AMERICAN FINANCIAL GROUP INC
Form 10-Q
August 08, 2013

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
Quarterly Report Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934
For the Quarterly Period Ended June 30, 2013 Commission File No. 1-13653

AMERICAN FINANCIAL GROUP, INC.
Incorporated under the Laws of Ohio IRS Employer I.D. No. 31-1544320
301 East Fourth Street, Cincinnati, Ohio 45202
(513) 579-2121

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes þ No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company:

Large Accelerated Filer þ Accelerated Filer ¨ Non-Accelerated Filer ¨ Smaller Reporting Company ¨

Indicate by check mark whether the Registrant is a shell company. Yes ¨ No þ

As of August 1, 2013, there were 88,968,433 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)

	June 30, 2013	December 31, 2012
Assets:		
Cash and cash equivalents	$1,271	$ 1,705
Investments:		
Fixed maturities, available for sale at fair value (amortized cost — $23,740 and $22,083)	25,035	24,118
Fixed maturities, trading at fair value	293	321
Equity securities, at fair value (cost — $984 and $778)	1,199	939
Mortgage loans	599	607
Policy loans	242	228
Real estate and other investments	623	531
Total cash and investments	29,262	28,449
Recoverables from reinsurers	3,044	3,750
Prepaid reinsurance premiums	520	471
Agents' balances and premiums receivable	754	636
Deferred policy acquisition costs	818	550
Assets of managed investment entities	2,973	3,225
Other receivables	422	539
Variable annuity assets (separate accounts)	608	580
Other assets	828	786
Goodwill	185	185
Total assets	$39,414	$ 39,171
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	$6,098	$ 6,845
Unearned premiums	1,789	1,651
Annuity benefits accumulated	18,848	17,609
Life, accident and health reserves	2,017	2,059
Payable to reinsurers	367	475
Liabilities of managed investment entities	2,603	2,892
Long-term debt	949	953
Variable annuity liabilities (separate accounts)	608	580
Other liabilities	1,497	1,359
Total liabilities	34,776	34,423
Shareholders' equity:		
Common Stock, no par value		
— 200,000,000 shares authorized	89	89
— 88,820,940 and 88,979,303 shares outstanding		
Capital surplus	1,088	1,063
Retained earnings:		
Appropriated — managed investment entities	33	75
Unappropriated	2,664	2,520
Accumulated other comprehensive income, net of tax	599	831

Total shareholders’ equity	4,473	4,578
Noncontrolling interests	165	170
Total equity	4,638	4,748
Total liabilities and equity	$39,414	$ 39,171

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF EARNINGS (UNAUDITED)
(In Millions, Except Per Share Data)

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Revenues:				
Property and casualty insurance net earned premiums	$709	$640	$1,396	$1,243
Life, accident and health net earned premiums	28	105	58	210
Net investment income	332	329	658	646
Realized gains (losses) on:				
Securities (*)	41	16	98	60
Subsidiaries	—	(1)	—	(1)
Income (loss) of managed investment entities:				
Investment income	32	32	66	61
Loss on change in fair value of assets/liabilities	(28)	(21)	(36)	(50)
Other income	25	24	47	42
Total revenues	1,139	1,124	2,287	2,211
Costs and Expenses:				
Property and casualty insurance:				
Losses and loss adjustment expenses	430	363	823	707
Commissions and other underwriting expenses	260	232	511	443
Annuity benefits	120	147	254	277
Life, accident and health benefits	38	82	78	172
Annuity and supplemental insurance acquisition expenses	52	47	88	92
Interest charges on borrowed money	18	19	36	38
Expenses of managed investment entities	24	20	46	39
Other expenses	71	78	150	161
Total costs and expenses	1,013	988	1,986	1,929
Earnings before income taxes	126	136	301	282
Provision for income taxes	49	52	111	110
Net earnings, including noncontrolling interests	77	84	190	172
Less: Net earnings (loss) attributable to noncontrolling interests	(33)	(15)	(40)	(40)
Net Earnings Attributable to Shareholders	$110	$99	$230	$212
Earnings Attributable to Shareholders per Common Share:				
Basic	$1.23	$1.02	$2.57	$2.18
Diluted	$1.20	$1.01	$2.52	$2.15
Average number of Common Shares:				
Basic	89.6	96.4	89.5	97.0
Diluted	91.5	98.0	91.3	98.7
Cash dividends per Common Share	$0.195	$0.175	$0.39	$0.35

(*) Consists of the following:

Realized gains before impairments	$42	$23	$99	$71

Losses on securities with impairment	(1)	(7)	(1)	(12)
Non-credit portion recognized in other comprehensive income (loss)	—	—	—	1
Impairment charges recognized in earnings	(1)	(7)	(1)	(11)
Total realized gains on securities	$41	$16	$98	$60

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

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Net earnings, including noncontrolling interests	$77	$84	$190	$172
Other comprehensive income (loss), net of tax:				
Net unrealized gains (losses) on securities:				
Unrealized holding gains (losses) on securities arising during the period	(245)	78	(166)	236
Reclassification adjustment for realized gains included in net earnings	(27)	(12)	(63)	(40)
Total net unrealized gains (losses) on securities	(272)	66	(229)	196
Foreign currency translation adjustments	(5)	(8)	(9)	(1)
Pension and other postretirement plans adjustments	—	—	—	1
Other comprehensive income (loss), net of tax	(277)	58	(238)	196
Total comprehensive income (loss), net of tax	(200)	142	(48)	368
Less: Comprehensive income (loss) attributable to noncontrolling interests	(40)	(16)	(46)	(37)
Comprehensive income (loss) attributable to shareholders	$(160)	$158	$(2)	$405

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

	Shareholders' Equity						Noncon-trolling	Total
	Common	Common Stock and Capital	Retained Earnings		Accumulated Other Comp			
	Shares	Surplus	Approp.	Unapprop.	Inc. (Loss)	Total	Interests	Equity
Balance at December 31, 2012	88,979,303	$1,152	$75	$2,520	$831	$4,578	$170	$4,748
Net earnings	—	—	—	230	—	230	(40)	190
Other comprehensive income	—	—	—	—	(232)	(232)	(6)	(238)
Allocation of losses of managed investment entities	—	—	(42)	—	—	(42)	42	—
Dividends on Common Stock	—	—	—	(34)	—	(34)	—	(34)
Shares issued:								
Exercise of stock options	943,697	30	—	—	—	30	—	30
Other benefit plans	368,051	6	—	—	—	6	—	6
Dividend reinvestment plan	7,398	—	—	—	—	—	—	—
Stock-based compensation expense	—	8	—	—	—	8	—	8
Shares acquired and retired	(1,448,156)	(19)	—	(51)	—	(70)	—	(70)
Shares exchanged — benefit plans	(29,353)	—	—	(1)	—	(1)	—	(1)
Other	—	—	—	—	—	—	(1)	(1)
Balance at June 30, 2013	88,820,940	$1,177	$33	$2,664	$599	$4,473	$165	$4,638
Balance at December 31, 2011	97,846,402	$1,219	$173	$2,439	$580	$4,411	$146	$4,557
Net earnings	—	—	—	212	—	212	(40)	172
Other comprehensive income	—	—	—	—	193	193	3	196
Allocation of losses of managed investment entities	—	—	(46)	—	—	(46)	46	—
Dividends on Common Stock	—	—	—	(33)	—	(33)	—	(33)
Shares issued:								
Exercise of stock options	814,394	21	—	—	—	21	—	21
Other benefit plans	276,195	5	—	—	—	5	—	5
Dividend reinvestment plan	7,711	—	—	—	—	—	—	—
Stock-based compensation expense	—	12	—	—	—	12	—	12

Shares acquired and retired	(3,985,470)	(50)	—	(103)	—	(153)	—	(153)
Other	—	—	—	—	—	—	(2)	(2)
Balance at June 30, 2012	94,959,232	$1,207	$127	$ 2,515	$ 773	$4,622	$153	$4,775

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

	Six months ended June 30, 2013	2012
Operating Activities:		
Net earnings, including noncontrolling interests	$190	$172
Adjustments:		
Depreciation and amortization	78	83
Annuity benefits	254	277
Realized gains on investing activities	(105)	(57)
Net sales of trading securities	24	5
Deferred annuity and life policy acquisition costs	(83)	(129)
Change in:		
Reinsurance and other receivables	659	212
Other assets	(41)	50
Insurance claims and reserves	(617)	(167)
Payable to reinsurers	(108)	(79)
Other liabilities	45	(179)
Managed investment entities' assets/liabilities	(115)	40
Other operating activities, net	15	(2)
Net cash provided by operating activities	196	226
Investing Activities:		
Purchases of:		
Fixed maturities	(3,009)	(1,976)
Equity securities	(274)	(194)
Mortgage loans	(73)	(97)
Real estate, property and equipment	(38)	(52)
Proceeds from:		
Maturities and redemptions of fixed maturities	1,456	993
Repayments of mortgage loans	82	6
Sales of fixed maturities	139	239
Sales of equity securities	142	107
Managed investment entities:		
Purchases of investments	(829)	(925)
Proceeds from sales and redemptions of investments	1,215	1,106
Other investing activities, net	(3)	(33)
Net cash used in investing activities	(1,192)	(826)
Financing Activities:		
Annuity receipts	1,685	1,710
Annuity surrenders, benefits and withdrawals	(749)	(696)
Net transfers from variable annuity assets	12	9
Additional long-term borrowings	—	223
Reductions of long-term debt	(4)	(6)
Issuances of managed investment entities' liabilities	652	359
Retirement of managed investment entities' liabilities	(960)	(633)

Issuances of Common Stock	31	22
Repurchases of Common Stock	(70)	(153)
Cash dividends paid on Common Stock	(34)	(33)
Other financing activities, net	(1)	(3)
Net cash provided by financing activities	562	799
Net Change in Cash and Cash Equivalents	(434)	199
Cash and cash equivalents at beginning of period	1,705	1,324
Cash and cash equivalents at end of period	$1,271	$1,523

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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A. Accounting Policies

Basis of Presentation The accompanying consolidated financial statements for American Financial Group, Inc. ("AFG") and its subsidiaries 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.

Certain reclassifications have been made to prior periods to conform to the current year's presentation, primarily the reclassification of investment expenses and real estate income and expenses to net investment income. All significant intercompany balances and transactions have been eliminated. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements. Events or transactions occurring subsequent to June 30, 2013, and prior to the filing date 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.

Accounting Standards Adopted in 2013 Effective January 1, 2013, AFG prospectively adopted Accounting Standards Update ("ASU") 2013-02, which requires companies to disclose, in a single location within the financial statements or footnotes, reclassifications out of accumulated other comprehensive income ("AOCI") separately for each component of other comprehensive income. For significant reclassifications, the disclosure is required to include the respective line items in net earnings affected by the reclassification. Disclosures required by the guidance are included in Note K — "Shareholders' Equity." This new disclosure requirement had no impact on AFG's results of operations or financial position.

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 of nonfinancial assets and liabilities in the first six months of 2013 or 2012.

Investments   Fixed maturity and equity 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 and equity securities classified as “trading” are reported at fair value with changes in unrealized holding gains or losses during the period included in 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 interest method; mortgage-backed securities (“MBS”) are amortized over a period based on estimated future principal payments, including prepayments. Prepayment assumptions are reviewed periodically and adjusted to reflect actual prepayments and changes in expectations.

Gains or losses on securities are determined on the specific identification basis. When a decline in the value of a specific investment is considered to be other-than-temporary at the balance sheet date, a provision for impairment is charged to earnings (included in realized gains (losses) on securities) and the cost basis of that investment is reduced. If management can assert that it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will have to sell the security before recovery of its amortized cost basis, then the other-than-temporary impairment is separated into two components: 1) the amount related to credit losses (recorded in earnings) and 2) 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 and consist primarily of (i) components of certain fixed maturity securities (primarily interest-only MBS) and (ii) the equity-based component of certain annuity products (included in annuity benefits accumulated) and related call options (included in other investments) designed to be consistent with the characteristics of the liabilities and used to mitigate the risk embedded in those annuity products. Changes in the fair value of derivatives are included in earnings.

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 (a) the estimated reinsurance recoverable on paid and unpaid losses, including an estimate for losses incurred but not reported, and (b) 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.

A 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 Note A, "Accounting Policies — Life, Accident and Health Reserves" for details on the impact of loss recognition on the accounting for traditional life and health insurance contracts.

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

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

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

AFG manages, and has investments in, collateralized loan obligations ("CLOs") that are VIEs (see Note H — "Managed Investment Entities"). Both the management fees (payment of which is subordinate to other obligations of the CLOs) and the investments in the CLOs are considered variable interests. 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) it has exposure to CLO losses (through its investments in the CLO debt tranches) and the right to receive benefits (through its subordinated management fees and returns on its investments), both of which 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 (at fair value). 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 excess of fair value of the CLOs' assets over the fair value of the liabilities is recorded in AFG's Balance Sheet as appropriated retained earnings — managed investment entities, representing amounts that ultimately will inure to the benefit of the CLO debt holders.

The net gain or loss from accounting for the CLO assets and liabilities at fair value is separately presented in AFG's Statement of Earnings. CLO earnings attributable to AFG's shareholders represent the change in fair value of AFG's investments in the CLOs (including distributions) and management fees earned. All other CLO earnings (losses) are not attributable to AFG's shareholders and will ultimately inure to the benefit of the CLO debt holders. As a result, such CLO earnings (losses) are included in net earnings (loss) attributable to noncontrolling interests in AFG's Statement of Earnings and in appropriated retained earnings — managed investment entities in the Balance Sheet. As the CLOs approach maturity (2016 to 2025), it is expected that losses attributable to noncontrolling interests will reduce appropriated retained earnings towards zero as the fair values of the assets and liabilities converge and the CLO assets are used to pay the CLO debt.

At June 30, 2013, assets and liabilities of managed investment entities included $96 million in assets and $66 million in liabilities of a temporary warehousing entity that was established in connection with the formation of a new CLO that is expected to close in the second half of 2013. Upon closing, all warehoused assets are expected to be transferred to the new CLO and the liabilities will be repaid. At December 31, 2012, assets and liabilities of managed investment entities included $107 million in assets and $87 million in liabilities of a temporary warehousing entity that was established in connection with the formation of a new CLO. All warehoused assets were transferred to that new CLO and the liabilities were repaid when the CLO formation was completed and the CLO issued securities in April 2013.

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

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

Annuity Benefits Accumulated   Annuity receipts and benefit payments are recorded as increases or decreases in annuity benefits accumulated rather than as revenue and expense. Increases in this liability for interest credited are charged to expense and decreases for policy charges are credited to other income.

For certain products, annuity benefits accumulated also includes reserves for accrued persistency and premium bonuses, guaranteed withdrawals and excess benefits expected to be paid on future deaths and annuitizations (“EDAR”). The liability for EDAR is 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 using the same assumptions and estimated gross profits used to amortize DPAC.

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

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

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

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

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

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

Noncontrolling Interests For Balance Sheet purposes, noncontrolling interests represents the interests of shareholders other than AFG in consolidated entities. In the Statement of Earnings, net earnings and losses attributable to noncontrolling interests represents such shareholders' interest in the earnings and losses of those entities.

Income Taxes Deferred income taxes are calculated using the liability method. Under this method, deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases and are measured using enacted tax rates. A valuation allowance is established to reduce total deferred tax assets to an amount that will more likely than not be realized.

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

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

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 adjustments to weighted average common shares related to stock-based compensation plans: second quarter of 2013 and 2012 — 1.9 million and 1.6 million; first six months of 2013 and 2012 — 1.8 million and 1.7 million, respectively.

AFG's weighted average diluted shares outstanding excludes the following anti-dilutive potential common shares related to stock compensation plans: second quarter of 2013 and 2012 — 1.3 million and 2.1 million; first six months of 2013 and 2012 — 1.4 million and 1.8 million, respectively. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2013 and 2012 periods.

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

B. Sale of Subsidiaries

Medicare Supplement and Critical Illness Segment In August 2012, AFG completed the sale of its Medicare supplement and critical illness businesses, which included Loyal American Life Insurance Company and four other insurance companies, to Cigna Corporation for $326 million in cash resulting in a pretax gain of $170 million (including post-closing adjustments). Since the transaction includes the ongoing cessions of certain business to Cigna, the operations sold are not reported as discontinued operations. Summarized Statement of Earnings information for the Medicare supplement and critical illness segment for the second quarter and first six months of 2012 is shown below (in millions):

	Three months ended June 30, 2012	Six months ended June 30, 2012
Total revenues	$79	$159
Total costs and expenses	67	141
Earnings before income taxes	$12	$18

C. Segments of Operations

AFG manages its business as five segments: (i) Property and casualty insurance, (ii) Annuity, (iii) Run-off long-term care and life, (iv) Medicare supplement and critical illness (sold in August 2012) and (v) Other, which includes holding company costs, and the operations attributable to the noncontrolling interests of the managed investment entities.

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes physical damage and liability coverage for buses, trucks and recreational vehicles, inland and ocean marine, agricultural-related products and other property coverages, (ii) Specialty casualty, which includes primarily excess and surplus, general liability, executive liability, umbrella and excess liability, customized programs for small to mid-sized businesses and workers' compensation, and (iii) Specialty financial, which includes risk management insurance programs for leasing and financing institutions (including collateral and lender-placed mortgage property insurance), surety and fidelity products and trade credit insurance. AFG's annuity business markets traditional fixed and fixed-indexed annuities in the retail, financial institutions and education markets. AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

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

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Revenues				
Property and casualty insurance:				
Premiums earned:				
Specialty				
Property and transportation	$301	$290	$594	$553
Specialty casualty	277	236	536	456
Specialty financial	113	98	229	201
Other specialty	18	16	37	33
Total premiums earned	709	640	1,396	1,243
Net investment income	65	69	131	139
Other income	6	8	9	11
Total property and casualty insurance	780	717	1,536	1,393
Annuity:				
Net investment income	257	245	505	473
Other income	15	12	29	25
Total annuity	272	257	534	498
Run-off long-term care and life	47	49	97	96
Medicare supplement and critical illness (a)	—	79	—	159
Other	(1)	7	22	6
Total revenues before realized gains	1,098	1,109	2,189	2,152
Realized gains on securities	41	16	98	60
Realized losses on subsidiaries	—	(1)	—	(1)
Total revenues	$1,139	$1,124	$2,287	$2,211
Earnings Before Income Taxes				
Property and casualty insurance:				
Underwriting:				
Specialty				
Property and transportation	$(31)	$6	$(21)	$33
Specialty casualty	32	33	51	37
Specialty financial	15	11	28	27
Other specialty	5	2	11	3
Other lines, primarily A&E charges	(2)	(7)	(7)	(7)
Total underwriting	19	45	62	93
Investment and other income, net	60	60	116	115
Total property and casualty insurance	79	105	178	208
Annuity (b)	77	59	153	119
Run-off long-term care and life	(2)	5	(3)	6
Medicare supplement and critical illness (a)	—	12	—	18
Other (c)	(69)	(60)	(125)	(128)
Total earnings before realized gains and income taxes	85	121	203	223
Realized gains on securities	41	16	98	60

Realized losses on subsidiaries	—	(1)	—	(1)
Total earnings before income taxes	$126	$136	$301	$282

(a) Sold in August 2012.

(b) Includes a $5 million charge in the second quarter of 2013 to cover expected assessments from state guaranty funds related to the insolvency and liquidation of an unaffiliated life insurance company.

(c) Includes holding company expenses and losses of managed investment entities attributable to noncontrolling interest of $31 million and $18 million for the second quarter and $42 million and $46 million for the first six months of 2013 and 2012, respectively.

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D. Fair Value Measurements

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

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

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

Level 3 — Valuations derived from market valuation techniques generally consistent with those used to estimate the fair values of Level 2 financial instruments in which one or more significant inputs are unobservable or when the market for a security exhibits significantly less liquidity relative to markets supporting Level 2 fair value measurements. The unobservable inputs may include management's own assumptions about the assumptions market participants would use based on the best information available in the circumstances. AFG's Level 3 is comprised of financial instruments, including liabilities of managed investment entities, 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.

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

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
June 30, 2013				
Assets:				
Available for sale (“AFS”) fixed maturities:				
U.S. Government and government agencies	$163	$129	$20	$312
States, municipalities and political subdivisions	—	4,753	63	4,816
Foreign government	—	242	—	242
Residential MBS	—	3,824	329	4,153
Commercial MBS	—	2,818	28	2,846
Asset-backed securities (“ABS”)	—	2,054	180	2,234
Corporate and other	15	10,122	295	10,432
Total AFS fixed maturities	178	23,942	915	25,035
Trading fixed maturities	—	293	—	293
Equity securities	953	168	78	1,199
Assets of managed investment entities (“MIE”)	335	2,607	31	2,973
Variable annuity assets (separate accounts) (a)	—	608	—	608
Other investments	—	187	—	187
Total assets accounted for at fair value	$1,466	$27,805	$1,024	$30,295
Liabilities:				
Liabilities of managed investment entities	$121	$—	$2,482	$2,603
Derivatives in annuity benefits accumulated	—	—	577	577
Other liabilities — derivatives	—	12	—	12
Total liabilities accounted for at fair value	$121	$12	$3,059	$3,192
December 31, 2012				
Assets:				
Available for sale fixed maturities:				
U.S. Government and government agencies	$227	$141	$20	$388
States, municipalities and political subdivisions	—	4,410	58	4,468
Foreign government	—	260	—	260
Residential MBS	—	3,833	371	4,204
Commercial MBS	—	2,896	22	2,918
Asset-backed securities	—	1,387	253	1,640
Corporate and other	5	9,999	236	10,240
Total AFS fixed maturities	232	22,926	960	24,118
Trading fixed maturities	—	321	—	321
Equity securities	781	121	37	939
Assets of managed investment entities	256	2,929	40	3,225
Variable annuity assets (separate accounts) (a)	—	580	—	580
Other investments	—	133	—	133
Total assets accounted for at fair value	$1,269	$27,010	$1,037	$29,316
Liabilities:				
Liabilities of managed investment entities	$147	$—	$2,745	$2,892
Derivatives in annuity benefits accumulated	—	—	465	465

Other liabilities — derivatives	—	17	—	17
Total liabilities accounted for at fair value	$147	$17	$3,210	$3,374

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

During the first six months of 2013 (all in the second quarter), five preferred stocks with an aggregate fair value of $11 million were transferred from Level 2 to Level 1 due to increases in trade frequency, resulting in trade data sufficient to warrant classification in Level 1. During the first six months of 2013, there were no transfers from Level 1 to Level 2. During the first six months of 2012 (all in the first quarter), six preferred stocks with an aggregate fair value of $35 million were transferred from Level 1 to Level 2 due to decreases in trade frequency, resulting in lack of available trade data sufficient to warrant classification in Level 1. During the first six months 2012, there were no transfers from Level 2 to Level 1. Approximately 3% of the total assets carried at fair value on June 30, 2013, were Level 3 assets. Approximately 82% of the Level 3 assets were priced using non-binding broker quotes, for which there is a lack of transparency as to the inputs used to determine fair value. Details as to the quantitative inputs are neither provided by the brokers nor otherwise reasonably obtainable by AFG. Since internally developed Level 3 asset fair values represent less than one-half of 1% of the total assets measured at fair value and less than 3% of AFG's shareholders' equity, changes in unobservable inputs used to determine internally developed fair values would not have a material impact on AFG's financial position.

The fair values of the liabilities of managed investment entities were determined using primarily non-binding broker quotes, which were reviewed by AFG's investment professionals. AFG's investment professionals are familiar with the cash flow models used by the brokers to determine the fair value of these liabilities and review the broker quotes based on their knowledge of the CLO market and the market for the underlying assets. Their review includes consideration of expected reinvestment, default and recovery rates on the assets supporting the CLO liabilities, as well as surveying general CLO liability fair values and analysis provided by third parties.

The only significant Level 3 assets or liabilities carried at fair value in the financial statements that were not measured using broker quotes are the derivatives embedded in AFG's fixed-indexed annuity liabilities, which are measured using a discounted cash flow approach and had a fair value of $577 million at June 30, 2013. The following table presents information about the unobservable inputs used by management in determining fair value of these embedded derivatives. See Note F — "Derivatives."

Unobservable Input	Range
Adjustment for insurance subsidiary's credit risk	0.50% – 2.00% over the risk free rate
Risk margin for uncertainty in cash flows	0.4% reduction in the discount rate
Surrenders	4% – 20% of indexed account value
Partial surrenders	2% – 5% of indexed account value
Annuitizations	1% – 2% of indexed account value
Deaths	1% – 2.5% of indexed account value
Budgeted option costs	2.5% – 4.0% of indexed account value

The range of adjustments for insurance subsidiary's credit risk reflects credit spread variations across the yield curve. The range of projected surrender rates reflects the specific surrender charges and other features of AFG's individual fixed-indexed annuity products with an expected range of 5% to 12% in the majority of future calendar years (4% — 20% over all periods). Increasing the budgeted option cost or risk margin for uncertainty in cash flows assumptions in the table above would increase the fair value of the fixed-indexed annuity embedded derivatives, while increasing any of the other unobservable inputs in the table above would decrease the fair value of the embedded derivatives.

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Changes in balances of Level 3 financial assets and liabilities carried at fair value during the second quarter and first six months of 2013 and 2012 are presented below (in millions). The transfers into and out of Level 3 were due to changes in the availability of market observable inputs. All transfers are reflected in the table at fair value as of the end of the reporting period.

	Balance at March 31, 2013	Total realized/unrealized gains (losses) included in Net income	Other comprehensive income (loss)	Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at June 30, 2013
AFS fixed maturities:								
U.S. government agency	$20	$—	$ —	$—	$—	$—	$—	$20
State and municipal	54	—	(1)	10	—	—	—	63
Residential MBS	354	2	(7)	—	(17)	9	(12)	329
Commercial MBS	30	(2)	—	—	—	—	—	28
Asset-backed securities	245	2	(2)	—	(39)	—	(26)	180
Corporate and other	244	—	(10)	44	(4)	25	(4)	295
Equity securities	49	—	(1)	39	—	—	(9)	78
Assets of MIE	30	1	—	6	(6)	—	—	31
Liabilities of MIE (*)	(2,501)	(14)	—	(406)	439	—	—	(2,482)
Embedded derivatives	(555)	3	—	(32)	7	—	—	(577)

(*) Total realized/unrealized loss included in net income includes losses of $9 million related to liabilities outstanding as of June 30, 2013. See Note H — “Managed Investment Entities.”

	Balance at March 31, 2012	Total realized/unrealized gains (losses) included in Net income	Other comprehensive income (loss)	Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at June 30, 2012
AFS fixed maturities:								
State and municipal	$72	$—	$ 1	$9	$—	$5	$(1)	$86
Residential MBS	314	1	—	63	(7)	21	(72)	320
Commercial MBS	20	—	—	—	—	—	—	20
Asset-backed securities	239	4	—	10	(9)	3	(7)	240
Corporate and other	276	1	8	41	(13)	4	—	317
Trading fixed maturities	1	—	—	—	—	—	—	1

Equity securities	24	—	—	17	—	—	—	41
Assets of MIE	64	—	—	1	(9)	—	(2)	54
Liabilities of MIE (*)	(2,554)	(19)	—	—	144	—	—	(2,429)
Embedded derivatives	(437)	3	—	(16)	6	—	—	(444)

(*) Total realized/unrealized loss included in net income includes losses of $14 million related to liabilities outstanding as of June 30, 2012. See Note H — “Managed Investment Entities.”

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		Total realized/unrealized gains (losses) included in						
	Balance at December 31, 2012	Net income	Other comprehensive income (loss)	Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at June 30, 2013
AFS fixed maturities:								
U.S. government agency	$20	$—	$ —	$—	$—	$—	$—	$20
State and municipal	58	—	(1)	10	—	—	(4)	63
Residential MBS	371	4	(1)	6	(29)	25	(47)	329
Commercial MBS	22	(1)	—	—	—	7	—	28
Asset-backed securities	253	3	(2)	12	(45)	—	(41)	180
Corporate and other	236	—	(10)	55	(6)	24	(4)	295
Equity securities	37	—	2	48	—	—	(9)	78
Assets of MIE	40	(3)	—	6	(6)	—	(6)	31
Liabilities of MIE (*)	(2,745)	(39)	—	(406)	689	—	19	(2,482)
Embedded derivatives	(465)	(77)	—	(49)	14	—	—	(577)

(*) Total realized/unrealized loss included in net income includes losses of $24 million related to liabilities outstanding as of June 30, 2013. See Note H — "Managed Investment Entities."

		Total realized/unrealized gains (losses) included in						
	Balance at December 31, 2011	Net income	Other comprehensive income (loss)	Purchases and issuances	Sales and settlements	Transfer into Level 3	Transfer out of Level 3	Balance at June 30, 2012
AFS fixed maturities:								
State and municipal	$83	$—	$ 1	$19	$—	$5	$(22)	$86
Residential MBS	361	2	—	71	(17)	81	(178)	320
Commercial MBS	19	—	1	—	—	—	—	20
Asset-backed securities	220	5	5	18	(14)	13	(7)	240
Corporate and other	299	2	6	59	(24)	15	(40)	317
Trading fixed maturities	1	—	—	—	—	—	—	1
Equity securities	11	—	—	26	—	4	—	41
Assets of MIE	44	—	—	13	(12)	14	(5)	54
Liabilities of MIE (*)	(2,593)	(103)	—	(366)	633	—	—	(2,429)
Embedded derivatives	(361)	(57)	—	(37)	11	—	—	(444)

(*) Total realized/unrealized loss included in net income includes losses of $51 million related to liabilities outstanding as of June 30, 2012. See Note H — “Managed Investment Entities.”

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

	Carrying Value	Fair Value	Level 1	Level 2	Level 3
June 30, 2013					
Financial assets:					
Cash and cash equivalents	$1,271	$1,271	$1,271	$—	$—
Mortgage loans	599	603	—	—	603
Policy loans	242	242	—	—	242
Total financial assets not accounted for at fair value	$2,112	$2,116	$1,271	$—	$845
Financial liabilities:					
Annuity benefits accumulated (*)	$18,648	$17,865	$—	$—	$17,865
Long-term debt	949	1,067	—	975	92
Total financial liabilities not accounted for at fair value	$19,597	$18,932	$—	$975	$17,957
December 31, 2012					
Financial assets:					
Cash and cash equivalents	$1,705	$1,705	$1,705	$—	$—
Mortgage loans	607	613	—	—	613
Policy loans	228	228	—	—	228
Total financial assets not accounted for at fair value	$2,540	$2,546	$1,705	$—	$841
Financial liabilities:					
Annuity benefits accumulated (*)	$17,405	$17,422	$—	$—	$17,422
Long-term debt	953	1,086	—	990	96
Total financial liabilities not accounted for at fair value	$18,358	$18,508	$—	$990	$17,518

(*) Excludes life contingent annuities in the payout phase.

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.

E. Investments

Available for sale fixed maturities and equity securities at June 30, 2013, and December 31, 2012, consisted of the following (in millions):

	June 30, 2013				December 31, 2012			
	Amortized	Fair	Gross Unrealized		Amortized	Fair	Gross Unrealized	
	Cost	Value	Gains	Losses	Cost	Value	Gains	Losses
Fixed maturities:								
U.S. Government and government agencies	$302	$312	$10	$—	$373	$388	$15	$—

States, municipalities and political subdivisions	4,705	4,816	190	(79)	4,144	4,468	329	(5)
Foreign government	230	242	12	—	242	260	18	—
Residential MBS	3,849	4,153	349	(45)	3,921	4,204	337	(54)
Commercial MBS	2,619	2,846	232	(5)	2,583	2,918	335	—
Asset-backed securities	2,205	2,234	41	(12)	1,590	1,640	52	(2)
Corporate and other	9,830	10,432	676	(74)	9,230	10,240	1,015	(5)
Total fixed maturities	$23,740	$25,035	$1,510	$(215)	$22,083	$24,118	$2,101	$(66)
Common stocks	$759	$966	$219	$(12)	$600	$749	$157	$(8)
Perpetual preferred stocks	$225	$233	$12	$(4)	$178	$190	$13	$(1)

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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 June 30, 2013 and December 31, 2012 were $227 million and related to residential MBS.

The following tables show gross unrealized losses (in millions) on fixed maturities and equity securities by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2013 and December 31, 2012.

	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
June 30, 2013						
Fixed maturities:						
U.S. Government and government agencies	$—	$84	100 %	$—	$—	— %
States, municipalities and political subdivisions	(78)	1,581	95 %	(1)	15	94 %
Foreign government	—	—	— %	—	—	— %
Residential MBS	(10)	618	98 %	(35)	263	88 %
Commercial MBS	(5)	150	97 %	—	—	— %
Asset-backed securities	(11)	749	99 %	(1)	24	96 %
Corporate and other	(73)	1,970	96 %	(1)	24	96 %
Total fixed maturities	$(177)	$5,152	97 %	$(38)	$326	90 %
Common stocks	$(12)	$138	92 %	$—	$—	— %
Perpetual preferred stocks	$(3)	$78	96 %	$(1)	$24	96 %
December 31, 2012						
Fixed maturities:						
U.S. Government and government agencies	$—	$22	100 %	$—	$—	— %
States, municipalities and political subdivisions	(5)	285	98 %	—	24	100 %
Foreign government	—	—	— %	—	—	— %
Residential MBS	(3)	146	98 %	(51)	411	89 %
Commercial MBS	—	16	100 %	—	—	— %
Asset-backed securities	—	146	100 %	(2)	57	97 %
Corporate and other	(3)	237	99 %	(2)	51	96 %
Total fixed maturities	$(11)	$852	99 %	$(55)	$543	91 %
Common stocks	$(8)	$88	92 %	$—	$—	— %
Perpetual preferred stocks	$—	$7	100 %	$(1)	$25	96 %

At June 30, 2013, the gross unrealized losses on fixed maturities of $215 million relate to approximately 1,000 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 79% of the gross unrealized loss and 85% 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 six months of 2013, AFG did not record any other-than-temporary impairment charges related to its residential MBS.

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 June 30, 2013.

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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).

	2013	2012
Balance at March 31	$191	$190
Additional credit impairments on:		
Previously impaired securities	—	1
Securities without prior impairments	—	—
Reductions — disposals	—	—
Balance at June 30	$191	$191
Balance at January 1	$192	$187
Additional credit impairments on:		
Previously impaired securities	—	4
Securities without prior impairments	—	—
Reductions — disposals	(1)	—
Balance at June 30	$191	$191

The table below sets forth the scheduled maturities of available for sale fixed maturities as of June 30, 2013 (in millions). Securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

	Amortized Cost	Fair Value Amount	%
Maturity			
One year or less	$1,077	$1,101	4 %
After one year through five years	4,674	5,014	20 %
After five years through ten years	6,588	6,915	28 %
After ten years	2,728	2,772	11 %
	15,067	15,802	63 %
ABS (average life of approximately 4 1/2 years)	2,205	2,234	9 %
MBS (average life of approximately 3 1/2 years)	6,468	6,999	28 %
Total	$23,740	$25,035	100 %

Certain risks are inherent in connection with 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 June 30, 2013 or December 31, 2012.

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

	Pretax	Deferred Tax and Amounts Attributable to Noncontrolling Interests	Net
June 30, 2013			
Unrealized gain on:			
Fixed maturities	$1,295	$ (461)	$834
Equity securities	215	(77)	138
Deferred policy acquisition costs	(438)	153	(285)
Annuity benefits accumulated	(87)	31	(56)
Life, accident and health reserves	(81)	28	(53)
Other liabilities	33	(11)	22
	$937	$ (337)	$600
December 31, 2012			
Unrealized gain on:			
Fixed maturities	$2,035	$ (726)	$1,309
Equity securities	161	(57)	104
Deferred policy acquisition costs	(710)	247	(463)
Annuity benefits accumulated	(136)	48	(88)
Life, accident and health reserves	(117)	41	(76)
Other liabilities	57	(20)	37
	$1,290	$ (467)	$823

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

	Fixed Maturities	Equity Securities	Mortgage Loans and Other Investments	Other (a)	Tax Effects	Noncon-trolling Interests	Total
Quarter ended June 30, 2013							
Realized before impairments	$ 8	$ 33	$ 1	$—	$ (15)	$—	$ 27
Realized — impairments	—	—	(1)	—	—	—	(1)
Change in unrealized	(725)	(13)	—	319	147	7	(265)
Quarter ended June 30, 2012							
Realized before impairments	$ 6	$ 21	$ (4)	$—	$ (8)	$ (1)	$ 14
Realized — impairments	—	(8)	—	1	3	—	(4)
Change in unrealized	231	(30)	—	(100)	(35)	—	66
Six months ended June 30, 2013							
Realized before impairments	$ 27	$ 71	$ 2	$ (1)	$ (35)	$ (1)	$ 63
Realized — impairments	—	—	(1)	—	—	—	(1)
Change in unrealized	(740)	54	—	333	124	6	(223)
Six months ended June 30, 2012							
Realized before impairments	$ 20	$ 56	$ (3)	$ (2)	$ (25)	$ (1)	$ 45
Realized — impairments	(4)	(10)	—	3	4	—	(7)
Change in unrealized	363	40	—	(102)	(105)	(3)	193

(a) Primarily adjustments to deferred policy acquisition costs and reserves related to annuities and long-term care business.

Realized gains (losses) on securities includes net losses of $3 million in the second quarter and $1 million in the first six months of 2013 compared to net losses of $1 million in the second quarter and net gains of $3 million in the first six months of 2012 from the mark-to-market of certain MBS, primarily interest-only securities with interest rates that float inversely with short-term rates. Gross realized gains and losses (excluding impairment writedowns and mark-to-market of derivatives) on available for sale fixed maturity and equity security investment transactions included in the Statement of Cash Flows consisted of the following (in millions):

	Six months ended June 30, 2013	2012
Fixed maturities:		
Gross gains	$28	$18
Gross losses	(1)	(1)
Equity securities:		
Gross gains	71	57
Gross losses	—	(1)

F. Derivatives

As discussed under "Derivatives" in Note A — "Accounting Policies," AFG uses derivatives in certain areas of its operations. AFG's derivatives do not qualify for hedge accounting under GAAP; changes in the fair value of derivatives are included in earnings.

The following derivatives are included in AFG's Balance Sheet at fair value (in millions):

		June 30, 2013		December 31, 2012	
Derivative	Balance Sheet Line	Asset	Liability	Asset	Liability
MBS with embedded derivatives	Fixed maturities	$130	$—	$110	$—
Public company warrants	Equity securities	15	—	—	—
Interest rate swaptions	Other investments	2	—	1	—
Fixed-indexed annuities (embedded derivative)	Annuity benefits accumulated	—	577	—	465
Equity index call options	Other investments	185	—	132	—
Reinsurance contracts (embedded derivative)	Other liabilities	—	12	—	17
		$332	$589	$243	$482

The MBS with embedded derivatives consist primarily of interest-only MBS with interest rates that float inversely with short-term rates. 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 must be marked to market through earnings.

AFG has $700 million notional amount of pay-fixed interest rate swaptions (options to enter into pay-fixed/receive floating interest rate swaps at future dates expiring between 2013 and 2015) outstanding at June 30, 2013 which are used to mitigate interest rate risk in its annuity operations. AFG paid $20 million to purchase these swaptions, which represents its maximum potential economic loss over the life of the contracts.

AFG's fixed-indexed annuities, which represented approximately 40% of annuity benefits accumulated at June 30, 2013, provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. AFG attempts to mitigate the risk in the index-based component of these products through the purchase of call options on the appropriate index. AFG's strategy is designed so that an increase in the liabilities, due to an increase in the market index, will be generally offset by unrealized and realized gains on the call options purchased by AFG. Both the index-based component of the annuities and the related call options are considered derivatives. As shown in the table below, the mark-to-market on the embedded derivative and call options both resulted in gains in the second quarter of 2013. The $16 million increase in fair value of call options reflects the increase in the stock market during the quarter. However, the offsetting unfavorable impact of stock market performance on the embedded derivative was outweighed by the favorable impact of higher market interest rates resulting in a $3 million overall gain from the mark-to-market of the embedded derivative. In the second quarter of 2012, poor stock market performance resulted in a $21 million loss from the mark-to-market of the call options. In that period, the offsetting favorable impact of poor stock market performance on the embedded derivative was mitigated by the negative impact of lower market interest rates resulting in a $3 million overall gain from the mark-to-market of the embedded derivative.

As discussed under “Reinsurance” in Note A, certain reinsurance contracts are considered to contain embedded derivatives.

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The following table summarizes the gain (loss) included in the Statement of Earnings for changes in the fair value of these derivatives for the second quarter and first six months of 2013 and 2012 (in millions):

		Three months ended June 30,		Six months ended June 30,	
Derivative	Statement of Earnings Line	2013	2012	2013	2012
MBS with embedded derivatives	Realized gains	$(3)	$(1)	$(1)	$3
Public company warrants	Realized gains	(1)	—	1	—
Interest rate swaptions	Realized gains	1	(3)	1	(3)
Fixed-indexed annuities (embedded derivative)	Annuity benefits	3	3	(77)	(57)
Equity index call options	Annuity benefits	16	(21)	93	36
Reinsurance contracts (embedded derivative)	Investment income	4	(4)	5	(3)
		$20	$(26)	$22	$(24)

G. Deferred Policy Acquisition Costs

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

	P&C	Annuity and Other (*)					
	Deferred Costs	Deferred Costs	Sales Inducements	Present Value of Future Profits	Unrealized	Total	Consolidated Total
Balance at March 31, 2013	$203	$793	$165	$95	$(691)	$362	$565
Additions	123	49	2	—	—	51	174
Amortization:							
Periodic amortization	(117)	(46)	(8)	(3)	—	(57)	(174)
Included in realized gains	—	1	—	—	—	1	1
Foreign currency translation	(1)	—	—	—	—	—	(1)
Change in unrealized	—	—	—	—	253	253	253
Balance at June 30, 2013	$208	$797	$159	$92	$(438)	$610	$818
Balance at March 31, 2012	$191	$939	$186	$139	$(539)	$725	$916
Additions	118	70	6	—	—	76	194
Amortization:							
Periodic amortization	(111)	(39)	(8)	(4)	—	(51)	(162)
Included in realized gains	—	1	—	—	—	1	1
Change in unrealized	—	—	—	—	(103)	(103)	(103)
Balance at June 30, 2012	$198	$971	$184	$135	$(642)	$648	$846
Balance at December 31, 2012	$204	$787	$170	$99	$(710)	$346	$550
Additions	242	83	4	—	—	87	329
Amortization:							
Periodic amortization	(237)	(73)	(15)	(7)	—	(95)	(332)
Included in realized gains	—	—	—	—	—	—	—
Foreign currency translation	(1)	—	—	—	—	—	(1)
Change in unrealized	—	—	—	—	272	272	272
Balance at June 30, 2013	$208	$797	$159	$92	$(438)	$610	$818
Balance at December 31, 2011	$189	$916	$189	$144	$(537)	$712	$901
Additions	221	129	11	—	—	140	361
Amortization:							
Periodic amortization	(212)	(75)	(16)	(9)	—	(100)	(312)
Included in realized gains	—	1	—	—	—	1	1
Change in unrealized	—	—	—	—	(105)	(105)	(105)
Balance at June 30, 2012	$198	$971	$184	$135	$(642)	$648	$846

(*) Includes AFG’s run-off long-term care and life segment and Medicare supplement and critical illness segment (sold in August 2012).

The PVFP amounts in the table above are net of $191 million and $184 million of accumulated amortization at June 30, 2013 and December 31, 2012, respectively.

H. Managed Investment Entities

AFG is the investment manager and its subsidiaries have investments ranging from 7.5% to 51.2% of the most subordinate debt tranche of ten 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 2013, 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 $336 million (including $105 million invested in the most subordinate debt tranches) at June 30, 2013, and $257 million at December 31, 2012.

In April 2013, AFG formed a new CLO, which issued $417 million face amount of liabilities (including $23 million face amount purchased by subsidiaries of AFG). During the first six months of 2013, AFG subsidiaries also purchased $94 million face amount of senior debt tranches of existing CLOs for $89 million.

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 June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Gains (losses) on change in fair value of assets/liabilities (a):				
Assets	$(14)	$(2)	$3	$53
Liabilities	(14)	(19)	(39)	(103)
Management fees paid to AFG	4	4	8	8
CLO earnings (losses) attributable to (b):				
AFG shareholders	7	5	18	10
Noncontrolling interests	(31)	(18)	(42)	(46)

(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 $26 million and $29 million at June 30, 2013 and December 31, 2012. The aggregate unpaid principal balance of the CLOs' debt exceeded its fair value by $88 million and $123 million at those dates. The CLO assets include $1 million and $5 million in loans (aggregate unpaid principal balance of $2 million and $12 million, respectively) at June 30, 2013 and December 31, 2012, for which the CLOs are not accruing interest because the loans are in default.

I. Goodwill and Other Intangibles

There were no changes in the goodwill balance of $185 million during the first six months ended June 30, 2013. Included in other assets in AFG's Balance Sheet is $21 million at June 30, 2013 and $28 million at December 31, 2012 in amortizable intangible assets related to property and casualty insurance acquisitions. These amounts are net of accumulated amortization of $68 million and $61 million, respectively. Amortization of these intangibles was $3 million in each of the second quarters of 2013 and 2012 and $7 million in each of the first six months of 2013 and 2012, respectively. Other assets also include $8 million in non-amortizable intangible assets related to property and casualty insurance acquisitions.

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J. Long-Term Debt

The carrying value of long-term debt consisted of the following (in millions):

	June 30, 2013	December 31, 2012
Direct obligations of AFG:		
9-7/8% Senior Notes due June 2019	$350	$ 350
6-3/8% Senior Notes due June 2042	230	230
5-3/4% Senior Notes due August 2042	125	125
7% Senior Notes due September 2050	132	132
Other	3	3
	840	840
Subsidiaries:		
Notes payable secured by real estate due 2013 through 2016	62	62
Secured borrowings ($15 and $16 guaranteed by AFG)	15	19
National Interstate bank credit facility	12	12
	89	93
Payable to Subsidiary Trusts:		
AAG Holding Variable Rate Subordinated Debentures due May 2033	20	20
	$949	$ 953

In June 2013, AFG called the $20 million in AAG Holding Subordinated Debentures for redemption on August 15, 2013 at par value. Including this redemption, scheduled principal payments on debt for the balance of 2013 and the subsequent five years were as follows:

2013 — $36 million; 2014 — $2 million; 2015 — $14 million; 2016 — $45 million; 2017 — $12 million and 2018 — none.

As shown below (in millions), the majority of AFG's long-term debt is unsecured obligations of the holding company and its subsidiaries:

	June 30, 2013	December 31, 2012
Unsecured obligations	$872	$ 872
Obligations secured by real estate	62	62
Other secured borrowings	15	19
	$949	$ 953

AFG can borrow up to $500 million under its revolving credit facility which expires in December 2016. 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 June 30, 2013 or December 31, 2012.

National Interstate can borrow up to $100 million under its unsecured credit agreement, which expires in November 2017. At June 30, 2013 there was $12 million outstanding under this agreement, bearing interest at 1.34% (six-month LIBOR plus 0.875%).

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

		Other Comprehensive Income					
	AOCI Beginning Balance	Pretax	Tax	Net of tax	Attributable to noncontrolling interests	Attributable to shareholders	AOCI Ending Balance
Quarter ended June 30, 2013							
Net unrealized gains on securities:							
Unrealized holding gains (losses) on securities arising during the period		$(378)	$133	$(245)	$ 6	$(239)	
Reclassification adjustment for realized gains (losses) included in net earnings (a)		(41)	14	(27)	1	(26)	
Total net unrealized gains on securities (b)	$865	(419)	147	(272)	7	(265)	$600
Foreign currency translation adjustments	10	(5)	—	(5)	—	(5)	5
Pension and other postretirement plans adjustments	(6)	—	—	—	—	—	(6)
Total	$869	$(424)	$147	$(277)	$ 7	$(270)	$599
Quarter ended June 30, 2012							
Net unrealized gains on securities	$705	$101	$(35)	$66	$ —	$66	$771
Foreign currency translation adjustments	16	(8)	—	(8)	1	(7)	9
Pension and other postretirement plans adjustments	(7)	—	—	—	—	—	(7)
Total	$714	$93	$(35)	$58	$ 1	$59	$773
Six months ended June 30, 2013							
Net unrealized gains on securities:							
Unrealized holding gains (losses) on securities arising during the period		$(256)	$90	$(166)	$ 5	$(161)	
Reclassification adjustment for realized gains (losses) included in net earnings (a)		(97)	34	(63)	1	(62)	
Total net unrealized gains on securities (b)	$823	(353)	124	(229)	6	(223)	$600
Foreign currency translation adjustments	14	(9)	—	(9)	—	(9)	5
Pension and other postretirement plans adjustments	(6)	—	—	—	—	—	(6)
Total	$831	$(362)	$124	$(238)	$ 6	$(232)	$599
Six months ended June 30, 2012							
Net unrealized gains on securities	$578	$301	$(105)	$196	$ (3)	$193	$771
Foreign currency translation adjustments	10	(1)	—	(1)	—	(1)	9
	(8)	1	—	1	—	1	(7)

Pension and other postretirement plans adjustments							
Total	$580	$301	$(105)	$196	$(3)	$193	$773

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

OCI component	Affected line in the Consolidated Statement of Earnings
Pretax	Realized gains on securities
Tax	Provision for income taxes
Attributable to noncontrolling interests	Net earnings (loss) attributable to noncontrolling interests

(b) Includes net unrealized gains of $42 million at June 30, 2013, $45 million at March 31, 2013 and $33 million at December 31, 2012 related to securities for which only the credit portion of an other-than-temporary impairment has been recorded in earnings.

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 six months of 2013, AFG issued 249,411 shares of restricted Common Stock (fair value of $44.01 per share) and granted stock options for 1.0 million shares of Common Stock (at an average exercise price of $44.01) under the Stock Incentive Plan. In addition, AFG issued 88,602 shares of Common Stock (fair value of $47.12 per share) in the first quarter of 2013 under the Equity Bonus Plan.

AFG uses the Black-Scholes option pricing model to calculate the fair value of its option grants. Expected volatility is based on historical volatility over a period equal to the expected term. The expected term was estimated based on historical exercise patterns and post vesting cancellations. The weighted average fair value of options granted during 2013 was $15.10 per share based on the following assumptions: expected dividend yield — 1.8%; expected volatility — 38.8%; expected term — 7.3 years; risk-free rate — 1.4%.

Total compensation expense related to stock incentive plans of AFG and its subsidiaries was $7 million and $9 million in the second quarter and $20 million and $15 million in the first six months of 2013 and 2012, respectively.

L. Income Taxes

The following is a reconciliation of income taxes at the statutory rate of 35% to the provision for income taxes as shown in the Statement of Earnings (in millions):

	Three months ended June 30,				Six months ended June 30,			
	2013		2012		2013		2012	
	Amount	% of EBT	Amount	% of EBT	Amount	% of EBT	Amount	% of EBT
Earnings before income taxes ("EBT")	$126		$136		$301		$282	
Income taxes at statutory rate	$44	35 %	$48	35 %	$105	35 %	$99	35 %
Effect of:								