I – Financial Information

Item 1. Financial Statements (unaudited)

Cincinnati Financial Corporation and Subsidiaries

Condensed Consolidated Balance Sheets

(In millions except per share data)	September 30, 2011	December 31, 2010
ASSETS		
Investments		
Fixed maturities, at fair value (amortized cost: 2011—$8,179; 2010—$7,888)	$ 8,854	$ 8,383
Equity securities, at fair value (cost: 2011—$2,132; 2010—$2,286)	2,609	3,041
Other invested assets	66	84
Total investments	11,529	11,508
Cash and cash equivalents	308	385
Investment income receivable	117	119
Finance receivable	75	73
Premiums receivable	1,107	1,015
Reinsurance receivable	714	572
Prepaid reinsurance premiums	15	18
Deferred policy acquisition costs	512	488
Land, building and equipment, net, for company use (accumulated depreciation: 2011—$368; 2010—$352)	228	229
Other assets	142	67
Separate accounts	665	621
Total assets	$ 15,412	$ 15,095
LIABILITIES		
Insurance reserves		
Loss and loss expense reserves	$ 4,521	$ 4,200
Life policy reserves	2,179	2,034
Unearned premiums	1,657	1,553
Other liabilities	519	556
Deferred income tax	191	260
Note payable	104	49
Long-term debt	790	790
Separate accounts	665	621
Total liabilities	10,626	10,063
Commitments and contingent liabilities (Note 10)	—	—
SHAREHOLDERS' EQUITY		
Common stock, par value—$2 per share; (authorized: 2011 and 2010—500 million shares; issued: 2011 and 2010—196 million shares)	393	393
Paid-in capital	1,098	1,091
Retained earnings	3,816	3,980
Accumulated other comprehensive income	703	769

Treasury stock at cost (2011—34 million shares and 2010—34 million shares)	(1,224)	(1,201)
Total shareholders' equity	4,786	5,032
Total liabilities and shareholders' equity	$ 15,412	$ 15,095

Accompanying notes are an integral part of these condensed consolidated financial statements.

Cincinnati Financial Corporation and Subsidiaries

Condensed Consolidated Statements of Income

(In millions except per share data)	Three months ended September 30, 2011	Three months ended September 30, 2010	Nine months ended September 30, 2011	Nine months ended September 30, 2010
REVENUES				
Earned premiums	$ 812	$ 784	$ 2,367	$ 2,299
Investment income, net of expenses	130	128	393	388
Fee revenues	1	1	3	3
Other revenues	3	3	8	6
Realized investment gains (losses), net:				
Other-than-temporary impairments on fixed maturity securities	(3)	(1)	(3)	(3)
Other-than-temporary impairments on fixed maturity securities transferred to other comprehensive income	-	-	-	-
Other realized investment gains, net	1	156	80	143
Total realized investment gains (losses), net	(2)	155	77	140
Total revenues	944	1,071	2,848	2,836
BENEFITS AND EXPENSES				
Insurance losses and policyholder benefits	656	575	2,032	1,686
Underwriting, acquisition and insurance expenses	260	258	772	772
Other operating expenses	4	4	14	11
Interest expense	13	13	40	40
Total benefits and expenses	933	850	2,858	2,509
INCOME (LOSS) BEFORE INCOME TAXES	11	221	(10)	327
PROVISION (BENEFIT) FOR INCOME TAXES				
Current	17	59	(9)	84
Deferred	(25)	6	(33)	(8)
Total provision (benefit) for income taxes	(8)	65	(42)	76
NET INCOME	$ 19	$ 156	$ 32	$ 251
PER COMMON SHARE				
Net income—basic	$ 0.12	$ 0.95	$ 0.20	$ 1.54
Net income—diluted	0.12	0.95	0.20	1.53

Accompanying notes are an integral part of these condensed consolidated financial statements.

Cincinnati Financial Corporation and Subsidiaries

Condensed Consolidated Statements of Shareholders' Equity

(In millions)	Common Stock Outstanding Shares	Common Stock Amount	Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Share-holders' Equity
Balance December 31, 2009	162	$ 393	$ 1,081	$ 3,862	$ 624	$ (1,200)	$ 4,760
Net income	-	-	-	251	-	-	251
Other comprehensive income, net	-	-	-	-	190	-	190
Total comprehensive income							441
Dividends declared	-	-	-	(194)	-	-	(194)
Stock options exercised	1	-	(2)	-	-	3	1
Stock-based compensation	-	-	9	-	-	-	9
Purchases	-	-	-	-	-	(10)	(10)
Other	-	-	(1)	-	-	4	3
Balance September 30, 2010	163	$ 393	$ 1,087	$ 3,919	$ 814	$ (1,203)	$ 5,010
Balance December 31, 2010	163	$ 393	$ 1,091	$ 3,980	$ 769	$ (1,201)	$ 5,032
Net income	-	-	-	32	-	-	32
Other comprehensive loss, net	-	-	-	-	(66)	-	(66)
Total comprehensive loss							(34)
Dividends declared	-	-	-	(196)	-	-	(196)
Stock options exercised	-	-	(5)	-	-	3	(2)
Stock-based compensation	-	-	10	-	-	-	10
Purchases	(1)	-	-	-	-	(30)	(30)
Other	-	-	2	-	-	4	6
Balance September 30, 2011	162	$ 393	$ 1,098	$ 3,816	$ 703	$ (1,224)	$ 4,786

Accompanying notes are an integral part of these condensed consolidated financial statements.

Cincinnati Financial Corporation and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(In millions)	Nine months ended September 30, 2011	Nine months ended September 30, 2010
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 32	$ 251
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and other non-cash items	38	30
Realized gains on investments	(77)	(140)
Stock-based compensation	10	9
Interest credited to contract holders	38	33
Deferred income tax benefit	(33)	(8)
Changes in:		
Investment income receivable	2	4
Premiums and reinsurance receivable	(231)	81
Deferred policy acquisition costs	(33)	(19)
Other assets	(1)	(2)
Loss and loss expense reserves	321	83
Life policy reserves	89	86
Unearned premiums	104	64
Other liabilities	(49)	(27)
Current income tax receivable/payable	(62)	(28)
Net cash provided by operating activities	148	417
CASH FLOWS FROM INVESTING ACTIVITIES		
Sale of fixed maturities	47	136
Call or maturity of fixed maturities	592	757
Sale of equity securities	410	128
Collection of finance receivables	23	21
Purchase of fixed maturities	(934)	(1,145)
Purchase of equity securities	(179)	(276)
Change in short-term investments, net	-	7
Investment in buildings and equipment, net	(12)	(14)
Investment in finance receivables	(23)	(17)
Change in other invested assets, net	5	1
Net cash used in investing activities	(71)	(402)
CASH FLOWS FROM FINANCING ACTIVITIES		
Payment of cash dividends to shareholders	(191)	(189)
Purchase of treasury shares	(30)	(10)
Increase in notes payable	55	-
Contract holders' funds deposited	81	130
Contract holders' funds withdrawn	(64)	(53)
Excess tax benefits on share-based compensation	3	1
Other	(8)	(6)
Net cash used in financing activities	(154)	(127)
Net change in cash and cash equivalents	(77)	(112)
Cash and cash equivalents at beginning of year	385	557

Cash and cash equivalents at end of period	$ 308	$ 445
Supplemental disclosures of cash flow information:		
Interest paid	$ 27	$ 27
Income taxes paid	53	113
Non-cash activities:		
Conversion of securities	$ -	$ 5
Equipment acquired under capital lease obligations	24	-

Accompanying notes are an integral part of these condensed consolidated financial statements.

Notes to Condensed Consolidated Financial Statements (unaudited)

NOTE 1 — Accounting Policies

The condensed consolidated financial statements include the accounts of Cincinnati Financial Corporation and its consolidated subsidiaries, each of which is wholly owned. These statements are presented in conformity with accounting principles generally accepted in the United States of America (GAAP). All intercompany balances and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Our actual results could differ from those estimates. The December 31, 2010, condensed consolidated balance sheet amounts are derived from the audited financial statements but do not include all disclosures required by GAAP.

Our September 30, 2011, condensed consolidated financial statements are unaudited. Certain financial information that is included in annual financial statements prepared in accordance with GAAP is not required for interim reporting and has been condensed or omitted. We believe that we have made all adjustments, consisting only of normal recurring accruals, that are necessary for fair presentation. These condensed consolidated financial statements should be read in conjunction with our consolidated financial statements included in our 2010 Annual Report on Form 10-K. The results of operations for interim periods do not necessarily indicate results to be expected for the full year.

Adopted Accounting Updates

ASU 2010-06, Fair Value Measurements and Disclosures

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-06, Fair Value Measurements and Disclosures. ASU 2010-06 applies to all entities that are required to make disclosures about recurring or nonrecurring fair value measurements. ASU 2010-06 requires separate disclosures of the activity in the Level 3 category related to any purchases, sales, issuances and settlements on a gross basis. The effective date of these separate disclosures is for interim and annual periods beginning after December 15, 2010. This portion of ASU 2010-06 does not have a material impact on our company's financial position, cash flows or results of operations as it focuses on additional disclosures.

ASU 2010-15, How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments

In April 2010, the FASB issued ASU 2010-15, How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments. ASU 2010-15 applies to all insurance entities that have separate accounts that meet the definition and requirements set forth in the Accounting Standards Codification Manual. ASU 2010-15 clarifies that an insurance entity should not consider any separate account interests held for the benefit of contract holders in an investment to be the insurer's interests. The insurance entity should not combine those interests with its general account interest in the same investment when assessing the investment for consolidation. The insurance entity may combine those interests when the separate account interests are held for the benefit of a related-party policyholder as defined in the Variable Interest Subsections of the Consolidation topic in the Codification Manual. The effective date of the amendments in this update is for interim and annual periods beginning after December 15, 2010, with early adoption permitted. The amendments in this update do not modify the disclosures currently required by GAAP and do not have a material impact on our company's financial position, cash flows or results of operations.

Pending Accounting Updates

ASU 2010-26, Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts

In October 2010, the FASB issued ASU 2010-26, Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts. ASU 2010-26 modifies the definitions of the type of costs incurred by insurance entities that can be capitalized in the successful acquisition of new and renewal contracts. ASU 2010-26 requires capitalization of incremental direct costs of successful contract acquisition as well as certain costs related to underwriting, policy issuance and processing, medical and inspection and sales force contract selling for successful contract acquisition. These incremental direct costs and other costs are those that are essential to the contract transaction and would not have been incurred had the contract transaction not occurred. The effective date of ASU 2010-26 is for interim and annual reporting periods beginning after December 15, 2011. We plan to adopt ASU 2010-26 retrospectively. We estimate that at September 30, 2011, approximately $100 million of the total $512 million deferred acquisition costs asset is subject to further analysis to determine what can continue to be capitalized. We estimate $35-65 million of the $100 million may relate to successful acquisition of new and renewal contracts and will be deferrable and capitalized. The ASU has not yet been adopted, and we will report at December 31, 2011, the impact it will have on our company's financial position, cash flows or results of operations.

ASU 2011-04, Fair Value Measurements, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurements, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards (IFRS). The ASU converges fair value measurement and disclosures among U.S. GAAP and IFRS. ASU 2011-04 changes certain fair value measurement principles and expands disclosure requirements, particularly for Level 3 inputs. The ASU is effective for interim and annual periods beginning after December 15, 2011, and should be applied prospectively. The ASU has not yet been adopted and will not have a material impact on our company's financial position, cash flows or results of operations.

ASU 2011-05, Presentation of Comprehensive Income

In June 2011, the FASB issued ASU 2011-05, Presentation of Comprehensive Income. ASU 2011-05 requires entities to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The ASU is effective for interim and annual reporting periods beginning after December 15, 2011, and should be applied prospectively. The ASU has not yet been adopted and will not have a material impact on our company's financial position, cash flows or results of operations, as it relates to modified presentation of existing financial statements.

NOTE 2 – Investments

Fixed maturities (bonds and redeemable preferred stocks) and equity securities (common and non-redeemable preferred stocks) have been classified as available for sale and are stated at fair values at September 30, 2011, and December 31, 2010. Realized gains and losses on investments are recognized in earnings on a specific identification basis.

The change in unrealized gains and losses, net of taxes, described in the following table, is included in other comprehensive income and shareholders' equity.

(In millions)	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Change in unrealized gains and losses summary:				
Fixed maturities	$ 76	$ 198	$ 180	$ 407
Equity securities	(379)	85	(278)	(105)
Adjustment to deferred acquisition costs and life policy reserves	(7)	(11)	(11)	(18)
Pension obligations	1	-	3	1
Other	1	2	4	7
Income taxes on above	108	(96)	36	(102)
Total	$ (200)	$ 178	$ (66)	$ 190

The following table analyzes cost or amortized cost, gross unrealized gains, gross unrealized losses and fair value for our investments, along with the amount of cumulative non-credit other-than-temporary impairment (OTTI) losses transferred to accumulated other comprehensive income (AOCI) in accordance with ASC 320-10-65, Recognition and Presentation of Other-Than-Temporary Impairments, for securities that also had a credit impairment:

(In millions) At September 30, 2011	Cost or amortized cost	Gross unrealized gains	losses	Fair Value	OTTI in AOCI
Fixed maturities:					
States, municipalities and political subdivisions	$ 3,020	$ 220	$ 1	$ 3,239	$ -
Convertibles and bonds with warrants attached	69	-	-	69	-
United States government	6	1	-	7	-
Government-sponsored enterprises	217	-	-	217	-
Foreign government	3	-	-	3	-
Corporate securities	4,864	472	17	5,319	-
Subtotal	8,179	693	18	8,854	$ -
Equity securities:					
Common equities	2,057	548	96	2,509	
Preferred equities	75	26	1	100	
Subtotal	2,132	574	97	2,609	NA
Total	$ 10,311	$ 1,267	$ 115	$ 11,463	
At December 31, 2010					
Fixed maturities:					
States, municipalities and political subdivisions	$ 3,043	$ 110	$ 10	$ 3,143	$ -
Convertibles and bonds with warrants attached	69	-	-	69	-
United States government	4	1	-	5	-
Government-sponsored enterprises	201	-	1	200	-
Foreign government	3	-	-	3	-
Corporate securities	4,568	404	9	4,963	-
Subtotal	7,888	515	20	8,383	$ -
Equity securities:					
Common equities	2,211	757	28	2,940	
Preferred equities	75	27	1	101	
Subtotal	2,286	784	29	3,041	NA
Total	$ 10,174	$ 1,299	$ 49	$ 11,424	

The unrealized investment gains at September 30, 2011, were largely due to a net gain position in our fixed maturity portfolio of $675 million and a net gain position in our common stock portfolio of $452 million. The net unrealized investment gains in our fixed maturity portfolio are primarily composed of $455 million in unrealized gains from the corporate bond portfolio and $219 million in net unrealized gains from the municipal bond portfolio.
The primary contributors to the net gain position in the common stock portfolio were Exxon Mobil Corporation (NYSE:XOM), The Procter & Gamble Company (NYSE:PG) and Chevron Corporation (NYSE:CVX) common stock, which had a combined net gain position of $251 million.

Of the 182 holdings with fair value below cost or amortized cost at September 30, 2011, the three largest contributors to the $115 million unrealized losses were equity securities. The fair value of these three securities was $125 million, and they accounted for $55 million in unrealized losses. Two securities have traded below cost for less than six months. One security has traded below cost for less than nine months.

Management reviews quantitative measurements such as a declining trend in fair value, the extent of the fair value decline and the length of time the value of the security has been depressed, as well as qualitative measures such as pending events, credit ratings and issuer liquidity when analyzing for other-than-temporary declines in value. Non-cash charges to income, as realized investment losses, are recorded when it is determined the value will not be recovered within a designated recovery period.

At September 30, 2011, we had $69 million fair value of hybrid securities included in fixed maturities that follow ASC 815-15-25, Accounting for Certain Hybrid Financial Instruments. The hybrid securities are carried at fair value, and the changes in fair value are included in realized investment gains and losses.

The table below provides fair values and unrealized losses by investment category and by the duration of the securities' continuous unrealized loss position:

(In millions)	Less than 12 months		12 months or more		Total	
At September 30, 2011	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Fixed maturities:						
States, municipalities and political subdivisions	$ 17	$ 1	$ 6	$ -	$ 23	$ 1
United States government	1	-	-	-	1	-
Government-sponsored enterprises	70	-	-	-	70	-
Corporate securities	448	14	28	3	476	17
Subtotal	536	15	34	3	570	18
Equity securities:						
Common equities	571	96	-	-	571	96
Preferred equities	8	-	18	1	26	1
Subtotal	579	96	18	1	597	97
Total	$ 1,115	$ 111	$ 52	$ 4	$ 1,167	$ 115
At December 31, 2010						
Fixed maturities:						
States, municipalities and political subdivisions	$ 325	$ 9	$ 9	$ 1	$ 334	$ 10
Government-sponsored enterprises	133	1	-	-	133	1
Corporate securities	354	6	39	3	393	9
Subtotal	812	16	48	4	860	20
Equity securities:						
Common equities	337	28	-	-	337	28
Preferred equities	5	-	23	1	28	1
Subtotal	342	28	23	1	365	29
Total	$ 1,154	$ 44	$ 71	$ 5	$ 1,225	$ 49

For the three months ended September 30, 2011, the net realized loss of $2 million includes $19 million in gross realized gains and $17 million in gross realized losses from sales of securities. For the three months ended September 30, 2010, the net realized gain of $155 million includes $148 million in gross realized gains and less than $1 million in gross realized losses from sales of securities. For the nine months ended September 30, 2011, the net realized gain of $77 million includes $136 million in gross realized gains and $35 million in gross realized losses from sales of securities. For the nine months ended September 30, 2010, the net realized gain of $140 million includes $177 million in gross realized gains and $12 million in gross realized losses from sales of securities.

Other-than-temporary Impairment Charges

During the three and nine months ended September 30, 2011, there were no credit losses on fixed-maturity securities for which a portion of OTTI has been recognized in other comprehensive income. The following table provides the amount of OTTI charges for the three and nine months ended September 30, 2011:

(In millions)	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010

Fixed maturities	$ 3	$ 1	$ 3	$ 3
Equity securities	-	-	30	33
Total	$ 3	$ 1	$ 33	$ 36

During the quarter ended September 30, 2011, we impaired four fixed-maturity securities for $3 million. At September 30, 2011, 13 fixed-maturity investments with a total unrealized loss of $3 million had been in an unrealized loss position for 12 months or more, but none were trading below 70 percent of amortized cost. At September 30, 2011, two equity securities with a total unrealized loss of $1 million had been in an unrealized loss position for 12 months or more, but none were trading below 70 percent of amortized cost.

At December 31, 2010, 17 fixed-maturity investments with a total unrealized loss of $4 million had been in an unrealized loss position for 12 months or more. Of that total, no fixed maturity investments were trading below 70 percent of amortized cost. Three equity investments with a total unrealized loss of $1 million had been in an unrealized loss position for 12 months or more as of December 31, 2010. Of that total, no equity investments were trading below 70 percent of amortized cost.

NOTE 3 – Fair Value Measurements

Fair Value Hierarchy

In accordance with accounting guidance for fair value measurements and disclosures, we categorized our financial instruments, based on the priority of the observable and market-based data for the valuation technique used, into a three-level fair value hierarchy. The fair value hierarchy gives the highest priority to quoted prices with readily available independent data in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable market inputs (Level 3). When various inputs for measurement fall within different levels of the fair value hierarchy, the lowest observable input that has a significant impact on fair value measurement is used. Our valuation techniques have not changed from those used at December 31, 2010, and ultimately management determines fair value.

Financial instruments are categorized based upon the following characteristics or inputs to the valuation techniques:

- Level 1 – Financial assets and liabilities for which inputs are observable and are obtained from reliable quoted prices for identical assets or liabilities in active markets. This is the most reliable fair value measurement and includes, for example, active exchange-traded equity securities.

- Level 2 – Financial assets and liabilities for which values are based on quoted prices in markets that are not active or for which values are based on similar assets and liabilities that are actively traded. This also includes pricing models for which the inputs are corroborated by market data.

- Level 3 – Financial assets and liabilities for which values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. Level 3 inputs include the following:

  - Quotes from brokers or other external sources that are not considered binding;

  - Quotes from brokers or other external sources where it cannot be determined that market participants would in fact transact for the asset or liability at the quoted price; or

  - Quotes from brokers or other external sources where the inputs are not deemed observable.

We conduct a thorough review of fair value hierarchy classifications on a quarterly basis. Reclassification of certain financial instruments may occur when input observability changes. As noted below in the Level 3 disclosure table, reclassifications are reported as transfers in or out of the Level 3 category as of the beginning of the quarter in which the reclassification occurred.

The following tables illustrate the fair value hierarchy for those assets measured at fair value on a recurring basis at September 30, 2011, and December 31, 2010. We do not have any material liabilities carried at fair value. There were no significant transfers between Level 1 and Level 2.

Fair Value Disclosures for Assets

(In millions)	Asset fair value measurements at September 30, 2011 using:			
	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total
Fixed maturities, available for sale:				
States, municipalities and political subdivisions	$ -	$ 3,236	$ 3	$ 3,239
Convertibles and bonds with warrants attached	-	69	-	69
United States government	7	-	-	7
Government-sponsored enterprises	-	217	-	217
Foreign government	-	3	-	3
Corporate securities	-	5,297	22	5,319
Subtotal	7	8,822	25	8,854
Common equities, available for sale	2,509	-	-	2,509
Preferred equities, available for sale	-	94	6	100
Taxable fixed maturities separate accounts	-	631	-	631
Top Hat Savings Plan	7	-	-	7
Total	$ 2,523	$ 9,547	$ 31	$ 12,101

(In millions)	Asset fair value measurements at December 31, 2010 using:			
	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total
Fixed maturities, available for sale:				
States, municipalities and political subdivisions	$ -	$ 3,139	$ 4	$ 3,143
Convertibles and bonds with warrants attached	-	69	-	69
United States government	5	-	-	5
Government-sponsored enterprises	-	200	-	200
Foreign government	-	3	-	3
Corporate securities	-	4,943	20	4,963
Subtotal	5	8,354	24	8,383
Common equities, available for sale	2,940	-	-	2,940
Preferred equities, available for sale	-	96	5	101
Taxable fixed maturities separate accounts	-	606	2	608
Top Hat Savings Plan	9	-	-	9
Total	$ 2,954	$ 9,056	$ 31	$ 12,041

Each financial instrument that was deemed to have significant unobservable inputs when determining valuation is identified in the tables below by security type with a summary of changes in fair value as of September 30, 2011. Total Level 3 assets continue to be less than 1 percent of financial assets measured at fair value. At September 30, 2011, total fair value of assets priced with broker quotes and other non-observable market inputs for the fair value measurements and disclosures was $31 million.

The following table provides the change in Level 3 assets for the three months ended September 30, 2011. Level 3 corporate fixed-maturity securities increased by $7 million as one security was purchased for $8 million, two securities totaling $8 million were transferred into Level 2 and one security totaling $7 million was transferred into Level 3. There were no other significant changes to Level 3 assets during this period.

(In millions)	Asset fair value measurements using significant unobservable inputs (Level 3)				
	Corporate fixed maturities	Taxable fixed maturities-separate accounts	States, municipalities and political subdivisions fixed maturities	Preferred equities	Total
Beginning balance, June 30, 2011	$ 15	$ -	$ 4	$ 7	$ 26
Total gains or losses (realized/unrealized):					
Included in earnings (or changes in net assets)	-	-	-	-	-
Included in other comprehensive income	-	-	-	(1)	(1)
Purchases	8	-	-	-	8
Sales	-	-	(1)	-	(1)
Transfers into Level 3	7	-	-	-	7
Transfers out of Level 3	(8)	-	-	-	(8)
Ending balance, September 30, 2011	$ 22	$ -	$ 3	$ 6	$ 31

(In millions)	Asset fair value measurements using significant unobservable inputs (Level 3)				
	Corporate fixed maturities	Taxable fixed maturities-separate accounts	States, municipalities and political subdivisions fixed maturities	Preferred equities	Total
Beginning balance, June 30, 2010	$ 23	$ -	$ 4	$ 5	$ 32
Total gains or losses (realized/unrealized):					
Included in earnings (or changes in net assets)	-	-	-	-	-
Included in other comprehensive income	1	-	-	-	1
Purchases, sales, issuances, and settlements	(4)	2	-	-	(2)
Transfers in and/or out of Level 3	1	-	-	-	1
Ending balance, September 30, 2010	$ 21	$ 2	$ 4	$ 5	$ 32

The following table provides the change in Level 3 assets for the nine months ended September 30, 2011. Level 3 corporate fixed-maturity securities increased $2 million for the nine months ended September 30, 2011. The change in corporate fixed-maturity securities resulted from the transfer of five securities totaling $20 million into Level 2, two securities totaling $7 million transferred into Level 3 and the purchase of two securities totaling $15 million. There were no other significant changes to Level 3 assets during this period.

(In millions)	Asset fair value measurements using significant unobservable inputs (Level 3)				
	Corporate fixed maturities	Taxable fixed maturities-separate accounts	States, municipalities and political subdivisions fixed maturities	Preferred equities	Total
Beginning balance, December 31, 2010	$ 20	$ 2	$ 4	$ 5	$ 31
Total gains or losses (realized/unrealized):					
Included in earnings (or changes in net assets)	-	-	-	-	-
Included in other comprehensive income	-	-	-	-	-
Purchases	15	-	-	-	15
Sales	-	-	(1)	-	(1)
Transfers into Level 3	7	-	-	1	8
Transfers out of Level 3	(20)	(2)	-	-	(22)
Ending balance, September 30, 2011	$ 22	$ -	$ 3	$ 6	$ 31

(In millions)	Asset fair value measurements using significant unobservable inputs (Level 3)				
	Taxable fixed maturities	Taxable fixed maturities-separate accounts	Tax-exempt fixed maturities	Preferred equities	Total
Beginning balance, December 31, 2009	$ 27	$ -	$ 4	$ 5	$ 36
Total gains or losses (realized/unrealized):					
Included in earnings (or changes in net assets)	-	-	-	-	-
Included in other comprehensive income	1	-	-	-	1
Purchases, sales, issuances, and settlements	(2)	2	-	-	-
Transfers in and/or out of Level 3	(5)	-	-	-	(5)
Ending balance, September 30, 2010	$ 21	$ 2	$ 4	$ 5	$ 32

Fair Value Disclosure for Senior Debt and Life Insurance Assets and Liabilities

The disclosures below are presented to provide timely information about the effects of current market conditions on financial instruments that are not reported at fair value in our condensed consolidated financial statements.

This table summarizes the amortized cost and principal amounts of our long-term debt:

(In millions)			Book value		Principal amount	
Interest rate	Year of issue		September 30, 2011	December 31, 2010	September 30, 2011	December 31, 2010
6.900%	1998	Senior debentures, due 2028	$ 28	$ 28	$ 28	$ 28
6.920%	2005	Senior debentures, due 2028	391	391	391	391
6.125%	2004	Senior notes, due 2034	371	371	374	374
		Total	$ 790	$ 790	$ 793	$ 793

The fair value of our senior debt approximated $815 million at September 30, 2011, compared with $783 million at year-end 2010. Fair value was determined under the fair value measurements and disclosure accounting rules based on market pricing of similar debt instruments that are actively trading. Fair value can vary with macroeconomic conditions. Regardless of the fluctuations in fair value, the outstanding principal amount of our long-term debt is $793 million. None of the long-term debt is encumbered by rating triggers. Also, we have one variable rate note payable with outstanding principal amount of $104 million, which approximates fair value. The additional $55 million in short-term borrowing in the third quarter was primarily to fund share repurchases using our relatively low-cost source of borrowing.

The fair value of life policy loans outstanding principal and interest approximated $41 million, compared with amortized cost of $38 million reported in the condensed consolidated balance sheets at September 30, 2011. The fair value of life policy loans outstanding principal and interest approximated $46 million, compared with amortized cost of $40 million reported in the consolidated balance sheets at December 31, 2010.

Life reserves and liabilities for deferred annuities and other investment contracts were $1.017 billion and $930 million at September 30, 2011, and December 31, 2010, respectively. Fair value for these deferred annuities and investment contracts was $923 million and $933 million at September 30, 2011, and December 31, 2010, respectively. Fair values of liabilities associated with certain investment contracts are calculated based upon internally developed models because active, observable markets do not exist for those items. To determine the fair value, we make the following significant assumptions: (1) the discount rates used to calculate the present value of expected payments are the risk-free spot rates plus an A3 rated bond spread for financial issuers at September 30, 2011, to account for non-performance risk; (2) the rate of interest credited to policyholders is the portfolio net earned interest rate less a spread for expenses and profit; and (3) additional lapses occur when the credited interest rate is exceeded by an assumed competitor credited rate, which is a function of the risk-free rate of the economic scenario being modeled.

NOTE 4 – Property Casualty Loss and Loss Expenses

This table summarizes activity for our consolidated property casualty loss and loss expense reserves:

(In millions)	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Gross loss and loss expense reserves, beginning of period	$ 4,479	$ 4,131	$ 4,137	$ 4,096
Less reinsurance receivable	508	311	326	435
Net loss and loss expense reserves, beginning of period	3,971	3,820	3,811	3,661
Net incurred loss and loss expenses related to:				
Current accident year	675	592	2,115	1,731
Prior accident years	(68)	(61)	(221)	(174)
Total incurred	607	531	1,894	1,557
Net paid loss and loss expenses related to:				
Current accident year	360	308	878	641
Prior accident years	205	196	814	730
Total paid	565	504	1,692	1,371
Net loss and loss expense reserves, end of period	4,013	3,847	4,013	3,847
Plus reinsurance receivable	450	319	450	319
Gross loss and loss expense reserves, end of period	$ 4,463	$ 4,166	$ 4,463	$ 4,166

We use actuarial methods, models and judgment to estimate, as of a financial statement date, the property casualty loss and loss expense reserves required to pay for and settle all outstanding insured claims, including incurred but not reported (IBNR) claims. The actuarial estimate is subject to review and adjustment by an inter-departmental committee that includes actuarial management, who is familiar with relevant company and industry business, claims and underwriting trends, as well as general economic and legal trends, that could affect future loss and loss expense payments.

We decreased the provision for prior accident years' incurred loss and loss expenses primarily due to reduced volatility in paid losses and reduced volatility in projections of future calendar year trends and favorable case reserve development. Favorable incurred development in prior accident years occurred mostly in the commercial lines casualty line of business and has had similar trends in the past two years, with approximately 60 percent coming from the most recent prior accident year in each nine-month period above. The reserve for loss and loss expenses in the condensed consolidated balance sheets also includes $58 million at September 30, 2011, and $59 million at September 30, 2010, for certain life and health loss and loss expense reserves.

NOTE 5 – Deferred Acquisition Costs

The expenses associated with issuing insurance policies – primarily commissions, premium taxes and underwriting costs – are deferred and amortized over the terms of the policies. We update our acquisition cost assumptions periodically to reflect actual experience, and we evaluate our deferred acquisition costs for recoverability. The table below shows the deferred policy acquisition costs and asset reconciliation, including the amortized deferred policy acquisition costs.

(In millions)	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Deferred policy acquisition costs asset, beginning of period	$ 511	$ 485	$ 488	$ 481
Capitalized deferred policy acquisition costs	182	168	543	510
Amortized deferred policy acquisition costs	(177)	(167)	(510)	(492)
Amortized shadow deferred policy acquisition costs	(4)	(17)	(9)	(30)
Deferred policy acquisition costs asset, end of period	$ 512	$ 469	$ 512	$ 469

There were no premium deficiencies recorded in the reported condensed consolidated statements of income, as the sum of the anticipated loss and loss adjustment expenses, policyholder dividends, maintenance expenses and underwriting expenses did not exceed the related unearned premiums and anticipated investment income.

NOTE 6 – Life Policy Reserves

We establish the reserves for traditional life insurance policies based on expected expenses, mortality, morbidity, withdrawal rates and investment yields, including a provision for uncertainty. Once these assumptions are established, they generally are maintained throughout the lives of the contracts. We use both our own experience and industry experience, adjusted for historical trends, in arriving at our assumptions for expected mortality, morbidity and withdrawal rates as well as for expected expenses. We base our assumptions for expected investment income on our own experience adjusted for current economic conditions.

We establish reserves for the company's universal life, deferred annuity and investment contracts equal to the cumulative account balances, which include premium deposits plus credited interest less charges and withdrawals. Some of our universal life policies contain no-lapse guarantee provisions. For these policies, we establish a reserve in addition to the account balance, based on expected no-lapse guarantee benefits and expected policy assessments.

(In millions)	September 30, 2011	December 31, 2010
Ordinary/traditional life	$ 671	$ 628
Universal life	474	459
Deferred annuities	819	730
Investment contracts	198	200
Other	17	17
Total gross reserves	$ 2,179	$ 2,034

NOTE 7 – Reinsurance

Our condensed consolidated statements of income include earned consolidated property casualty insurance premiums on assumed and ceded business:

(In millions)	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Direct earned premiums	$ 817	$ 782	$ 2,404	$ 2,295
Assumed earned premiums	3	3	10	8
Ceded earned premiums	(51)	(42)	(170)	(124)
Net earned premiums	$ 769	$ 743	$ 2,244	$ 2,179

Changes in 2011 ceded earned premiums compared with prior periods are related to earned reinstatement premiums as a result of the increase in catastrophe losses that occurred in the second quarter of 2011.

Our condensed consolidated statements of income include incurred consolidated property casualty insurance loss and loss expenses on assumed and ceded business:

(In millions)	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Direct incurred loss and loss expenses	$ 649	$ 549	$ 2,157	$ 1,526
Assumed incurred loss and loss expenses	8	3	28	8
Ceded incurred loss and loss expenses	(50)	(21)	(291)	23

Net incurred loss and loss expenses	$ 607	$ 531	$ 1,894