CINCINNATI FINANCIAL CORP
Form 10-Q
April 24, 2014

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 March 31, 2014.

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a nonaccelerated 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 ¨ Nonaccelerated 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 April 21, 2014, there were 163,519,128 shares of common stock outstanding.

CINCINNATI FINANCIAL CORPORATION
FORM 10-Q FOR THE QUARTER ENDED March 31, 2014

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Part I – Financial Information
Item 1. Financial Statements (unaudited)

CINCINNATI FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(In millions except per share data)	March 31, 2014	December 31, 2013
Assets		
Investments		
Fixed maturities, at fair value (amortized cost: 2014—$8,609; 2013—$8,638)	$9,180	$9,121
Equity securities, at fair value (cost: 2014—$2,545; 2013—$2,523)	4,426	4,375
Other invested assets	72	68
Total investments	13,678	13,564
Cash and cash equivalents	521	433
Investment income receivable	116	121
Finance receivable	83	85
Premiums receivable	1,396	1,346
Reinsurance recoverable	546	547
Prepaid reinsurance premiums	27	26
Deferred policy acquisition costs	564	565
Land, building and equipment, net, for company use (accumulated depreciation: 2014—$424; 2013—$420)	207	210
Other assets	79	73
Separate accounts	725	692
Total assets	$17,942	$17,662
Liabilities		
Insurance reserves		
Loss and loss expense reserves	$4,375	$4,311
Life policy and investment contract reserves	2,435	2,390
Unearned premiums	2,035	1,976
Other liabilities	545	611
Deferred income tax	721	673
Note payable	104	104
Long-term debt and capital lease obligations	834	835
Separate accounts	725	692
Total liabilities	11,774	11,592
Commitments and contingent liabilities (Note 12)	—	—
Shareholders' Equity		
Common stock, par value—$2 per share; (authorized: 2014 and 2013—500 million shares; issued: 2014 and 2013—198 million shares)	397	397
Paid-in capital	1,191	1,191
Retained earnings	4,287	4,268
Accumulated other comprehensive income	1,578	1,504
Treasury stock at cost (2014 and 2013—35 million shares)	(1,285)	(1,290)
Total shareholders' equity	6,168	6,070
Total liabilities and shareholders' equity	$17,942	$17,662

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 March 31,	
	2014	2013
Revenues		
Earned premiums	$1,027	$931
Investment income, net of expenses	135	128
Realized investment gains, net	22	41
Fee revenues	3	1
Other revenues	2	2
Total revenues	1,189	1,103
Benefits and Expenses		
Insurance losses and policyholder benefits	732	568
Underwriting, acquisition and insurance expenses	320	300
Interest expense	14	13
Other operating expenses	4	5
Total benefits and expenses	1,070	886
Income Before Income Taxes	119	217
Provision for Income Taxes		
Current	20	54
Deferred	8	9
Total provision for income taxes	28	63
Net Income	$91	$154
Per Common Share		
Net income—basic	$0.56	$0.95
Net income—diluted	0.55	0.94

Accompanying Notes are an integral part of these Condensed Consolidated Financial Statements.

CINCINNATI FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In millions)	Three months ended March 31,	
	2014	2013
Net Income	$91	$154
Other Comprehensive Income		
Unrealized gains on investments available-for-sale, net of tax of $41 and $124, respectively	76	232
Net change in pension actuarial loss and prior service cost, net of tax of $0 and $1, respectively	(1)	1
Change in life deferred acquisition costs, life policy reserves and other, net of tax of $0 and $0, respectively	(1)	—
Other comprehensive income, net of tax	74	233
Comprehensive Income	$165	$387

CINCINNATI FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(In millions)	Common Stock				Accumulated Other		Total Share-
	Outstanding Shares	Amount	Paid-in Capital	Retained Earnings	Comprehensive Income	Treasury Stock	holders' Equity
Balance December 31, 2012	163	$394	$1,134	$4,021	$1,129	$(1,225)	$5,453
Net income	—	—	—	154	—	—	154
Other comprehensive income, net	—	—	—	—	233	—	233
Dividends declared	—	—	—	(66)	—	—	(66)
Treasury stock acquired—share repurchase authorization	—	—	—	—	—	—	—
Other	—	1	12	—	—	(2)	11
Balance March 31, 2013	163	$395	$1,146	$4,109	$1,362	$(1,227)	$5,785
Balance December 31, 2013	163	$397	$1,191	$4,268	$1,504	$(1,290)	$6,070
Net income	—	—	—	91	—	—	91
Other comprehensive income, net	—	—	—	—	74	—	74
Dividends declared	—	—	—	(72)	—	—	(72)
Treasury stock acquired—share repurchase authorization	—	—	—	—	—	(7)	(7)
Other	—	—	—	—	—	12	12
Balance March 31, 2014	163	$397	$1,191	$4,287	$1,578	$(1,285)	$6,168

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)	Three months ended March 31, 2014	2013
Cash Flows From Operating Activities		
Net income	$91	$154
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	13	9
Realized gains on investments, net	(22)	(41)
Stock-based compensation	6	5
Interest credited to contract holders	10	11
Deferred income tax expense	8	9
Changes in:		
Investment income receivable	5	(2)
Premiums and reinsurance receivable	(50)	(82)
Deferred policy acquisition costs	(5)	(19)
Other assets	(5)	(2)
Loss and loss expense reserves	64	10
Life policy reserves	49	13
Unearned premiums	59	83
Other liabilities	(102)	(88)
Current income tax receivable/payable	8	(3)
Net cash provided by operating activities	129	57
Cash Flows From Investing Activities		
Sale of fixed maturities	24	12
Call or maturity of fixed maturities	252	221
Sale of equity securities	31	98
Purchase of fixed maturities	(236)	(325)
Purchase of equity securities	(33)	(108)
Investment in finance receivables	(4)	(8)
Collection of finance receivables	7	7
Investment in buildings and equipment, net	(3)	(1)
Change in other invested assets, net	1	2
Net cash provided by (used in) investing activities	39	(102)
Cash Flows From Financing Activities		
Payment of cash dividends to shareholders	(67)	(65)
Purchase of treasury shares	(7)	—
Proceeds from stock options exercised	8	6
Contract holders' funds deposited	20	24
Contract holders' funds withdrawn	(32)	(31)
Other	(2)	4
Net cash used in financing activities	(80)	(62)
Net change in cash and cash equivalents	88	(107)
Cash and cash equivalents at beginning of year	433	487
Cash and cash equivalents at end of period	$521	$380
Supplemental disclosures of cash flow information:		
Interest paid	$—	$—
Income taxes paid	11	54
Non-cash activities:		

Conversion of securities	$—	$43
Equipment acquired under capital lease obligations	5	12
Cashless exercise of stock options	4	9

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. Our December 31, 2013, condensed consolidated balance sheet amounts are derived from the audited financial statements but do not include all disclosures required by GAAP.

Our March 31, 2014, 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 2013 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.

NOTE 2 – INVESTMENTS

The following table provides cost or amortized cost, gross unrealized gains, gross unrealized losses and fair value for our invested assets:

(In millions)	Cost or amortized	Gross unrealized		Fair
At March 31, 2014	cost	gains	losses	value
Fixed maturity securities:				
States, municipalities and political subdivisions	$3,113	$143	$12	$3,244
Convertibles and bonds with warrants attached	17	—	—	17
United States government	7	—	—	7
Government-sponsored enterprises	211	—	20	191
Foreign government	10	—	—	10
Commercial mortgage-backed	206	2	2	206
Corporate	5,045	468	8	5,505
Subtotal	8,609	613	42	9,180
Equity securities:				
Common equities	2,418	1,845	6	4,257
Nonredeemable preferred equities	127	43	1	169
Subtotal	2,545	1,888	7	4,426
Total	$11,154	$2,501	$49	$13,606
At December 31, 2013				
Fixed maturity securities:				
States, municipalities and political subdivisions	$3,107	$125	$21	$3,211
Convertibles and bonds with warrants attached	17	—	—	17
United States government	7	—	—	7
Government-sponsored enterprises	227	—	27	200
Foreign government	10	—	—	10
Commercial mortgage-backed	148	—	5	143
Corporate	5,122	433	22	5,533
Subtotal	8,638	558	75	9,121
Equity securities:				
Common equities	2,396	1,818	1	4,213
Nonredeemable preferred equities	127	38	3	162
Subtotal	2,523	1,856	4	4,375
Total	$11,161	$2,414	$79	$13,496

The net unrealized investment gains in our fixed-maturity portfolio are primarily the result of the continued low interest rate environment that increased the fair value of our fixed-maturity portfolio. The five largest unrealized investment gains in our common stock portfolio are from Exxon Mobil Corporation (NYSE:XOM), The Procter & Gamble Company (NYSE:PG), Honeywell International Incorporated (NYSE:HON), Chevron Corporation (NYSE:CVX), and Dover Corporation (NYSE:DOV), which had a combined gross unrealized gain of $431 million.
At March 31, 2014, we had $17 million fair value of hybrid securities included in fixed maturities that follow Accounting Standards Codification (ASC) 815-15-25, Accounting for Certain Hybrid Financial Instruments, compared with $18 million fair value of hybrid securities at December 31, 2013. 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 gross 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	Total
	Fair	Unrealized	Fair	Unrealized	fair	unrealized
At March 31, 2014	value	losses	value	losses	value	losses
Fixed maturity securities:						
States, municipalities and political subdivisions	$289	$7	$98	$5	$387	$12
United States government	11	—	—	—	11	—
Government-sponsored enterprises	83	8	96	12	179	20
Commercial mortgage-backed	55	1	15	1	70	2
Corporate	291	7	65	1	356	8
Subtotal	729	23	274	19	1,003	42
Equity securities:						
Common equities	72	6	—	—	72	6
Nonredeemable preferred equities	39	1	—	—	39	1
Subtotal	111	7	—	—	111	7
Total	$840	$30	$274	$19	$1,114	$49
At December 31, 2013						
Fixed maturity securities:						
States, municipalities and political subdivisions	$490	$18	$42	$3	$532	$21
United States government	1	—	—	—	1	—
Government-sponsored enterprises	199	27	1	—	200	27
Foreign government	10	—	—	—	10	—
Commercial mortgage-backed	125	5	—	—	125	5
Corporate	572	20	43	2	615	22
Subtotal	1,397	70	86	5	1,483	75
Equity securities:						
Common equities	77	1	—	—	77	1
Nonredeemable preferred equities	42	3	—	—	42	3
Subtotal	119	4	—	—	119	4
Total	$1,516	$74	$86	$5	$1,602	$79

The following table provides investment income, realized investment gains and losses, the change in unrealized investment gains and losses, and other items:

(In millions)	Three months ended March 31, 2014	2013
Investment income summary:		
Interest on fixed maturities	$104	$102
Dividends on equity securities	32	27
Other investment income	1	1
Total	137	130
Less investment expenses	2	2
Total	$135	$128
Realized investment gains and losses summary:		
Fixed maturities:		
Gross realized gains	$2	$2
Gross realized losses	—	—
Other-than-temporary impairments	—	(2)
Equity securities:		
Gross realized gains	18	37
Gross realized losses	—	—
Other-than-temporary impairments	(1)	—
Securities with embedded derivatives	(1)	1
Other	4	3
Total	$22	$41
Change in unrealized gains and losses summary:		
Fixed maturities	$88	$(25)
Equity securities	29	381
Net change in pension actuarial loss and prior service cost	(1)	2
Adjustment to deferred acquisition costs and life policy reserves	(3)	3
Other	2	(3)
Income taxes on above	(41)	(125)
Total	$74	$233

During the three months ended March 31, 2014 and 2013, there were no credit losses on fixed-maturity securities for which a portion of other-than-temporary impairment (OTTI) has been recognized in other comprehensive income.

During the quarter ended March 31, 2014, there were two equity securities and one fixed-maturity security other-than-temporarily impaired. At March 31, 2014, ninety-nine fixed-maturity investments with a total unrealized loss of $19 million had been in an unrealized loss position for 12 months or more. Of that total, no fixed-maturity investments had fair values below 70 percent of amortized cost. One equity investment with a total unrealized loss of less than $500,000 had been in an unrealized loss position for 12 months or more as of March 31, 2014. This equity investment was not trading below 70 percent of cost.

During 2013, we other-than-temporarily impaired seven fixed-maturity securities. At December 31, 2013, forty fixed-maturity investments with a total unrealized loss of $5 million had been in an unrealized loss position for 12 months or more. Of that total, no fixed-maturity investments had fair values below 70 percent of amortized cost. There were no equity investments in an unrealized loss position for 12 months or more as of December 31, 2013.

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, 2013, and ultimately management determines fair value. See our 2013 Annual Report on Form 10-K, Item 8, Note 3, Fair Value Measurements, Page 121, for information on characteristics and valuation techniques used in determining fair value.

Fair Value Disclosures for Assets
The following tables illustrate the fair value hierarchy for those assets measured at fair value on a recurring basis at March 31, 2014, and December 31, 2013. We do not have any material liabilities carried at fair value. There were no transfers between Level 1 and Level 2.

(In millions) At March 31, 2014	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	$—	$3,244	$—	$3,244
Convertibles and bonds with warrants attached	—	17	—	17
United States government	7	—	—	7
Government-sponsored enterprises	—	191	—	191
Foreign government	—	10	—	10
Commercial mortgage-backed	—	201	5	206
Corporate	—	5,497	8	5,505
Subtotal	7	9,160	13	9,180
Common equities, available for sale	4,257	—	—	4,257
Nonredeemable preferred equities, available for sale	—	167	2	169
Separate accounts taxable fixed maturities	—	700	—	700
Top Hat Savings Plan mutual funds and common equity (included in Other assets)	17	—	—	17
Total	$4,281	$10,027	$15	$14,323
At December 31, 2013				
Fixed maturities, available for sale:				
States, municipalities and political subdivisions	$—	$3,211	$—	$3,211
Convertibles and bonds with warrants attached	—	17	—	17
United States government	7	—	—	7
Government-sponsored enterprises	—	200	—	200
Foreign government	—	10	—	10
Commercial mortgage-backed	—	143	—	143
Corporate	—	5,531	2	5,533
Subtotal	7	9,112	2	9,121
Common equities, available for sale	4,213	—	—	4,213
	—	160	2	162

Nonredeemable preferred equities, available for sale				
Separate accounts taxable fixed-maturities	—	682	—	682
Top Hat Savings Plan mutual funds and common equity (included in Other assets)	14	—	—	14
Total	$4,234	$9,954	$4	$14,192

Each financial instrument that was deemed to have significant unobservable inputs when determining valuation is identified in the following tables by security type with a summary of changes in fair value as of March 31, 2014. Total Level 3 assets continue to be less than 1 percent of financial assets measured at fair value in the condensed consolidated balance sheets. Assets presented in the table below were valued based primarily on broker/dealer quotes for which there is a lack of transparency as to inputs used to develop the valuations. The quantitative detail of these unobservable inputs is neither provided nor reasonably available to us.

The following tables provide the change in Level 3 assets for the three months ended March 31:

(In millions)	Asset fair value measurements using significant unobservable inputs (Level 3)				
	Corporate fixed maturities	Commercial mortgage-backed fixed maturities	States, municipalities and political subdivisions fixed maturities	Nonredeemable preferred equities	Total
Beginning balance, January 1, 2014	$2	$—	$—	$2	$4
Total gains or losses (realized/unrealized):					
Included in net income	—	—	—	—	—
Included in other comprehensive income	—	—	—	—	—
Purchases	—	—	—	—	—
Sales	—	—	—	—	—
Transfers into Level 3	6	5	—	—	11
Transfers out of Level 3	—	—	—	—	—
Ending balance, March 31, 2014	$8	$5	$—	$2	$15
Beginning balance, January 1, 2013	$3	$—	$1	$1	$5
Total gains or losses (realized/unrealized):					
Included in net income	—	—	—	—	—
Included in other comprehensive income	—	—	—	—	—
Purchases	—	—	—	1	1
Sales	—	—	—	—	—
Transfers into Level 3	—	—	—	—	—
Transfers out of Level 3	—	—	—	—	—
Ending balance, March 31, 2013	$3	$—	$1	$2	$6

Additional disclosures for the Level 3 category are not material.

Fair Value Disclosure for Assets and Liabilities Not Carried at Fair Value

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 book value and principal amounts of our long-term debt:

(In millions)				Book value		Principal amount	
Interest rate		Year of issue		March 31, 2014	December 31, 2013	March 31, 2014	December 31, 2013
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 following table shows fair values of our note payable and long-term debt subject to fair value disclosure requirements:

(In millions) At March 31, 2014	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total
Note payable	$—	$104	$—	$104
6.900% senior debentures, due 2028	—	32	—	32
6.920% senior debentures, due 2028	—	470	—	470
6.125% senior notes, due 2034	—	419	—	419
Total	$—	$1,025	$—	$1,025
At December 31, 2013				
Note payable	$—	$104	$—	$104
6.900% senior debentures, due 2028	—	30	—	30
6.920% senior debentures, due 2028	—	458	—	458
6.125% senior notes, due 2034	—	399	—	399
Total	$—	$991	$—	$991

The following table shows the fair value of our life policy loans, included in other invested assets, subject to fair value disclosure requirements:

(In millions) At March 31, 2014	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total
Life policy loans	$—	$—	$44	$44
At December 31, 2013				
Life policy loans	$—	$—	$45	$45

Outstanding principal and interest for these life policy loans was $35 million and $36 million at March 31, 2014, and December 31, 2013, respectively.

The following table shows fair values of our deferred annuities and structured settlements, included in life policy and investment contract reserves, subject to fair value disclosure requirements:

(In millions) At March 31, 2014	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total
Deferred annuities	$—	$—	$900	$900
Structured settlements	—	212	—	212
Total	$—	$212	$900	$1,112
At December 31, 2013				
Deferred annuities	$—	$—	$911	$911
Structured settlements	—	219	—	219
Total	$—	$219	$911	$1,130

Recorded reserves for the deferred annuities and structured settlements were $1.051 billion at March 31, 2014, and December 31, 2013.

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 March 31,	
	2014	2013
Gross loss and loss expense reserves, beginning of period	$4,241	$4,169
Less reinsurance receivable	299	356
Net loss and loss expense reserves, beginning of period	3,942	3,813
Net incurred loss and loss expenses related to:		
Current accident year	705	534
Prior accident years	(29)	(10)
Total incurred	676	524
Net paid loss and loss expenses related to:		
Current accident year	197	121
Prior accident years	387	392
Total paid	584	513
Net loss and loss expense reserves, end of period	4,034	3,824
Plus reinsurance receivable	289	349
Gross loss and loss expense reserves, end of period	$4,323	$4,173

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, as of that date. The actuarial estimate is subject to review and adjustment by an inter-departmental committee that includes actuarial management that 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. The amount we will actually have to pay for claims can be highly uncertain. This uncertainty, together with the size of our reserves, makes the loss and loss expense reserves our most significant estimate. The reserve for loss and loss expenses in the condensed consolidated balance sheets also included $52 million at March 31, 2014, and $67 million at March 31, 2013, for certain life and health loss and loss expense reserves.

For the three months ended March 31, 2014, we experienced $29 million of favorable development on prior accident years, including $3 million of favorable development in commercial lines, $17 million of favorable development in personal lines and $9 million favorable development in excess and surplus lines. This included $9 million from favorable development of catastrophe losses for the three months ended March 31, 2014, compared with $7 million of favorable development of catastrophe losses for the three months ended March 31, 2013.

NOTE 5 – LIFE POLICY AND INVESTMENT CONTRACT RESERVES

We establish the reserves for traditional life insurance policies based on expected expenses, mortality, morbidity, withdrawal rates, timing of claim presentation 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 structured settlement policies 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.

This table summarizes our life policy and investment contract reserves:

(In millions)	March 31, 2014	December 31, 2013
Ordinary/traditional life	$830	$815
Universal life	509	508
Deferred annuities	864	862
Structured settlements	187	189
Other	45	16
Total life policy and investment contract reserves	$2,435	$2,390

NOTE 6 – DEFERRED ACQUISITION COSTS

Expenses directly related to successfully acquiring 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 the costs for recoverability. The table below shows the deferred policy acquisition costs and asset reconciliation.

(In millions)	Three months ended March 31, 2014	2013
Deferred policy acquisition costs asset, beginning of period	$565	$470
Capitalized deferred policy acquisition costs	206	198
Amortized deferred policy acquisition costs	(201)	(179)
Amortized shadow deferred policy acquisition costs	(6)	2
Deferred policy acquisition costs asset, end of period	$564	$491

No premium deficiencies were recorded in the condensed consolidated statements of income, as the sum of the anticipated loss and loss adjustment expenses, policyholder dividends and unamortized deferred acquisition expenses did not exceed the related unearned premiums and anticipated investment income.

NOTE 7 – ACCUMULATED OTHER COMPREHENSIVE INCOME
Accumulated other comprehensive income includes changes in unrealized gains and losses on available for sale investments and other invested assets, changes in pension obligations and changes in life deferred acquisition costs, life policy reserves and other as follows:

(In millions)	Three months ended March 31,					
	2014			2013		
	Before tax	Income tax	Net	Before tax	Income tax	Net
Accumulated unrealized gains, net, on investments available for sale, beginning of period	$2,335	$808	$1,527	$1,875	$647	$1,228
Other comprehensive income before reclassification	135	48	87	397	139	258
Reclassification adjustment for realized investment gains, net, included in net income	(18)	(7)	(11)	(41)	(15)	(26)
Effect on other comprehensive income	117	41	76	356	124	232
Accumulated unrealized gains, net, on investments available for sale, end of period	$2,452	$849	$1,603	$2,231	$771	$1,460
Accumulated unrealized losses, net, for pension obligations, beginning of period	$(18)	$(6)	$(12)	$(101)	$(35)	$(66)
Effect on other comprehensive income	(1)	—	(1)	2	1	1
Accumulated unrealized losses, net, for pension obligations, end of period	$(19)	$(6)	$(13)	$(99)	$(34)	$(65)
Accumulated unrealized losses, net, on life deferred acquisition costs, life policy reserves and other, beginning of period	$(16)	$(5)	$(11)	$(50)	$(17)	$(33)
Other comprehensive income before reclassification	3	1	2	—	—	—
Reclassification adjustment for life deferred acquisition costs, life policy reserves and other, net, included in net income	(4)	(1)	(3)	—	—	—
Effect on other comprehensive income	(1)	—	(1)	—	—	—
Accumulated unrealized losses, net, on life deferred acquisition costs, life policy reserves and other, end of period	$(17)	$(5)	$(12)	$(50)	$(17)	$(33)
Accumulated other comprehensive income, beginning of period	$2,301	$797	$1,504	$1,724	$595	$1,129
Change in unrealized gains, net, on investments available for sale	117	41	76	356	124	232
Change in pension obligations	(1)	—	(1)	2	1	1
	(1)	—	(1)	—	—	—

Change in life deferred acquisition costs, life policy reserves and other						
Effect on other comprehensive income	115	41	74	358	125	233
Accumulated other comprehensive income, end of period	$2,416	$838	$1,578	$2,082	$720	$1,362

The reclassification adjustment for realized gains on investments available for sale and life deferred acquisition costs, life policy reserves and other is recorded in the total realized investment gains, net, line item of the condensed consolidated statements of income.

NOTE 8 – REINSURANCE

Reinsurance mitigates the risk of highly uncertain exposures and limits the maximum net loss that can arise from large risks or risks concentrated in areas of exposure. Management's decisions about the appropriate level of risk retention are affected by various factors, including changes in our underwriting practices, capacity to retain risks and reinsurance market conditions.

Primary components of our property casualty reinsurance program include a property per risk treaty, property excess treaty, casualty per occurrence treaty, casualty excess treaty, property catastrophe treaty and catastrophe bonds.

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

(In millions)	Three months ended March 31,	
	2014	2013
Direct earned premiums	$1,019	$935
Assumed earned premiums	3	2
Ceded earned premiums	(43)	(48)
Net earned premiums	$979	$889

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 March 31,	
	2014	2013
Direct incurred loss and loss expenses	$677	$535
Assumed incurred loss and loss expenses	2	2
Ceded incurred loss and loss expenses	(3)	(13)
Net incurred loss and loss expenses	$676	$524

Our life insurance company purchases reinsurance for protection of a portion of the risk that is written. Primary components of our life reinsurance program include individual mortality coverage and aggregate catastrophe and accidental death coverage in excess of certain deductibles.

Our condensed consolidated statements of income include earned life insurance premiums on ceded business:

(In millions)	Three months ended March 31,	
	2014	2013
Direct earned premiums	$62	$56
Ceded earned premiums	(14)	(14)
Net earned premiums	$48	$42

Our condensed consolidated statements of income include life insurance policyholders’ benefits incurred on ceded business:

(In millions)	Three months ended March 31,	
	2014	2013
Direct policyholders' benefits incurred	$80	$64
Ceded policyholders' benefits incurred	(24)	(20)
Net policyholders' benefits incurred	$56	$44

The ceded benefits incurred can vary depending on the type of life insurance policy held and the year the policy was sold.

NOTE 9 – INCOME TAXES

As of March 31, 2014, and December 31, 2013, we had no liability for unrecognized tax benefits.

The differences between the 35 percent statutory income tax rate and our effective income tax rate were as follows:

(In millions)	Three months ended March 31,			
	2014		2013	
Tax at statutory rate	$42	35.0 %	$76	35.0 %
Increase (decrease) resulting from:				
Tax-exempt income from municipal bonds	(8)	(6.7)	(8)	(3.7)
Dividend received exclusion	(7)	(5.9)	(6)	(2.6)
Other	1	1.1	1	0.3
Provision for income taxes	$28	23.5 %	$63	29.0 %

The change in our effective tax rate was primarily due to changes in pretax income from underwriting results and realized investment gains and losses, compared with unchanged levels of permanent book-tax differences.

NOTE 10 – NET INCOME PER COMMON SHARE

Basic earnings per share are computed based on the weighted average number of common shares outstanding. Diluted earnings per share are computed based on the weighted average number of common and dilutive potential common shares outstanding using the treasury stock method. The table shows calculations for basic and diluted earnings per share:

(In millions except per share data)	Three months ended March 31, 2014	2013
Numerator:		
Net income—basic and diluted	$91	$154
Denominator:		
Basic weighted-average common shares outstanding	163.4	163.1
Effect of stock-based awards:		
Stock options	1.0	1.0
Nonvested shares	0.6	0.8
Adjusted diluted weighted-average shares	165.0	164.9
Earnings per share:		
Basic	$0.56	$0.95
Diluted	0.55	0.94
Number of anti-dilutive stock-based awards	0.7	2.1

The sources of dilution of our common shares are certain equity-based awards. See our 2013 Annual Report on Form 10-K, Item 8, Note 17, Share-Based Associate Compensation Plans, Page 154, for information about equity-based awards. The above table shows the number of anti-dilutive stock-based awards for the three months ended March 31, 2014 and 2013. We did not include these stock-based awards in the computation of net income per common share (diluted) because their exercise would have anti-dilutive effects.

NOTE 11 – EMPLOYEE RETIREMENT BENEFITS

The following summarizes the components of net periodic costs for our qualified and supplemental pension plans:

(In millions)	Three months ended March 31,	
	2014	2013
Service cost	$2	$3
Interest cost	4	3
Expected return on plan assets	(4)	(4)
Amortization of actuarial loss and prior service cost	1	2
Net periodic benefit cost	$3	$4

See our 2013 Annual Report on Form 10-K, Item 8, Note 13, Employee Retirement Benefits, Page 148, for information on our retirement benefits. We made matching contributions of $4 million and $3 million to our 401(k) and Top Hat savings plans during the first quarters of 2014 and 2013.

We contributed $5 million to our qualified pension plan during the first quarter of 2014. We do not anticipate further contributions to our qualified pension plan during the remainder of 2014.

NOTE 12 – COMMITMENTS AND CONTINGENT LIABILITIES

In the ordinary course of conducting business, the company and its subsidiaries are named as defendants in various legal proceedings. Most of these proceedings are claims litigation involving the company's insurance subsidiaries in which the company is either defending or providing indemnity for third-party claims brought against insureds or litigating first-party coverage claims. The company accounts for such activity through the establishment of unpaid loss and loss adjustment expense reserves. We believe that the ultimate liability, if any, with respect to such ordinary-course claims litigation, after consideration of provisions made for potential losses and costs of defense, is immaterial to our consolidated financial condition, results of operations and cash flows.

The company and its subsidiaries also are occasionally involved in other legal and regulatory proceedings, some of which assert claims for substantial amounts. These actions include, among others, putative class actions seeking certification of a state or national class. Such proceedings have alleged, for example, breach of an alleged duty to search national data bases to ascertain unreported deaths of insureds under life insurance policies. The company's insurance subsidiaries also are occasionally parties to individual actions in which extra-contractual damages, punitive damages or penalties are sought, such as claims alleging bad faith handling of insurance claims or writing unauthorized coverage or claims alleging discrimination by former associates.

On a quarterly basis, we review these outstanding matters. Under current accounting guidance, we establish accruals when it is probable that a loss has been incurred and we can reasonably estimate its potential exposure. The company accounts for such probable and estimable losses, if any, through the establishment of legal expense reserves. Based on our quarterly review, we believe that our accruals for probable and estimable losses are reasonable and that the amounts accrued do not have a material effect on our consolidated financial condition or results of operations. However, if any one or more of these matters results in a judgment against us or settlement for an amount that is significantly greater than the amount accrued, the resulting liability could have a material effect on the company's consolidated results of operations or cash flows. Based on our most recent review, our estimate for any other matters for which the risk of loss is not probable, but more than remote, is less than $1 million.

NOTE 13 – SEGMENT INFORMATION

We operate primarily in two industries, property casualty insurance and life insurance. We regularly review our reporting segments to make decisions about allocating resources and assessing performance:

- Commercial lines property casualty insurance
- Personal lines property casualty insurance
- Excess and surplus lines property casualty insurance
- Life insurance
- Investments

We report as Other the noninvestment operations of the parent company and its noninsurer subsidiary, CFC Investment Company. See our 2013 Annual Report on Form 10-K, Item 8, Note 18, Segment Information, Page 156, for a description of revenue, income or loss before income taxes and identifiable assets for each of the five segments.

Segment information is summarized in the following table:

(In millions)	Three months ended March 31,	
	2014	2013
Revenues:		
Commercial lines insurance		
Commercial casualty	$224	$204
Commercial property	171	147
Commercial auto	126	114
Workers' compensation	92	88
Specialty packages	36	39
Management liability and surety	31	29
Machinery and equipment	12	10
Commercial lines insurance premiums	692	