AMERICAN FINANCIAL GROUP INC
Form 10-Q
November 03, 2017

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
Quarterly Report Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934
For the
Quarterly
Period
Ended
September
30, 2017

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. Yes þ No ¨
Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company or an emerging growth company. See definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act.
Large accelerated filer þ Accelerated filer ¨ Non-accelerated filer ¨
Smaller reporting company ¨ Emerging growth company ¨
If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨
Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No þ
As of November 1, 2017, there were 88,112,753 shares of the Registrant’s Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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PART I
ITEM I — FINANCIAL STATEMENTS
AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET (UNAUDITED)
(Dollars in Millions)

| | September 30, 2017 | December 31, 2016 |
|---|---|---|
| Assets: | | |
| Cash and cash equivalents | $ 2,349 | $ 2,107 |
| Investments: | | |
| Fixed maturities, available for sale at fair value (amortized cost — $36,412 and $33,735) | 37,818 | 34,544 |
| Fixed maturities, trading at fair value | 350 | 359 |
| Equity securities, available for sale at fair value (cost — $1,312 and $1,351) | 1,579 | 1,502 |
| Equity securities, trading at fair value | 60 | 56 |
| Mortgage loans | 1,043 | 1,147 |
| Policy loans | 186 | 192 |
| Equity index call options | 629 | 492 |
| Real estate and other investments | 1,239 | 1,034 |
| Total cash and investments | 45,253 | 41,433 |
| Recoverables from reinsurers | 3,262 | 2,737 |
| Prepaid reinsurance premiums | 691 | 539 |
| Agents' balances and premiums receivable | 1,173 | 997 |
| Deferred policy acquisition costs | 1,119 | 1,239 |
| Assets of managed investment entities | 4,767 | 4,765 |
| Other receivables | 1,545 | 908 |
| Variable annuity assets (separate accounts) | 628 | 600 |
| Other assets | 1,526 | 1,655 |
| Goodwill | 199 | 199 |
| Total assets | $ 60,163 | $ 55,072 |
| | | |
| Liabilities and Equity: | | |
| Unpaid losses and loss adjustment expenses | $ 9,563 | $ 8,563 |
| Unearned premiums | 2,567 | 2,171 |
| Annuity benefits accumulated | 32,671 | 29,907 |
| Life, accident and health reserves | 667 | 691 |
| Payable to reinsurers | 906 | 634 |
| Liabilities of managed investment entities | 4,506 | 4,549 |
| Long-term debt | 1,284 | 1,283 |
| Variable annuity liabilities (separate accounts) | 628 | 600 |
| Other liabilities | 1,992 | 1,755 |
| Total liabilities | 54,784 | 50,153 |
| Shareholders' equity: | | |
| Common Stock, no par value | | |
| — 200,000,000 shares authorized | 88 | 87 |
| — 88,092,794 and 86,924,399 shares outstanding | | |
| Capital surplus | 1,167 | 1,111 |
| Retained earnings | 3,435 | 3,343 |
| Accumulated other comprehensive income, net of tax | 689 | 375 |

| | | |
|---|---|---|
| Total shareholders’ equity | 5,379 | 4,916 |
| Noncontrolling interests | — | 3 |
| Total equity | 5,379 | 4,919 |
| Total liabilities and equity | $ 60,163 | $ 55,072 |

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 |
| Revenues: | | | | |
| Property and casualty insurance net earned premiums | $1,267 | $1,159 | $3,354 | $3,184 |
| Life, accident and health net earned premiums | 6 | 6 | 17 | 18 |
| Net investment income | 471 | 433 | 1,366 | 1,267 |
| Realized gains (losses) on: | | | | |
| Securities (*) | (12) | 2 | (1) | (32) |
| Subsidiaries | — | — | — | 2 |
| Income of managed investment entities: | | | | |
| Investment income | 54 | 48 | 155 | 141 |
| Gain on change in fair value of assets/liabilities | 1 | 11 | 12 | 9 |
| Other income | 48 | 46 | 154 | 172 |
| Total revenues | 1,835 | 1,705 | 5,057 | 4,761 |
| | | | | |
| Costs and Expenses: | | | | |
| Property and casualty insurance: | | | | |
| Losses and loss adjustment expenses | 995 | 765 | 2,239 | 2,033 |
| Commissions and other underwriting expenses | 357 | 356 | 1,062 | 1,038 |
| Annuity benefits | 215 | 189 | 635 | 640 |
| Life, accident and health benefits | 6 | 8 | 21 | 26 |
| Annuity and supplemental insurance acquisition expenses | 55 | 54 | 156 | 131 |
| Interest charges on borrowed money | 21 | 19 | 65 | 56 |
| Expenses of managed investment entities | 45 | 38 | 137 | 109 |
| Other expenses | 112 | 98 | 285 | 258 |
| Total costs and expenses | 1,806 | 1,527 | 4,600 | 4,291 |
| Earnings before income taxes | 29 | 178 | 457 | 470 |
| Provision for income taxes | 18 | 65 | 146 | 190 |
| Net earnings, including noncontrolling interests | 11 | 113 | 311 | 280 |
| Less: Net earnings attributable to noncontrolling interests | — | 4 | 2 | 16 |
| Net Earnings Attributable to Shareholders | $11 | $109 | $309 | $264 |
| | | | | |
| Earnings Attributable to Shareholders per Common Share: | | | | |
| Basic | $0.13 | $1.25 | $3.52 | $3.04 |
| Diluted | $0.13 | $1.23 | $3.44 | $2.98 |
| Average number of Common Shares: | | | | |
| Basic | 88.1 | 86.9 | 87.7 | 86.8 |
| Diluted | 90.0 | 88.5 | 89.7 | 88.4 |
| | | | | |
| Cash dividends per Common Share | $0.3125 | $0.28 | $2.4375 | $0.84 |

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| (*) Consists of the following: | | | | |
|---|---|---|---|---|
| Realized gains before impairments | $26 | $18 | $52 | $75 |

| | | | | |
|---|---|---|---|---|
| Losses on securities with impairment | (38) | (16) | (54) | (106) |
| Non-credit portion recognized in other comprehensive income (loss) | — | — | 1 | (1) |
| Impairment charges recognized in earnings | (38) | (16) | (53) | (107) |
| Total realized gains (losses) on securities | $(12) | $2 | $(1) | $(32) |

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 |
| Net earnings, including noncontrolling interests | $ 11 | $ 113 | $ 311 | $ 280 |
| Other comprehensive income, net of tax: | | | | |
| Net unrealized gains on securities: | | | | |
| Unrealized holding gains on securities arising during the period | 59 | 89 | 299 | 427 |
| Reclassification adjustment for realized (gains) losses included in net earnings | 8 | (1 ) | 3 | 20 |
| Total net unrealized gains on securities | 67 | 88 | 302 | 447 |
| Net unrealized gains on cash flow hedges | — | — | 1 | 4 |
| Foreign currency translation adjustments | 7 | (3 ) | 11 | 4 |
| Pension and other postretirement plans adjustments | — | — | — | 1 |
| Other comprehensive income, net of tax | 74 | 85 | 314 | 456 |
| Total comprehensive income, net of tax | 85 | 198 | 625 | 736 |
| Less: Comprehensive income attributable to noncontrolling interests | — | 5 | 2 | 23 |
| Comprehensive income attributable to shareholders | $ 85 | $ 193 | $ 623 | $ 713 |

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

| | Shareholders' Equity | | | | | | |
|---|---|---|---|---|---|---|---|
| | Common Shares | Common Stock and Capital Surplus | Retained Earnings | Accumulated Other Comprehensive Income | Total | Noncontrolling Interests | Total Equity |
| Balance at December 31, 2016 | 86,924,399 | $1,198 | $3,343 | $ 375 | $4,916 | $ 3 | $4,919 |
| Net earnings | — | — | 309 | — | 309 | 2 | 311 |
| Other comprehensive income | — | — | — | 314 | 314 | — | 314 |
| Dividends on Common Stock | — | — | (214) | — | (214) | — | (214) |
| Shares issued: | | | | | | | |
| Exercise of stock options | 870,022 | 29 | — | — | 29 | — | 29 |
| Restricted stock awards | 232,250 | — | — | — | — | — | — |
| Other benefit plans | 85,190 | 8 | — | — | 8 | — | 8 |
| Dividend reinvestment plan | 22,243 | 2 | — | — | 2 | — | 2 |
| Stock-based compensation expense | — | 18 | — | — | 18 | — | 18 |
| Shares exchanged — benefit plans | (34,922) | — | (3) | — | (3) | — | (3) |
| Forfeitures of restricted stock | (6,388) | — | — | — | — | — | — |
| Other | — | — | — | — | — | (5) | (5) |
| Balance at September 30, 2017 | 88,092,794 | $1,255 | $3,435 | $ 689 | $5,379 | $ — | $5,379 |
| | | | | | | | |
| Balance at December 31, 2015 | 87,474,452 | $1,301 | $2,987 | $ 304 | $4,592 | $ 178 | $4,770 |
| Net earnings | — | — | 264 | — | 264 | 16 | 280 |
| Other comprehensive income | — | — | — | 449 | 449 | 7 | 456 |
| Dividends on Common Stock | — | — | (73) | — | (73) | — | (73) |
| Shares issued: | | | | | | | |
| Exercise of stock options | 753,095 | 26 | — | — | 26 | — | 26 |
| Restricted stock awards | 318,940 | — | — | — | — | — | — |
| Other benefit plans | 82,087 | 6 | — | — | 6 | — | 6 |
| Dividend reinvestment plan | 10,930 | 1 | — | — | 1 | — | 1 |
| Stock-based compensation expense | — | 22 | — | — | 22 | — | 22 |
| Shares acquired and retired | (1,796,009) | (27) | (97) | — | (124) | — | (124) |
| Shares exchanged — benefit plans | (28,059) | — | (2) | — | (2) | — | (2) |
| Forfeitures of restricted stock | (2,785) | — | — | — | — | — | — |
| Other | — | — | — | — | — | (4) | (4) |
| Balance at September 30, 2016 | 86,812,651 | $1,329 | $3,079 | $ 753 | $5,161 | $ 197 | $5,358 |

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

| | Nine months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Operating Activities: | | |
| Net earnings, including noncontrolling interests | $311 | $280 |
| Adjustments: | | |
| Depreciation and amortization | 105 | 91 |
| Annuity benefits | 635 | 640 |
| Realized gains on investing activities | (18) | (6) |
| Net sales of trading securities | 5 | 73 |
| Deferred annuity and life policy acquisition costs | (177) | (172) |
| Change in: | | |
| Reinsurance and other receivables | (1,467) | (972) |
| Other assets | (59) | (193) |
| Insurance claims and reserves | 1,372 | 796 |
| Payable to reinsurers | 272 | 244 |
| Other liabilities | — | 230 |
| Managed investment entities’ assets/liabilities | 14 | (235) |
| Other operating activities, net | — | (30) |
| Net cash provided by operating activities | 993 | 746 |
| | | |
| Investing Activities: | | |
| Purchases of: | | |
| Fixed maturities | (7,163) | (5,604) |
| Equity securities | (73) | (143) |
| Mortgage loans | (149) | (310) |
| Equity index call options and other investments | (594) | (490) |
| Real estate, property and equipment | (46) | (37) |
| Proceeds from: | | |
| Maturities and redemptions of fixed maturities | 4,690 | 3,111 |
| Repayments of mortgage loans | 191 | 197 |
| Sales of fixed maturities | 179 | 496 |
| Sales of equity securities | 97 | 193 |
| Sales and settlements of equity index call options and other investments | 565 | 138 |
| Sales of real estate, property and equipment | 54 | 45 |
| Managed investment entities: | | |
| Purchases of investments | (2,330) | (1,405) |
| Proceeds from sales and redemptions of investments | 2,343 | 1,381 |
| Other investing activities, net | 6 | (91) |
| Net cash used in investing activities | (2,230) | (2,519) |
| | | |
| Financing Activities: | | |
| Annuity receipts | 3,432 | 3,474 |
| Annuity surrenders, benefits and withdrawals | (1,725) | (1,726) |

| | | |
|---|---|---|
| Net transfers from variable annuity assets | 43 | 29 |
| Additional long-term borrowings | 345 | 302 |
| Reductions of long-term debt | (355 ) | — |
| Issuances of managed investment entities’ liabilities | 1,926 | 1,028 |
| Retirements of managed investment entities’ liabilities | (1,998 ) | (747 ) |
| Issuances of Common Stock | 30 | 34 |
| Repurchases of Common Stock | — | (124 ) |
| Cash dividends paid on Common Stock | (212 ) | (72 ) |
| Other financing activities, net | (7 ) | (6 ) |
| Net cash provided by financing activities | 1,479 | 2,192 |
| Net Change in Cash and Cash Equivalents | 242 | 419 |
| Cash and cash equivalents at beginning of period | 2,107 | 1,220 |
| Cash and cash equivalents at end of period | $2,349 | $1,639 |

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A. Accounting Policies

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

Certain reclassifications have been made to prior periods to conform to the current year's presentation. All significant intercompany balances and transactions have been eliminated. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements. Events or transactions occurring subsequent to September 30, 2017, and prior to the filing of this Form 10-Q, have been evaluated for potential recognition or disclosure herein.

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

Fair Value Measurements Accounting standards define fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. The standards establish a hierarchy of valuation techniques based on whether the assumptions that market participants would use in pricing the asset or liability ("inputs") are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect AFG's assumptions about the assumptions market participants would use in pricing the asset or liability. AFG did not have any significant nonrecurring fair value measurements in the first nine months of 2017.

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

In January 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-01, which, among other things, will require all equity securities currently classified as "available for sale" to be reported at fair value, with holding gains and losses recognized in net income, instead of AOCI. AFG will be required to adopt this guidance effective January 1, 2018. At the date of adoption, the net unrealized gain on equity securities included in AOCI will be reclassified to retained earnings in the Balance Sheet as the cumulative effect of an accounting change.

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

Gains or losses on securities are determined on the specific identification basis. When a decline in the value of a specific investment is considered to be other-than-temporary at the balance sheet date, a provision for impairment is charged to earnings (included in realized gains (losses) on securities) and the cost basis of that investment is reduced. If management can assert that

it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will have to sell the security before recovery of its amortized cost basis, then the other-than-temporary impairment is separated into two components: (i) the amount related to credit losses (recorded in earnings) and (ii) the amount related to all other factors (recorded in other comprehensive income). The credit-related portion of an other-than-temporary impairment is measured by comparing a security's amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge. Both components are shown in the statement of earnings. If management intends to sell an impaired security, or it is more likely than not that it will be required to sell the security before recovery, an impairment charge to earnings is recorded to reduce the amortized cost of that security to fair value.

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

To qualify for hedge accounting, at the inception of a derivative contract, AFG formally documents the relationship between the terms of the hedge and the hedged items and its risk management objective. This documentation includes defining how hedge effectiveness and ineffectiveness will be measured on a retrospective and prospective basis.

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

For derivatives that are designated and qualify as highly effective fair value hedges, changes in the fair value of the derivative, along with changes in the fair value of the hedged item attributable to the hedged risk, are recognized in current period earnings. AFG has entered into an interest rate swap that qualifies as a highly effective fair value hedge to mitigate the interest rate risk associated with fixed-rate long-term debt by economically converting certain fixed-rate debt obligations to floating-rate obligations. Since the terms of the swap match the terms of the hedged debt, changes in the fair value of the swap are offset by changes in the fair value of the hedged debt attributable to changes in interest rates. Accordingly, the net impact on AFG's current period earnings is that the interest expense associated with the hedged debt is effectively recorded at the floating rate.

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

Reinsurance   Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policies. AFG's property and casualty insurance subsidiaries report as assets (i) the estimated reinsurance recoverable on paid and unpaid losses, including an estimate for losses incurred but not

reported, and (ii) amounts paid or due to reinsurers applicable to the unexpired terms of policies in force. Payable to reinsurers includes ceded premiums due to reinsurers, as well as ceded premiums retained by AFG's property and casualty insurance subsidiaries under contracts to fund ceded losses as they become due. AFG's insurance subsidiaries also assume reinsurance from other companies. Earnings on reinsurance assumed is recognized based on information received from ceding companies.

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

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

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

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

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

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

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

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

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

AFG invested) and the right to receive CLO benefits that could potentially be significant to the CLOs.

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

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

At September 30, 2017, assets and liabilities of managed investment entities included $383 million in assets and $316 million in liabilities of a temporary warehousing entity that was established in connection with the formation of a new CLO that closed in October 2017. At closing, all warehoused assets were transferred to the new CLO and the liabilities were repaid.

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

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

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

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

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

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

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

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

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

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

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

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

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

Noncontrolling Interests   For balance sheet purposes, noncontrolling interests 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.

In the fourth quarter of 2016, AFG adopted ASU 2016-09, which, among other things, requires excess tax benefits or deficiencies for share-based payments to be recorded through income tax expense in the statement of earnings instead of directly to capital surplus (as required under the previous guidance). In addition, under the new guidance, AFG elected to account for forfeitures of awards when they occur rather than accruing expense based on an estimate of expected forfeitures (as required under the previous guidance). The resulting cumulative effect of accounting change

of less than $1 million was recorded directly to retained earnings on January 1, 2016.

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

Earnings Per Share   Although basic earnings per share only considers shares of common stock outstanding during the period, the calculation of diluted earnings per share includes the following adjustments to weighted average common shares related to

stock-based compensation plans: third quarter of 2017 and 2016 — 1.9 million and 1.6 million; first nine months of 2017 and 2016 — 2.0 million and 1.6 million, respectively.

AFG's weighted average diluted shares outstanding for the third quarter and first nine months of 2016 excludes 0.2 million and 0.6 million anti-dilutive potential common shares related to stock compensation plans, respectively. There were no anti-dilutive potential common shares in the third quarter or first nine months of 2017.

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

Effective October 1, 2016, AFG early adopted (on a retrospective basis) ASU 2016-15, which addresses the diversity in practice in how certain cash receipts and cash payments are presented in the statement of cash flows. Among other things, this guidance requires proceeds received from the settlement of corporate-owned life insurance policies to be classified as cash inflows from investing activities and allows premiums paid for policies to be reported as cash outflows either from investing activities or operating activities. AFG has elected to show all corporate-owned life insurance activity in investing activities. Prior to adoption of this guidance, AFG accounted for these transactions as operating activities. In addition, ASU 2016-15 clarifies when distributions received from investees accounted under the equity method should be accounted for as a cash inflow from operating activities or as a cash inflow from investing activities. AFG had previously accounted for all distributions from investments accounted for under the equity method as investing activities. The new guidance solely related to the presentation of certain transactions in the statement of cash flows. Accordingly, adoption of this guidance did not impact AFG's results of operations or financial position.

Revenue Recognition Guidance Effective in 2018   In May 2014, the FASB issued ASU 2014-09, which requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Revenue is recognized when (or as) the entity satisfies a performance obligation under the contract. The new guidance also updates the accounting for certain costs associated with obtaining and fulfilling contracts with customers and requires disclosures regarding the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Revenue recognition for insurance contracts and financial instruments, which are AFG's primary sources of revenue, is excluded from the scope of the new guidance. AFG will adopt the new guidance effective January 1, 2018. Because the new guidance does not apply to the vast majority of AFG's business, management does not expect the adoption of this guidance to have a material impact on AFG's results of operations or financial position. Based on implementation efforts to date, management believes that the new standard would only have applied to 2% of AFG's 2016 consolidated revenues.

B.  Acquisition of Business

Acquisition of Noncontrolling Interest in National Interstate Corporation   In November 2016, AFG acquired the 49% of National Interstate Corporation ("NATL") not previously owned by AFG's wholly-owned subsidiary, Great American Insurance Company, for $315 million ($32.00 per share) in a merger transaction. In addition, NATL paid a one-time special cash dividend of $0.50 per share to its shareholders immediately prior to the merger closing. Because NATL

was already a consolidated subsidiary of AFG prior to the merger, the acquisition was accounted for as an equity transaction.

C. Segments of Operations

AFG manages its business as four segments: (i) Property and casualty insurance, (ii) Annuity, (iii) Run-off long-term care and life and (iv) Other, which includes holding company costs.

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes physical damage and liability coverage for buses, trucks and recreational vehicles, inland and ocean marine, agricultural-related products and other property coverages, (ii) Specialty casualty, which includes primarily excess and surplus, general liability, executive liability, professional liability, umbrella and excess liability, specialty coverage in targeted markets, customized programs for small to mid-sized businesses and workers' compensation insurance, and (iii) Specialty financial, which includes risk management insurance programs for leasing and financing institutions (including collateral and lender-placed mortgage property insurance), surety and fidelity products and trade credit insurance. Premiums and underwriting profit included under Other specialty represent business assumed by AFG's internal reinsurance program from the operations that make up AFG's other Specialty sub-segments and amortization of deferred gains on retroactive reinsurance transactions related to the sales of businesses in prior years. AFG's annuity business markets traditional fixed and fixed-indexed annuities in the retail, financial institutions and education markets. AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 |
| Revenues | | | | |
| Property and casualty insurance: | | | | |
| Premiums earned: | | | | |
| Specialty | | | | |
| Property and transportation | $527 | $493 | $1,226 | $1,197 |
| Specialty casualty | 568 | 497 | 1,613 | 1,496 |
| Specialty financial | 142 | 145 | 435 | 416 |
| Other specialty | 30 | 24 | 80 | 75 |
| Total premiums earned | 1,267 | 1,159 | 3,354 | 3,184 |
| Net investment income | 94 | 93 | 276 | 265 |
| Other income (a) | 1 | 3 | 21 | 46 |
| Total property and casualty insurance | 1,362 | 1,255 | 3,651 | 3,495 |
| Annuity: | | | | |
| Net investment income | 375 | 351 | 1,082 | 1,010 |
| Other income | 26 | 26 | 79 | 76 |
| Total annuity | 401 | 377 | 1,161 | 1,086 |
| Run-off long-term care and life | 12 | 13 | 35 | 37 |
| Other | 72 | 58 | 211 | 173 |
| Total revenues before realized gains (losses) | 1,847 | 1,703 | 5,058 | 4,791 |
| Realized gains (losses) on securities | (12) | 2 | (1) | (32) |
| Realized gains on subsidiaries | — | — | — | 2 |
| Total revenues | $1,835 | $1,705 | $5,057 | $4,761 |
| Earnings Before Income Taxes | | | | |
| Property and casualty insurance: | | | | |
| Underwriting: | | | | |
| Specialty | | | | |
| Property and transportation | $6 | $44 | $70 | $91 |
| Specialty casualty | 2 | 13 | 46 | 65 |
| Specialty financial | (3) | 19 | 42 | 64 |
| Other specialty | 4 | 2 | 3 | 7 |
| Other lines (b) | (90) | (36) | (92) | (101) |
| Total underwriting | (81) | 42 | 69 | 126 |
| Investment and other income, net (a) | 87 | 79 | 271 | 269 |
| Total property and casualty insurance | 6 | 121 | 340 | 395 |
| Annuity | 102 | 107 | 283 | 236 |
| Run-off long-term care and life | 2 | 1 | 4 | — |
| Other (c) | (69) | (53) | (169) | (131) |
| Total earnings before realized gains (losses) and income taxes | 41 | 176 | 458 | 500 |
| Realized gains (losses) on securities | (12) | 2 | (1) | (32) |
| Realized gains on subsidiaries | — | — | — | 2 |

| Total earnings before income taxes | $29 | $178 | $457 | $470 |
|---|---|---|---|---|

(a) Includes pretax income of $13 million (before noncontrolling interest) from the sale of a hotel in the first quarter of 2017 and pretax income of $32 million (before noncontrolling interest) from the sale of an apartment property in the second quarter of 2016.

(b) Includes special charges of $89 million and $36 million in the third quarter of 2017 and 2016, respectively, to increase asbestos and environmental ("A&E") reserves and a $65 million special charge related to the exit of certain lines of business with AFG's Lloyd's-based insurer, Neon, in the second quarter of 2016.

(c) Includes holding company interest and expenses, including losses on retirement of debt of $4 million in the third quarter of 2017 and $7 million in the second quarter of 2017, and special charges of $24 million and $5 million in the third quarter of 2017 and 2016, respectively, to increase A&E reserves related to AFG's former railroad and manufacturing operations.

D. Fair Value Measurements

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

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

Level 2 — Quoted prices for similar instruments in active markets; quoted prices for identical or similar assets or liabilities in inactive markets (markets in which there are few transactions, the prices are not current, price quotations vary substantially over time or among market makers, or in which little information is released publicly); and valuations based on other significant inputs that are observable in active markets. AFG's Level 2 financial instruments include separate account assets, corporate and municipal fixed maturity securities, asset-backed securities, 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 at the valuation date. AFG's Level 3 is comprised of financial instruments whose fair value is estimated based on non-binding broker quotes or internally developed using significant inputs not based on, or corroborated by, observable market information.

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

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

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

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

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| September 30, 2017 | | | | |
| Assets: | | | | |
| Available for sale (“AFS”) fixed maturities: | | | | |
| U.S. Government and government agencies | $120 | $129 | $8 | $257 |
| States, municipalities and political subdivisions | — | 6,845 | 152 | 6,997 |
| Foreign government | — | 144 | — | 144 |
| Residential MBS | — | 3,252 | 144 | 3,396 |
| Commercial MBS | — | 974 | 36 | 1,010 |
| Asset-backed securities (“ABS”) | — | 6,860 | 536 | 7,396 |
| Corporate and other | 30 | 17,538 | 1,050 | 18,618 |
| Total AFS fixed maturities | 150 | 35,742 | 1,926 | 37,818 |
| Trading fixed maturities | 48 | 302 | — | 350 |
| Equity securities — AFS and trading | 1,397 | 79 | 163 | 1,639 |
| Assets of managed investment entities (“MIE”) | 368 | 4,378 | 21 | 4,767 |
| Variable annuity assets (separate accounts) (*) | — | 628 | — | 628 |
| Equity index call options | — | 629 | — | 629 |
| Other assets — derivatives | — | 1 | — | 1 |
| Total assets accounted for at fair value | $1,963 | $41,759 | $2,110 | $45,832 |
| Liabilities: | | | | |
| Liabilities of managed investment entities | $348 | $4,138 | $20 | $4,506 |
| Derivatives in annuity benefits accumulated | — | — | 2,293 | 2,293 |
| Derivatives in long-term debt | — | — | — | — |
| Other liabilities — derivatives | — | 31 | — | 31 |
| Total liabilities accounted for at fair value | $348 | $4,169 | $2,313 | $6,830 |
| | | | | |
| December 31, 2016 | | | | |
| Assets: | | | | |
| Available for sale fixed maturities: | | | | |
| U.S. Government and government agencies | $133 | $174 | $8 | $315 |
| States, municipalities and political subdivisions | — | 6,641 | 140 | 6,781 |
| Foreign government | — | 136 | — | 136 |
| Residential MBS | — | 3,445 | 190 | 3,635 |
| Commercial MBS | — | 1,468 | 25 | 1,493 |
| Asset-backed securities | — | 5,475 | 484 | 5,959 |
| Corporate and other | 29 | 15,484 | 712 | 16,225 |
| Total AFS fixed maturities | 162 | 32,823 | 1,559 | 34,544 |
| Trading fixed maturities | 30 | 329 | — | 359 |
| Equity securities — AFS and trading | 1,305 | 79 | 174 | 1,558 |
| Assets of managed investment entities | 380 | 4,356 | 29 | 4,765 |
| Variable annuity assets (separate accounts) (*) | — | 600 | — | 600 |
| Equity index call options | — | 492 | — | 492 |
| Other assets — derivatives | — | 1 | — | 1 |
| Total assets accounted for at fair value | $1,877 | $38,680 | $1,762 | $42,319 |

| | | | | |
|---|---|---|---|---|
| Liabilities: | | | | |
| Liabilities of managed investment entities | $363 | $4,158 | $28 | $4,549 |
| Derivatives in annuity benefits accumulated | — | — | 1,759 | 1,759 |
| Derivatives in long-term debt | — | (1) | — | (1) |
| Other liabilities — derivatives | — | 30 | — | 30 |
| Total liabilities accounted for at fair value | $363 | $4,187 | $1,787 | $6,337 |

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

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

During the third quarter of 2017, there was one perpetual preferred stock with an aggregate fair value of $1 million that transferred between Level 2 and Level 1. During the first nine months of 2017, there were three preferred stocks with an aggregate fair value of $17 million that transferred from Level 2 to Level 1. During the third quarter of 2016, there was one common stock with a fair value of less than $1 million that transferred from Level 1 to Level 2. During the first nine months of 2016, there were six perpetual preferred stocks with a fair value of $35 million that transferred from Level 2 to Level 1 and five perpetual preferred stocks and one common stock with aggregate fair values of $12 million and less than $1 million, respectively, that transferred from Level 1 to Level 2.

Approximately 5% of the total assets carried at fair value at September 30, 2017, were Level 3 assets. Approximately 76% ($1.61 billion) of the Level 3 assets were priced using non-binding broker quotes, for which there is a lack of transparency as to the inputs used to determine fair value. Details as to the quantitative inputs are neither provided by the brokers nor otherwise reasonably obtainable by AFG. Since internally developed Level 3 asset fair values represent less than 10% of AFG's Shareholders' Equity, any justifiable changes in unobservable inputs used to determine internally developed fair values would not have a material impact on AFG's financial position.

The only significant Level 3 assets or liabilities carried at fair value in the financial statements that were not measured using broker quotes are the derivatives embedded in AFG's fixed-indexed annuity liabilities, which are measured using a discounted cash flow approach and had a fair value of $2.29 billion at September 30, 2017. 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 | 0.2% – 2.4% over the risk free rate |
| Risk margin for uncertainty in cash flows | 0.68% reduction in the discount rate |
| Surrenders | 3% – 23% of indexed account value |
| Partial surrenders | 2% – 10% of indexed account value |
| Annuitizations | 0.1% – 1% of indexed account value |
| Deaths | 1.5% – 8.0% of indexed account value |
| Budgeted option costs | 2.4% – 3.7% 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 6% to 10% in the majority of future calendar years (3% to 23% over all periods). Increasing the budgeted option cost or risk margin for uncertainty in cash flows assumptions in the table above would increase the fair value of the fixed-indexed annuity embedded derivatives, while increasing any of the other unobservable inputs in the table above would decrease the fair value of the embedded derivatives.

Changes in balances of Level 3 financial assets and liabilities carried at fair value during the third quarter and first nine months of 2017 and 2016 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.

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

| | | Total realized/unrealized gains (losses) included in | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Balance at June 30, 2016 | Net income | Other comprehensive income (loss) | Purchases and issuances | Sales and settlements | Transfer into Level 3 | Transfer out of Level 3 | Balance at September 30, 2016 |
| AFS fixed maturities: | | | | | | | | |
| U.S. government agency | $8 | $ — | $ — | $ — | $ — | $ — | $ — | $ 8 |
| State and municipal | 91 | — | 1 | — | (1) | — | — | 91 |
| Residential MBS | 231 | (2) | — | — | (8) | — | (2) | 219 |
| Commercial MBS | 36 | — | — | — | (2) | — | — | 34 |
| Asset-backed securities | 478 | (1) | 4 | — | (5) | — | (9) | 467 |
| Corporate and other | 689 | — | (3) | 37 | (14) | — | — | 709 |
| Total AFS fixed maturities | 1,533 | (3) | 2 | 37 | (30) | — | (11) | 1,528 |
| Equity securities | 166 | 5 | 5 | 10 | (21) | — | — | 165 |
| Assets of MIE | 26 | (2) | — | — | — | — | — | 24 |
| Total Level 3 assets | $1,725 | $ — | $ 7 | $ 47 | $ (51) | $ — | $ (11) | $ 1,717 |
| | | | | | | | | |
| Embedded derivatives | $(1,557) | $ (109) | $ — | $ (53) | $ 31 | $ — | $ — | $ (1,688) |
| Total Level 3 liabilities (*) | $(1,557) | $ (109) | $ — | $ (53) | $ 31 | $ — | $ — | $ (1,688) |

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

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AMERICAN FINANCIAL GROUP, INC. 10-Q
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

| | Balance at December 31, 2015 | Total realized/unrealized gains (losses) included in Net income | Other comprehensive income (loss) | Purchases and issuances | Sales and settlements | Transfer into Level 3 | Transfer out of Level 3 | Balance at September 30, 2016 |
|---|---|---|---|---|---|---|---|---|
| AFS fixed maturities: | | | | | | | | |
| U.S. government agency | $ 15 | $ (8 ) | $ 1 | $ — | $ — | $ — | $ — | $ 8 |
| State and municipal | 89 | — | 4 | — | (2 ) | — | — | 91 |
| Residential MBS | 224 | — | 1 | — | (21 ) | 33 | (18 ) | 219 |
| Commercial MBS | 39 | (1 ) | — | — | (4 ) | — | — | 34 |
| Asset-backed securities | 470 | (1 ) | 1 | 15 | (24 ) | 41 | (35 ) | 467 |
| Corporate and other | 633 | — | 24 | 131 | (89 ) | 15 | (5 ) | 709 |
| Total AFS fixed maturities | 1,470 | (10 ) | 31 | 146 | (140 ) | 89 | (58 ) | 1,528 |
| Equity securities | 140 | (12 ) | 21 | 22 | (21 ) | 15 | — | 165 |
| Assets of MIE | 26 | (6 ) | — | 4 | — | — | — | 24 |
| Total Level 3 assets | $ 1,636 | $ (28 ) | $ 52 | $ 172 | $ (161 ) | $ 104 | $ (58 ) | $ 1,717 |
| | | | | | | | | |
| Embedded derivatives | $ (1,369 ) | $ (188 ) | $ — | $ (207 ) | $ 76 | $ — | $ — | $ (1,688 ) |
| Total Level 3 liabilities (*) | $ (1,369 ) | $ (188 ) | $ — | $ (207 ) | $ 76 | $ — | $ — | $ (1,688 ) |

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

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

| | Carrying | Fair Value | | | |
|---|---|---|---|---|---|
| | Value | Total | Level 1 | Level 2 | Level 3 |
| September 30, 2017 | | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | $2,349 | $2,349 | $2,349 | $— | $— |
| Mortgage loans | 1,043 | 1,040 | — | — | 1,040 |
| Policy loans | 186 | 186 | — | — | 186 |
| Total financial assets not accounted for at fair value | $3,578 | $3,575 | $2,349 | $— | $1,226 |
| Financial liabilities: | | | | | |
| Annuity benefits accumulated (*) | $32,464 | $31,857 | $— | $— | $31,857 |
| Long-term debt | 1,284 | 1,380 | — | 1,377 | 3 |
| Total financial liabilities not accounted for at fair value | $33,748 | $33,237 | $— | $1,377 | $31,860 |
| December 31, 2016 | | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | $2,107 | $2,107 | $2,107 | $— | $— |
| Mortgage loans | 1,147 | 1,146 | — | — | 1,146 |
| Policy loans | 192 | 192 | — | — | 192 |
| Total financial assets not accounted for at fair value | $3,446 | $3,445 | $2,107 | $— | $1,338 |
| Financial liabilities: | | | | | |
| Annuity benefits accumulated (*) | $29,703 | $28,932 | $— | $— | $28,932 |
| Long-term debt | 1,284 | 1,356 | — | 1,353 | 3 |
| Total financial liabilities not accounted for at fair value | $30,987 | $30,288 | $— | $1,353 | $28,935 |

(*) Excludes $207 million and $204 million of life contingent annuities in the payout phase at September 30, 2017 and December 31, 2016, respectively.

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

E. Investments

Available for sale fixed maturities and equity securities at September 30, 2017 and December 31, 2016, consisted of the following (in millions):

| | September 30, 2017 | | | | | December 31, 2016 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Net Unrealized | Fair Value | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Net Unrealized | Fair Value |
| Fixed maturities: | | | | | | | | | | |
| U.S. Government and government agencies | $257 | $2 | $(2) | $— | $257 | $315 | $3 | $(3) | $— | $315 |
| States, municipalities and political subdivisions | 6,761 | 259 | (23) | 236 | 6,997 | 6,650 | 200 | (69) | 131 | 6,781 |
| Foreign government | 141 | 3 | — | 3 | 144 | 131 | 5 | — | 5 | 136 |
| Residential MBS | 3,062 | 341 | (7) | 334 | 3,396 | 3,367 | 281 | (13) | 268 | 3,635 |
| Commercial MBS | 967 | 44 | (1) | 43 | 1,010 | 1,446 | 49 | (2) | 47 | 1,493 |
| Asset-backed securities | 7,268 | 143 | (15) | 128 | 7,396 | 5,962 | 43 | (46) | (3) | 5,959 |
| Corporate and other | 17,956 | 699 | (37) | 662 | 18,618 | 15,864 | 473 | (112) | 361 | 16,225 |
| Total fixed maturities | $36,412 | $1,491 | $(85) | $1,406 | $37,818 | $33,735 | $1,054 | $(245) | $809 | $34,544 |
| | | | | | | | | | | |
| Equity Securities: | | | | | | | | | | |
| Common stocks | $830 | $251 | $(27) | $224 | $1,054 | $879 | $160 | $(23) | $137 | $1,016 |
| Perpetual preferred stocks | 482 | 44 | (1) | 43 | 525 | 472 | 21 | (7) | 14 | 486 |
| Total equity securities | $1,312 | $295 | $(28) | $267 | $1,579 | $1,351 | $181 | $(30) | $151 | $1,502 |

The non-credit related portion of other-than-temporary impairment charges is included in other comprehensive income. Cumulative non-credit charges taken for securities still owned at September 30, 2017 and December 31, 2016 were $165 million and $189 million, respectively. Gross unrealized gains on such securities at September 30, 2017 and December 31, 2016 were $141 million and $130 million, respectively. Gross unrealized losses on such securities at September 30, 2017 and December 31, 2016 were $4 million and $3 million, respectively. These amounts represent the non-credit other-than-temporary impairment charges recorded in AOCI adjusted for subsequent changes in fair values and nearly all relate to residential MBS.

The following tables show gross unrealized losses (dollars in millions) on fixed maturities and equity securities by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2017 and December 31, 2016.

| | Less Than Twelve Months | | | Twelve Months or More | | |
|---|---|---|---|---|---|---|
| | Unrealized Loss | Fair Value | Fair Value as % of Cost | Unrealized Loss | Fair Value | Fair Value as % of Cost |
| September 30, 2017 | | | | | | |
| Fixed maturities: | | | | | | |
| U.S. Government and government agencies | $ — | $ 97 | 100 % | $ (2 ) | $ 57 | 97 % |
| States, municipalities and political subdivisions | (18 ) | 1,099 | 98 % | (5 ) | 160 | 97 % |
| Residential MBS | (2 ) | 163 | 99 % | (5 ) | 189 | 97 % |
| Commercial MBS | (1 ) | 69 | 99 % | — | — | — % |
| Asset-backed securities | (7 ) | 828 | 99 % | (8 ) | 245 | 97 % |
| Corporate and other | (24 ) | 1,744 | 99 % | (13 ) | 310 | 96 % |
| Total fixed maturities | $ (52 ) | $ 4,000 | 99 % | $ (33 ) | $ 961 | 97 % |
| | | | | | | |
| Equity securities: | | | | | | |
| Common stocks | $ (27 ) | $ 141 | 84 % | $ — | $ — | — % |
| Perpetual preferred stocks | — | 23 | 100 % | (1 ) | 13 | 93 % |
| Total equity securities | $ (27 ) | $ 164 | 86 % | $ (1 ) | $ 13 | 93 % |
| | | | | | | |
| December 31, 2016 | | | | | | |
| Fixed maturities: | | | | | | |
| U.S. Government and government agencies | $ (1 ) | $ 153 | 99 % | $ (2 ) | $ 8 | 80 % |
| States, municipalities and political subdivisions | (64 ) | 2,289 | 97 % | (5 ) | 44 | 90 % |
| Residential MBS | (7 ) | 502 | 99 % | (6 ) | 162 | 96 % |
| Commercial MBS | (2 ) | 121 | 98 % | — | — | — % |
| Asset-backed securities | (29 ) | 1,737 | 98 % | (17 ) | 634 | 97 % |
| Corporate and other | (93 ) | 3,849 | 98 % | (19 ) | 312 | 94 % |
| Total fixed maturities | $ (196 ) | $ 8,651 | 98 % | $ (49 ) | $ 1,160 | 96 % |
| | | | | | | |
| Equity securities: | | | | | | |
| Common stocks | $ (23 ) | $ 215 | 90 % | $ — | $ — | — % |
| Perpetual preferred stocks | (6 ) | 135 | 96 % | (1 ) | 6 | 86 % |
| Total equity securities | $ (29 ) | $ 350 | 92 % | $ (1 ) | $ 6 | 86 % |

At September 30, 2017, the gross unrealized losses on fixed maturities of $85 million relate to 735 securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 73% of the gross unrealized loss and 88% of the fair value.

AFG analyzes its MBS securities for other-than-temporary impairment each quarter based upon expected future cash flows. Management estimates expected future cash flows based upon its knowledge of the MBS market, cash flow projections (which reflect loan to collateral values, subordination, vintage and geographic concentration) received from independent sources, implied cash flows inherent in security ratings and analysis of historical payment data. In the first nine months of 2017, AFG recorded $1 million in other-than-temporary impairment charges related to its residential MBS.

In the first nine months of 2017, AFG recorded $15 million in other-than-temporary impairment charges related to corporate bonds and other fixed maturities.

AFG recorded $42 million in other-than-temporary impairment charges on common stocks in the first nine months of 2017. At September 30, 2017, the gross unrealized losses on common stocks of $27 million relate to 19 securities, none of which has been in an unrealized loss position for more than 12 months.

AFG recorded $7 million in other-than-temporary impairment charges on preferred stocks in the first nine months of 2017. At September 30, 2017, the gross unrealized losses on preferred stocks of $1 million relate to 5 securities, 3 of which have been in an unrealized loss position for 12 months or more and are rated investment grade.

Management believes AFG will recover its cost basis in the securities with unrealized losses and that AFG has the ability to hold the securities until they recover in value and had no intent to sell them at September 30, 2017.

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):

| | 2017 | 2016 |
|---|---|---|
| Balance at June 30 | $145 | $157 |
| Additional credit impairments on: | | |
| Previously impaired securities | — | — |
| Securities without prior impairments | 3 | — |
| Reductions due to sales or redemptions | (1) | (2) |
| Balance at September 30 | $147 | $155 |
| | | |
| Balance at January 1 | $153 | $160 |
| Additional credit impairments on: | | |
| Previously impaired securities | 1 | 2 |
| Securities without prior impairments | 3 | — |
| Reductions due to sales or redemptions | (10) | (7) |
| Balance at September 30 | $147 | $155 |

The table below sets forth the scheduled maturities of available for sale fixed maturities as of September 30, 2017 (dollars in millions). Securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

| | Amortized Cost | Fair Value Amount | % |
|---|---|---|---|
| Maturity | | | |
| One year or less | $ 927 | $939 | 2 % |
| After one year through five years | 6,521 | 6,787 | 18 % |
| After five years through ten years | 13,074 | 13,527 | 36 % |
| After ten years | 4,593 | 4,763 | 13 % |
| | 25,115 | 26,016 | 69 % |
| ABS (average life of approximately 5 years) | 7,268 | 7,396 | 19 % |
| MBS (average life of approximately 4-1/2 years) | 4,029 | 4,406 | 12 % |
| Total | $ 36,412 | $37,818 | 100% |

Certain risks are inherent in fixed maturity securities, including loss upon default, price volatility in reaction to changes in interest rates, and general market factors and risks associated with reinvestment of proceeds due to prepayments or redemptions in a period of declining interest rates.
There were no investments in individual issuers that exceeded 10% of shareholders’ equity at September 30, 2017 or December 31, 2016.

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

| | Pretax | Deferred Tax | Net |
|---|---|---|---|
| September 30, 2017 | | | |
| Net unrealized gain on: | | | |
| Fixed maturities — annuity segment (*) | $1,131 | $ (396) | $735 |
| Fixed maturities — all other | 275 | (96) | 179 |
| Total fixed maturities | 1,406 | (492) | 914 |
| Equity securities | 267 | (94) | 173 |
| Total investments | 1,673 | (586) | 1,087 |
| Deferred policy acquisition costs — annuity segment | (465) | 163 | (302) |
| Annuity benefits accumulated | (141) | 49 | (92) |
| Unearned revenue | 20 | (7) | 13 |
| Total net unrealized gain on marketable securities | $1,087 | $ (381) | $706 |
| | | | |
| December 31, 2016 | | | |
| Net unrealized gain on: | | | |
| Fixed maturities — annuity segment (*) | $640 | $ (224) | $416 |
| Fixed maturities — all other | 169 | (59) | 110 |
| Total fixed maturities | 809 | (283) | 526 |
| Equity securities | 151 | (53) | 98 |
| Total investments | 960 | (336) | 624 |
| Deferred policy acquisition costs — annuity segment | (273) | 96 | (177) |
| Annuity benefits accumulated | (78) | 27 | (51) |
| Unearned revenue | 13 | (5) | 8 |
| Total net unrealized gain on marketable securities | $622 | $ (218) | $404 |

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

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 |
| Investment income: | | | | |
| Fixed maturities | $405 | $378 | $1,191 | $1,126 |
| Equity securities | 17 | 20 | 57 | 59 |
| Equity in earnings of partnerships and similar investments | 20 | 16 | 51 | 31 |
| Other | 33 | 23 | 80 | 64 |
| Gross investment income | 475 | 437 | 1,379 | 1,280 |

| | | | | |
|---|---|---|---|---|
| Investment expenses | (4 ) | (4 ) | (13 ) | (13 ) |
| Net investment income | $471 | $433 | $1,366 | $1,267 |

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

| | Three months ended September 30, 2017 | | | | Three months ended September 30, 2016 | | | |
|---|---|---|---|---|---|---|---|---|
| | Realized gains (losses) | | | | Realized gains (losses) | | | |
| | Before Impairments | Impairments | Total | Change in Unrealized | Before Impairments | Impairments | Total | Change in Unrealized |
| Fixed maturities | $9 | $ (15) | $(6) | $ 133 | $5 | $ (2) | $3 | $ 52 |
| Equity securities | 19 | (29) | (10) | 24 | 14 | (16) | (2) | 89 |
| Mortgage loans and other investments | — | — | — | — | — | — | — | — |
| Other (*) | (2) | 6 | 4 | (53) | (1) | 2 | 1 | (5) |
| Total pretax | 26 | (38) | (12) | 104 | 18 | (16) | 2 | 136 |
| Tax effects | (9) | 13 | 4 | (37) | (7) | 5 | (2) | (48) |
| Noncontrolling interests | — | — | — | — | — | 1 | 1 | (1) |
| Net of tax and noncontrolling interests | $17 | $ (25) | $(8) | $ 67 | $11 | $ (10) | $1 | $ 87 |

| | Nine months ended September 30, 2017 | | | | Nine months ended September 30, 2016 | | | |
|---|---|---|---|---|---|---|---|---|
| | Realized gains (losses) | | | | Realized gains (losses) | | | |
| | Before Impairments | Impairments | Total | Change in Unrealized | Before Impairments | Impairments | Total | Change in Unrealized |
| Fixed maturities | $25 | $ (16) | $9 | $ 597 | $36 | $ (37) | $(1) | $ 1,089 |
| Equity securities | 29 | (49) | (20) | 116 | 46 | (83) | (37) | 77 |
| Mortgage loans and other investments | 3 | — | 3 | — | — | — | — | — |
| Other (*) | (5) | 12 | 7 | (248) | (7) | 13 | 6 | (478) |
| Total pretax | 52 | (53) | (1) | 465 | 75 | (107) | (32) | 688 |
| Tax effects | (18) | 18 | — | (163) | (27) | 38 | 11 | (241) |
| Noncontrolling interests | — | — | — | — | (1) | 3 | 2 | (7) |
| Net of tax and noncontrolling interests | $34 | $ (35) | $(1) | $ 302 | $47 | $ (66) | $(19) | $ 440 |

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

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

| | Nine months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Fixed maturities: | | |
| Gross gains | $32 | $44 |
| Gross losses | (4) | (8) |
| Equity securities: | | |
| Gross gains | 36 | 49 |
| Gross losses | (6) | (3) |

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F. Derivatives

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

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

| | | September 30, 2017 | | December 31, 2016 | |
|---|---|---|---|---|---|
| Derivative | Balance Sheet Line | Asset | Liability | Asset | Liability |
| MBS with embedded derivatives | Fixed maturities | $111 | $— | $107 | $— |
| Public company warrants | Equity securities | 3 | — | 4 | — |
| Fixed-indexed annuities (embedded derivative) | Annuity benefits accumulated | — | 2,293 | — | 1,759 |
| Equity index call options | Equity index call options | 629 | — | 492 | — |
| Reinsurance contracts (embedded derivative) | Other liabilities | — | 10 | — | 8 |
| | | $743 | $ 2,303 | $603 | $ 1,767 |

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 are required to be carried at fair value through earnings.

AFG’s fixed-indexed annuities 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 receives collateral from its counterparties to support its purchased call option assets. This collateral ($374 million at September 30, 2017 and $380 million at December 31, 2016) is included in other assets in AFG’s Balance Sheet with an offsetting liability to return the collateral, which is included in other liabilities. AFG’s strategy is designed so that the change in the fair value of the call option assets will generally offset the economic change in the liabilities from the index participation. Both the index-based component of the annuities and the related call options are considered derivatives. Fluctuations in interest rates and the stock market, among other factors, can cause volatility in the periodic measurement of fair value of the embedded derivative that management believes can be inconsistent with the long-term economics of these products.

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

The following table summarizes the gain (loss) included in AFG’s Statement of Earnings for changes in the fair value of derivatives that do not qualify for hedge accounting for the third quarter and first nine months of 2017 and 2016 (in millions):

| | Three months ended September | Nine months ended September 30, |
|---|---|---|

| Derivative | Statement of Earnings Line | 30, 2017 | 2016 | 2017 | 2016 |
|---|---|---|---|---|---|
| MBS with embedded derivatives | Realized gains on securities | $— | $(4) | $(3) | $— |
| Public company warrants | Realized gains on securities | (1) | 1 | (1) | — |
| Fixed-indexed annuities (embedded derivative) | Annuity benefits | (127) | (109) | (386) | (188) |
| Equity index call options | Annuity benefits | 116 | 105 | 338 | 81 |
| Reinsurance contracts (embedded derivative) | Net investment income | — | — | (2) | (6) |
| | | $(12) | $(7) | $(54) | $(113) |

Derivatives Designated and Qualifying as Cash Flow Hedges As of September 30, 2017, AFG has entered into eight interest rate swaps that are designated and qualify as highly effective cash flow hedges to mitigate interest rate risk related to certain floating-rate securities included in AFG's portfolio of fixed maturity securities. The purpose of each of these swaps is to effectively convert a portion of AFG's floating-rate fixed maturity securities to fixed rates by offsetting the variability in cash flows attributable to changes in short-term LIBOR.

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Under the terms of the swaps, AFG receives fixed-rate interest payments in exchange for variable interest payments based on short-term LIBOR. The notional amounts of the interest rate swaps generally decline over each swap's respective life (the swaps expire between August 2019 and June 2030) in anticipation of the expected decline in AFG's portfolio of fixed maturity securities with floating interest rates based on short-term LIBOR. The total outstanding notional amount of AFG's interest rate swaps was $1.35 billion at September 30, 2017 compared to $1.08 billion at December 31, 2016, reflecting a new swap with an aggregate notional amount at issuance of $400 million entered into in the third quarter of 2017, partially offset by the scheduled amortization discussed above. The fair value of the effective portion of the interest rate swaps in an asset position and included in other assets was $1 million at both September 30, 2017 and December 31, 2016. The fair value of the effective portion of the interest rate swaps in a liability position and included in other liabilities was $21 million at September 30, 2017 and $22 million at December 31, 2016. The net unrealized gain or loss on cash flow hedges is included in AOCI, net of DPAC and deferred taxes. Amounts reclassified from AOCI (before DPAC and taxes) to net investment income were $1 million and $2 million in the third quarters and $4 million and $5 million in the first nine months of 2017 and 2016, respectively. There was no ineffectiveness recorded in net earnings during these periods. A collateral receivable supporting these swaps of $60 million at both September 30, 2017 and December 31, 2016 is included in other assets in AFG's Balance Sheet.

Derivative Designated and Qualifying as a Fair Value Hedge   In June 2015, AFG entered into an interest rate swap to mitigate the interest rate risk associated with its fixed-rate 9-7/8% Senior Notes due June 2019 by effectively converting the interest rate on those notes to a floating rate of three-month LIBOR plus 8.099% (9.4190% at September 30, 2017). Since the terms of the interest rate swap match the terms of the hedged debt, changes in the fair value of the interest rate swap are offset by changes in the fair value of the hedged debt attributable to changes in interest rates. The fair value of the interest rate swap (a liability of less than $1 million at September 30, 2017 and an asset of $1 million at December 31, 2016) and the offsetting adjustment to the carrying value of the 9-7/8% Senior Notes are both included in long-term debt on AFG's Balance Sheet. Accordingly, the net impact on AFG's current period earnings is that the interest expense associated with the hedged debt is effectively recorded at the floating rate. The net reduction in interest expense from the swap was less than $1 million and $1 million in the third quarters and $1 million and $3 million in the first nine months of 2017 and 2016, respectively.

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G. Deferred Policy Acquisition Costs

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

| | P&C Deferred Costs | Annuity and Run-off Long-term Care and Life Deferred Costs | Sales Inducements | PVFP | Subtotal | Unrealized (*) | Total | Consolidated Total |
|---|---|---|---|---|---|---|---|---|
| Balance at June 30, 2017 | $ 258 | $1,167 | $ 103 | $42 | $1,312 | $ (414) | $898 | $ 1,156 |
| Additions | 149 | 44 | 1 | — | 45 | — | 45 | 194 |
| Amortization: | | | | | | | | |
| Periodic amortization | (142) | (44) | (4) | (2) | (50) | — | (50) | (192) |
| Included in realized gains | — | 4 | — | — | 4 | — | 4 | 4 |
| Foreign currency translation | 1 | — | — | — | — | — | — | 1 |
| Change in unrealized | — | — | — | — | — | (44) | (44) | (44) |
| Balance at September 30, 2017 | $ 266 | $1,171 | $ 100 | $40 | $1,311 | $ (458) | $853 | $ 1,119 |
| | | | | | | | | |
| Balance at June 30, 2016 | $ 234 | $1,089 | $ 116 | $51 | $1,256 | $ (609) | $647 | $ 881 |
| Additions | 132 | 48 | 1 | — | 49 | — | 49 | 181 |
| Amortization: | | | | | | | | |
| Periodic amortization | (134) | (42) | (6) | (3) | (51) | — | (51) | (185) |
| Included in realized gains | — | 1 | — | — | 1 | — | 1 | 1 |
| Foreign currency translation | (1) | — | — | — | — | — | — | (1) |
| Change in unrealized | — | — | — | — | — | (10) | (10) | (10) |
| Balance at September 30, 2016 | $ 231 | $1,096 | $ 111 | $48 | $1,255 | $ (619) | $636 | $ 867 |
| | | | | | | | | |
| Balance at December 31, 2016 | $ 238 | $1,110 | $ 110 | $46 | $1,266 | $ (265) | $1,001 | $ 1,239 |
| Additions | 439 | 177 | 3 | — | 180 | — | 180 | 619 |
| Amortization: | | | | | | | | |
| Periodic amortization | (413) | (122) | (14) | (6) | (142) | — | (142) | (555) |
| Included in realized gains | — | 6 | 1 | — | 7 | — | 7 | 7 |
| Foreign currency translation | 2 | — | — | — | — | — | — | 2 |
| Change in unrealized | — | — | — | — | — | (193) | (193) | (193) |
| Balance at September 30, 2017 | $ 266 | $1,171 | $ 100 | $40 | $1,311 | $ (458) | $853 | $ 1,119 |
| | | | | | | | | |
| Balance at December 31, 2015 | $ 226 | $1,018 | $ 119 | $55 | $1,192 | $ (234) | $958 | $ 1,184 |
| Additions | 403 | 172 | 8 | — | 180 | — | 180 | 583 |
| Amortization: | | | | | | | | |
| Periodic amortization | (396) | (99) | (17) | (7) | (123) | — | (123) | (519) |
| Included in realized gains | — | 5 | 1 | — | 6 | — | 6 | 6 |
| Foreign currency translation | (2) | — | — | — | — | — | — | (2) |
| Change in unrealized | — | — | — | — | — | (385) | (385) | (385) |
| Balance at September 30, 2016 | $ 231 | $1,096 | $ 111 | $48 | $1,255 | $ (619) | $636 | $ 867 |

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

The present value of future profits (“PVFP”) amounts in the table above are net of $140 million and $134 million of accumulated amortization at September 30, 2017 and December 31, 2016, respectively.

H. Managed Investment Entities

AFG is the investment manager and its subsidiaries have investments ranging from 15.0% to 60.9% of the most subordinate debt tranche of fifteen collateralized loan obligation entities or "CLOs," which are considered variable interest entities. AFG's subsidiaries also own portions of the senior debt tranches of certain of these CLOs. Upon formation between 2004 and 2017, 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 $261 million (including $197 million invested in the most subordinate tranches) at September 30, 2017, and $216 million at December 31, 2016.

In March 2017, AFG formed a new CLO, which issued $408 million face amount of liabilities (including $24 million face amount purchased by subsidiaries of AFG). During the first nine months of 2017, AFG subsidiaries also purchased $58 million face amount of senior debt and subordinate tranches of existing CLOs for $58 million. In May 2016, AFG formed a new CLO, which issued $406 million face amount of liabilities (including $36 million face amount purchased by subsidiaries of AFG). During the first nine months of 2016, AFG subsidiaries also purchased $19 million face amount of senior debt and subordinate tranches of existing CLOs for $15 million. During the first nine months of 2017 and 2016, AFG subsidiaries received $86 million and $69 million, respectively, in sale and redemption proceeds from its CLO investments. During the first nine months of 2017, two AFG CLOs were substantially liquidated, as permitted by the CLO indenture.

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 September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 |
| Investment in CLO tranches at end of period | $261 | $245 | $261 | $245 |
| Gains (losses) on change in fair value of assets/liabilities (a): | | | | |
| Assets | (8) | 60 | (12) | 107 |
| Liabilities | 9 | (49) | 24 | (98) |
| Management fees paid to AFG | 5 | 4 | 14 | 12 |
| CLO earnings (losses) attributable to AFG shareholders (b) | 5 | 17 | 16 | 29 |

(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 $66 million and $75 million at September 30, 2017 and December 31, 2016, respectively. The

aggregate unpaid principal balance of the CLOs' debt exceeded its carrying value by $135 million and $159 million at those dates. The CLO assets include loans with an aggregate fair value of $5 million at September 30, 2017 and $1 million at December 31, 2016, for which the CLOs are not accruing interest because the loans are in default (aggregate unpaid principal balance of $19 million and $10 million at those dates, respectively).

I. Goodwill and Other Intangibles

There were no changes in the goodwill balance of $199 million during the first nine months of 2017. Included in other assets in AFG's Balance Sheet is $29 million at September 30, 2017 and $34 million at December 31, 2016 in amortizable intangible assets related to property and casualty insurance acquisitions. These amounts are net of accumulated amortization of $28 million and $25 million, respectively. Amortization of intangibles was $2 million in both the third quarters of 2017 and 2016 and $6 million in both the first nine months of 2017 and 2016.

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J. Long-Term Debt

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

| | September 30, 2017 | | | December 31, 2016 | | |
|---|---|---|---|---|---|---|
| | Principal | Discount and Issue Costs | Carrying Value | Principal | Discount and Issue Costs | Carrying Value |
| Direct Senior Obligations of AFG: | | | | | | |
| 9-7/8% Senior Notes due June 2019 | $350 | $ (1) | $ 349 | $350 | $ (1) | $ 349 |
| 4.50% Senior Notes due June 2047 | 350 | (5) | 345 | — | — | — |
| 3.50% Senior Notes due August 2026 | 300 | (3) | 297 | 300 | (3) | 297 |
| 6-3/8% Senior Notes due June 2042 | — | — | — | 230 | (7) | 223 |
| 5-3/4% Senior Notes due August 2042 | — | — | — | 125 | (4) | 121 |
| Other | 3 | — | 3 | 3 | — | 3 |
| | 1,003 | (9) | 994 | 1,008 | (15) | 993 |
| Direct Subordinated Obligations of AFG: | | | | | | |
| 6-1/4% Subordinated Debentures due September 2054 | 150 | (5) | 145 | 150 | (5) | 145 |
| 6% Subordinated Debentures due November 2055 | 150 | (5) | 145 | 150 | (5) | 145 |
| | 300 | (10) | 290 | 300 | (10) | 290 |
| | $1,303 | $ (19) | $ 1,284 | $1,308 | $ (25) | $ 1,283 |

To achieve a desired balance between fixed and variable rate debt, AFG entered into an interest rate swap in June 2015, which effectively converts its 9-7/8% Senior Notes to a floating rate of three-month LIBOR plus 8.099% (9.4190% at September 30, 2017 and 9.0624% at December 31, 2016). The fair value of the interest rate swap (a liability of less than $1 million at September 30, 2017 and an asset of $1 million at December 31, 2016) and the offsetting adjustment to the carrying value of the notes are both included in the carrying value of the 9-7/8% Senior Notes in the table above.

Scheduled principal payments on debt for the balance of 2017, the subsequent five years and thereafter were as follows:
2017 — none; 2018 — none; 2019 — $350 million; 2020 — none; 2021 — none; 2022 — none and thereafter — $953 million

In June 2017, AFG issued $350 million in 4.50% Senior Notes due in 2047 at a price of 99.46%. The net proceeds were used to redeem AFG's $230 million outstanding principal amount of 6-3/8% Senior Notes due June 2042 at par value and to redeem AFG's $125 million outstanding principal amount of 5-3/4% Senior Notes due August 2042 at par value in June 2017 and August 2017, respectively.

AFG can borrow up to $500 million under its revolving credit facility, which expires in June 2021. Amounts borrowed under this agreement bear interest at rates ranging from 1.00% to 1.875% (currently 1.375%) over LIBOR based on AFG's credit rating. No amounts were borrowed under this facility at September 30, 2017 or December 31, 2016.

K. Shareholders' Equity

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — CONTINUED

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

| | AOCI Beginning Balance | Other Comprehensive Income | | | | | AOCI Ending Balance |
|---|---|---|---|---|---|---|---|
| | | Pretax | Tax | Net of tax | Attributable to noncontrolling interests | Attributable to shareholders | |
| Quarter ended September 30, 2017 | | | | | | | |
| Net unrealized gains on securities: | | | | | | | |
| Unrealized holding gains on securities arising during the period | | $92 | $(33) | $59 | $ — | $ 59 | |
| Reclassification adjustment for realized (gains) losses included in net earnings (a) | | 12 | (4) | 8 | — | 8 | |
| Total net unrealized gains on securities (b) | $ 639 | 104 | (37) | 67 | — | 67 | $ 706 |
| Net unrealized losses on cash flow hedges | (6) | (1) | 1 | — | — | — | (6) |
| Foreign currency translation adjustments | (11) | 5 | 2 | 7 | — | 7 | (4) |
| Pension and other postretirement plans adjustments | (7) | — | — | — | — | — | (7) |
| Total | $ 615 | $108 | $(34) | $74 | $ — | $ 74 | $ 689 |
| | | | | | | | |
| Quarter ended September 30, 2016 | | | | | | | |
| Net unrealized gains on securities: | | | | | | | |
| Unrealized holding gains on securities arising during the period | | $138 | $(49) | $89 | $ (1) | $ 88 | |
| Reclassification adjustment for realized (gains) losses included in net earnings (a) | | (2) | 1 | (1) | — | (1) | |
| Total net unrealized gains on securities | $ 685 | 136 | (48) | 88 | (1) | 87 | $ 772 |
| Net unrealized gains (losses) on cash flow hedges | 5 | (1) | 1 | — | — | — | 5 |
| Foreign currency translation adjustments | (15) | (2) | (1) | (3) | — | (3) | (18) |
| Pension and other postretirement plans adjustments | (6) | — | — | — | — | — | (6) |
| Total | $ 669 | $133 | $(48) | $85 | $ (1) | $ 84 | $ 753 |
| | | | | | | | |
| Nine months ended September 30, 2017 | | | | | | | |
| Net unrealized gains on securities: | | | | | | | |
| Unrealized holding gains on securities arising during the period | | $461 | $(162) | $299 | $ — | $ 299 | |
| Reclassification adjustment for realized (gains) losses included in net earnings (a) | | 4 | (1) | 3 | — | 3 | |
| Total net unrealized gains on securities (b) | $ 404 | 465 | (163) | 302 | — | 302 | $ 706 |
| Net unrealized gains (losses) on cash flow hedges | (7) | 1 | — | 1 | — | 1 | (6) |
| Foreign currency translation adjustments | (15) | 8 | 3 | 11 | — | 11 | (4) |
| Pension and other postretirement plans adjustments | (7) | — | — | — | — | — | (7) |
| Total | $ 375 | $474 | $(160) | $314 | $ — | $ 314 | $ 689 |
| | | | | | | | |
| Nine months ended September 30, 2016 | | | | | | | |
| Net unrealized gains on securities: | | | | | | | |
| Unrealized holding gains on securities arising during the period | | $656 | $(229) | $427 | $ (6) | $ 421 | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Reclassification adjustment for realized (gains) losses included in net earnings (a) | | 32 | (12) | 20 | (1) | 19 | |
| Total net unrealized gains on securities | $ 332 | 688 | (241) | 447 | (7) | 440 | $ 772 |
| Net unrealized gains on cash flow hedges | 1 | 6 | (2) | 4 | — | 4 | 5 |
| Foreign currency translation adjustments | (22) | 2 | 2 | 4 | — | 4 | (18) |
| Pension and other postretirement plans adjustments | (7) | 1 | — | 1 | — | 1 | (6) |
| Total | $ 304 | $ 697 | $ (241) | $ 456 | $ (7) | $ 449 | $ 753 |

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

| OCI component | Affected line in the statement of earnings |
| --- | --- |
| Pretax | Realized gains (losses) on securities |
| Tax | Provision for income taxes |
| Attributable to noncontrolling interests | Net earnings (loss) attributable to noncontrolling interests |

(b) Includes net unrealized gains of $58 million at September 30, 2017 compared to $56 million at June 30, 2017 and $52 million at December 31, 2016 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 nine months of 2017, AFG issued 232,250 shares of restricted Common Stock (fair value of $94.44 per share) under the Stock Incentive Plan. In addition, AFG issued 47,826 shares of Common Stock (fair value of $96.13 per share) in the first quarter of 2017 under the Equity Bonus Plan. AFG did not grant any stock options in the first nine months of 2017.

Total compensation expense related to stock incentive plans of AFG and its subsidiaries was $7 million and $7 million in the third quarters of 2017 and 2016 and $24 million and $21 million in the first nine months of 2017 and 2016, 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 AFG's Statement of Earnings (dollars in millions):

| | Three months ended September 30, | | | | Nine months ended September 30, | | | |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| | 2017 | | 2016 | | 2017 | | 2016 | |
| | Amount | % of EBT | Amount | % of EBT | Amount | % of EBT | Amount | % of EBT |
| Earnings before income taxes ("EBT") | $29 | | $178 | | $457 | | $470 | |
| Income taxes at statutory rate | $10 | 35 % | $63 | 35% | $160 | 35% | $165 | 35% |
| Effect of: | | | | | | | | |
| Stock-based compensation | (1 ) | (3 %) | — | —% | (14 ) | (3 %) | — | —% |
| Tax exempt interest | (5 ) | (17%) | (5 ) | (3 %) | (17 ) | (4 %) | (18 ) | (4 %) |
| Dividends received deduction | (2 ) | (7 %) | (1 ) | (1 %) | (6 ) | (1 %) | (5 ) | (1 %) |
| Employee Stock Ownership Plan dividends paid deduction | — | — % | — | —% | (2 ) | —% | (1 ) | —% |
| Change in valuation allowance | 16 | 55 % | 7 | 4 % | 16 | 4 % | 40 | 9 % |
| Subsidiaries not in AFG's tax return | — | — % | 2 | 1 % | — | —% | 4 | 1 % |
| Other | — | (1 %) | (1 ) | 1 % | 9 | 1 % | 5 | —% |
| Provision for income taxes as shown in the statement of earnings | $18 | 62 % | $65 | 37% | $146 | 32% | $190 | 40% |

AFG's effective tax rate for the three months ended September 30, 2017 reflects the impact of catastrophe losses in the Neon Lloyd's insurance business for which no tax benefit is recognized. AFG maintains a full valuation allowance against the deferred tax benefits associated with losses related to Neon. Excluding the $53 million in catastrophe

losses at Neon, AFG's effective tax rate for the three months ended September 30, 2017 was 22%, which reflects the impact of a typical level of tax-favored investment income on lower earnings before income taxes. Excluding the $65 million charge in the second quarter of 2016 related to the exit of certain lines of business within Neon, AFG's effective tax rate for the nine months ended September 30, 2016, was 36%. The favorable impact of stock-based compensation on AFG's effective tax rate in the first nine months of 2017 reflects the high volume of employee stock option exercises during that period and the increase in the market price of AFG Common Stock.

Approximately $13 million of AFG's net operating loss carryforwards ("NOL") subject to separate return limitation year ("SRLY") tax rules will expire unutilized at December 31, 2017. Since AFG maintains a full valuation allowance against its SRLY NOLs, the expiration of these loss carryforwards will be offset by a corresponding reduction in the valuation allowance and will have no overall impact on AFG's income tax expense or results of operations.

During the first nine months of 2017, there were no material changes to AFG's liability for uncertain tax positions.

M. Contingencies

There have been no significant changes to the matters discussed and referred to in Note M — "Contingencies" of AFG's 2016 Form 10-K, which covers property and casualty insurance reserves for claims related to environmental exposures, asbestos and other mass tort claims and environmental and occupational injury and disease claims of former subsidiary railroad and manufacturing operations, as well as contingencies related to the sale of substantially all of AFG's run-off long-term care insurance business.

N. Insurance

Property and Casualty Insurance Reserves The following table provides an analysis of changes in the liability for losses and loss adjustment expenses during the first nine months of 2017 and 2016 (in millions):

| | Nine months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Balance at beginning of year | $8,563 | $8,127 |
| Less reinsurance recoverables, net of allowance | 2,302 | 2,201 |
| Net liability at beginning of year | 6,261 | 5,926 |
| Provision for losses and LAE occurring in the current period | 2,237 | 2,011 |
| Net increase (decrease) in the provision for claims of prior years: | | |
| Special A&E charges | 89 | 36 |
| Neon exited lines charge | — | 57 |
| Other | (87) | (71) |
| Total losses and LAE incurred | 2,239 | 2,033 |
| Payments for losses and LAE of: | | |
| Current year | (530) | (463) |
| Prior years | (1,272) | (1,206) |
| Total payments | (1,802) | (1,669) |
| Foreign currency translation and other | 32 | (3) |
| Net liability at end of period | 6,730 | 6,287 |
| Add back reinsurance recoverables, net of allowance | 2,833 | 2,374 |
| Gross unpaid losses and LAE included in the balance sheet at end of period | $9,563 | $8,661 |

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

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

The net increase in the provision for claims of prior years during the first nine months of 2016 reflects (i) the $36 million special charge to increase asbestos and environmental reserves, (ii) adverse reserve development at Neon, higher than anticipated severity in New York contractor claims and higher than anticipated claim severity in the general liability insurance (all within the Specialty casualty sub-segment), (iii) the $57 million special charge to increase loss reserves related to Neon's exit of its UK and international medical malpractice and general liability lines of business and (iv) higher than anticipated claim frequency in the financial institutions business (within the Specialty financial sub-segment). This adverse development was partially offset by (i) lower than expected losses in the crop business and lower than expected claim severity in the property and inland marine and trucking businesses (all within the Property and transportation sub-segment), (ii) lower than anticipated claim

severity in workers' compensation business and directors and officers liability insurance and lower than expected claim frequency and severity in excess liability business (all within the Specialty casualty sub-segment) and (iii) lower than anticipated claim severity in the fidelity business and lower than expected claim frequency and severity in the surety business (all within the Specialty financial sub-segment).

Reinsurance Subsequent to Hurricane Irma, AFG's property and casualty operations purchased replacement reinsurance coverage for those layers of the catastrophe reinsurance program expected to be affected by Hurricanes Harvey and Irma. The following table presents (by type of coverage) the amount of each loss above the specified retention covered by treaty reinsurance programs in AFG's property and casualty insurance operations (in millions) as of October 1, 2017:

| | | Reinsurance Coverage | | | AFG |
|---|---|---|---|---|---|
| | | | AFG Participation (a) | | |
| | Primary Retention | Coverage Amount | % | $ | Maximum Loss (b) |
| U.S.-based operations: | | | | | |
| California Workers' Compensation | $ 2 | $148 | 1 % | $ 1 | $ 3 |
| Other Workers' Compensation | 3 | 37 | — % | — | 3 |
| Commercial Umbrella | 1 | 49 | 13 % | 6 | 7 |
| Property — General | 5 | 45 | — % | — | 5 |
| Property — Catastrophe | 15 | 85 | 5 % | 4 | 19 |
| Neon Lloyd's Syndicate | 15 | 210 | — % | — | 15 |
| Riverfront Re Ltd. catastrophe bond (c) | 100 | 200 | 5 % | 10 | N/A |

(a) Includes the participation of AFG's internal reinsurance program.
(b) Maximum loss for claims up to reinsurance coverage limit.
(c) Includes aggregate coverage. See description below.

In June 2017, AFG's property and casualty insurance subsidiaries entered into a reinsurance agreement to obtain supplemental catastrophe protection through a catastrophe bond structure with Riverfront Re Ltd. ("Riverfront"). The reinsurance agreement provides supplemental reinsurance coverage up to 95% of $200 million (fully collateralized) for catastrophe losses in excess of $100 million (per occurrence and annual aggregate) occurring between June 1, 2017 and December 31, 2020. In connection with the reinsurance agreement, Riverfront issued notes to unrelated investors for the full amount of coverage provided under the reinsurance agreement. Through September 30, 2017, AFG's incurred catastrophe losses have not reached the level of attachment for the catastrophe bond structure. Riverfront is a variable interest entity in which AFG does not have a variable interest because the variability in Riverfront's results will be absorbed entirely by the investors in Riverfront. Accordingly, Riverfront is not consolidated in AFG's financial statements and the reinsurance agreement is accounted for as ceded reinsurance. AFG's cost for this coverage is approximately $11 million per year.

O. Subsequent Event

Wildfires struck northern California's wine region in October 2017, which will result in fourth quarter 2017 catastrophe losses in AFG's property and casualty insurance segment. Based on information available as of the filing of this Form 10-Q, management estimates a pretax loss from these events, net of reinsurance and inclusive of reinstatement premiums and other associated offsets, in the range of $20 million to $25 million. At the midpoint of

that range, AFG's earnings per share would be negatively impacted by approximately $0.18.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

ITEM 2

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

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## FORWARD-LOOKING STATEMENTS

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

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

- changes in financial, political and economic conditions, including changes in interest and inflation rates, currency fluctuations and extended economic recessions or expansions in the U.S. and/or abroad;
- performance of securities markets;
- new legislation or declines in credit quality or credit ratings that could have a material impact on the valuation of securities in AFG's investment portfolio;
- the availability of capital;
- regulatory actions (including changes in statutory accounting rules);
- changes in the legal environment affecting AFG or its customers;
- tax law and accounting changes;
- levels of natural catastrophes and severe weather, terrorist activities (including any nuclear, biological, chemical or radiological events), incidents of war or losses resulting from civil unrest and other major losses;
- development of insurance loss reserves and establishment of other reserves, particularly with respect to amounts associated with asbestos and environmental claims;
- availability of reinsurance and ability of reinsurers to pay their obligations;
- trends in persistency and mortality;
- competitive pressures, including as a result of the outcome of U.S. business tax reform efforts;
- the ability to obtain adequate rates and policy terms;

- changes in AFG’s credit ratings or the financial strength ratings assigned by major ratings agencies to AFG’s operating subsidiaries; and
- the impact of the conditions in the international financial markets and the global economy (including those associated with the United Kingdom’s expected withdrawal from the European Union, or “Brexit”) relating to AFG’s international operations.

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

## OVERVIEW

### Financial Condition

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

### Results of Operations

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

Net earnings attributable to AFG's shareholders for the third quarter and first nine months of 2017 were $11 million ($0.13 per share, diluted) and $309 million ($3.44 per share, diluted), respectively, compared to $109 million ($1.23 per share, diluted) and $264 million ($2.98 per share, diluted) reported in the same periods of 2016, reflecting:

- lower underwriting profit in the property and casualty insurance segment due primarily to higher catastrophe losses and higher special charges to increase asbestos and environmental reserves, partially offset by the impact of a second quarter 2016 charge related to the exit of certain lines of business within Neon Underwriting Ltd. ("Neon"), AFG's Lloyd's-based insurer,
- higher net investment income in the property and casualty insurance segment,
- realized losses on securities in the third quarter of 2017 compared to realized gains in the third quarter of 2016 and lower realized losses in the first nine months of 2017 compared to the first nine months of 2016,
- for the nine month period, higher earnings in the annuity segment, and
- the impact of the gain on the sale of an apartment property in the second quarter of 2016.

## CRITICAL ACCOUNTING POLICIES

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

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

For a discussion of these policies, see Management's Discussion and Analysis — "Critical Accounting Policies" in AFG's 2016 Form 10-K.

LIQUIDITY AND CAPITAL RESOURCES

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

| | September 30, 2017 | December 31, 2016 | December 31, 2015 |
|---|---|---|---|
| Principal amount of long-term debt | $ 1,303 | $1,308 | $1,020 |
| Total capital | 6,149 | 5,921 | 5,512 |
| Ratio of debt to total capital: | | | |
| Including subordinated debt | 21.2 % | 22.1 % | 18.5 % |
| Excluding subordinated debt | 16.3 % | 17.0 % | 13.1 % |

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

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 1.62 for the nine months ended September 30, 2017 and 1.85 for the year ended December 31, 2016. Excluding annuity benefits, this ratio was 6.45 and 8.62, respectively. Although the ratio excluding annuity benefits is not required or encouraged to be disclosed under Securities and Exchange Commission rules, it is presented because interest credited to annuity policyholder accounts is not always considered a borrowing cost for an insurance company.

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

| | Nine months ended September 30, 2017 | 2016 |
|---|---|---|
| Net cash provided by operating activities | $993 | $746 |
| Net cash used in investing activities | (2,230) | (2,519) |
| Net cash provided by financing activities | 1,479 | 2,192 |
| Net change in cash and cash equivalents | $242 | $419 |

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

operating expenses. Interest credited on annuity policyholder funds is a non-cash increase in AFG's annuity benefits accumulated liability and annuity premiums, benefits and withdrawals are considered financing activities due to the deposit-type nature of annuities. Cash flows provided by operating activities also includes the activity of AFG's managed investment entities (collateralized loan obligations) other than those activities included in investing or financing activities. The changes in the assets and liabilities of the managed investment entities included in operating activities increased cash flows from operating activities by $14 million during the first nine months of 2017 and reduced cash flows from operating activities by $235 million in the first nine months of 2016, accounting for a $249 million increase in cash flows from operating activities in the 2017 period compared to the 2016 period. As discussed in Note A — "Accounting Policies — Managed Investment Entities" to the financial statements, AFG has no right to use the CLO assets and no obligation to pay the CLO liabilities and such assets and liabilities are shown separately in AFG's Balance Sheet. Excluding the impact of the managed investment entities, net cash flows provided by operating activities were

$979 million in the first nine months of 2017 compared to $981 million in the first nine months of 2016, a decrease of $2 million.

Net Cash Used in Investing Activities AFG's investing activities consist primarily of the investment of funds provided by its property and casualty and annuity products. Net cash used in investing activities was $2.23 billion for the first nine months of 2017 compared to $2.52 billion in the first nine months of 2016, a decrease of $289 million reflecting the timing of investing available cash. As discussed below, AFG's annuity group had net cash flows from annuity policyholders of $1.75 billion in the first nine months of 2017 and $1.78 billion in the first nine months of 2016, which is the primary source of AFG's cash used in investing activities. Settlements of equity index call options exceeded purchases by $201 million in the first nine months of 2017 compared to purchases exceeding settlements by $124 million in the first nine months of 2016, accounting for a $325 million decrease in cash used in investing activities. In general, purchases of equity index call options have increased due to growth in the fixed-indexed annuity business while proceeds from settlements of equity options are impacted by the performance of the stock market during the term of the options. In addition to the investment of funds provided by the insurance operations, investing activities also include the purchase and disposal of managed investment entity investments, which are presented separately in AFG's Balance Sheet. Net investment activity in the managed investment entities was a $13 million source of cash in the first nine months of 2017 compared to a $24 million use of cash in the 2016 period, accounting for a $37 million decrease in net cash used in investing activities in the first nine months of 2017 compared to the same 2016 period. See Note A — "Accounting Policies — Managed Investment Entities" and Note H — "Managed Investment Entities" to the financial statements.

Net Cash Provided by Financing Activities AFG's financing activities consist primarily of transactions with annuity policyholders, issuances and retirements of long-term debt, repurchases of common stock and dividend payments. Net cash provided by financing activities was $1.48 billion for the first nine months of 2017 compared to $2.19 billion in the first nine months of 2016, a decrease of $713 million. Annuity receipts exceeded annuity surrenders, benefits, withdrawals and transfers by $1.75 billion in the first nine months of 2017 compared to $1.78 billion in the first nine months of 2016 accounting for a $27 million decrease in net cash provided by financing activities in the 2017 period compared to the 2016 period. In June 2017, AFG issued $350 million of 4.50% Senior Notes due 2047, the net proceeds of which contributed $345 million to net cash provided by financing activities in the first nine months of 2017 compared to net proceeds from additional long-term borrowings of $302 million in the first nine months of 2016. Redemptions of long-term debt were a $355 million use of cash in the first nine months of 2017 compared to no redemptions of long-term debt in 2016. There were no shares of AFG Common Stock repurchased during the first nine months of 2017 compared to $124 million repurchased in the first nine months of 2016, which accounted for a $124 million increase in net cash provided by financing activities in the 2017 period compared to the 2016 period. In May 2017, AFG paid a special cash dividend of $1.50 per share of American Financial Group Common Stock, which was in addition to its regular quarterly cash dividend. The aggregate amount of the special cash dividend was $132 million, which decreased net cash provided by financing activities. Financing activities also include issuances and retirements of managed investment entity liabilities, which are nonrecourse to AFG and presented separately in AFG's Balance Sheet. Retirements of managed investment entity liabilities exceeded issuances by $72 million in the first nine months of 2017 compared to issuances exceeding retirements by $281 million in the first nine months of 2016, accounting for a $353 million decrease in net cash provided by financing activities in the 2017 period compared to the 2016 period. See Note A — "Accounting Policies — Managed Investment Entities" and Note H — "Managed Investment Entities" to the financial statements.

Parent and Subsidiary Liquidity

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

In June 2016, AFG replaced its bank credit facility with a five-year, $500 million revolving credit line. Amounts borrowed under this agreement bear interest at rates ranging from 1.00% to 1.875% (currently 1.375%) over LIBOR based on AFG's credit rating. There were no borrowings under this agreement, or under any other parent company short-term borrowing arrangements, during 2016 or the first nine months of 2017.

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

In May 2017, AFG paid a special cash dividend of $1.50 per share of AFG Common Stock totaling $132 million.

In November 2016, AFG acquired the 49% of National Interstate Corporation ("NATL") not previously owned by AFG's wholly-owned subsidiary, Great American Insurance Company ("GAI") for $315 million ($32.00 per share) in cash in a merger transaction. In addition, NATL paid a one-time special cash dividend of $0.50 per share to its shareholders immediately prior to the merger closing ($5 million was paid to noncontrolling shareholders).

In August 2016, AFG issued $300 million of 3.50% Senior Notes due 2026. AFG used the net proceeds from the offering to fund a portion of the acquisition of NATL mentioned above.

During 2016, AFG repurchased 1.9 million shares of its Common Stock for $133 million.

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

Subsidiary Liquidity   Great American Life Insurance Company ("GALIC"), a wholly-owned annuity subsidiary, is a member of the Federal Home Loan Bank of Cincinnati ("FHLB"). The FHLB makes advances and provides other banking services to member institutions, which provides the annuity operations with an additional source of liquidity. These advances further the FHLB's mission of improving access to housing by increasing liquidity in the residential mortgage-backed securities market. At September 30, 2017, GALIC had $935 million in outstanding advances from the FHLB (included in annuity benefits accumulated), bearing interest at rates ranging from 0.03% to 0.53% over LIBOR (average rate of 1.60% at September 30, 2017). While these advances must be repaid between 2018 and 2021 ($285 million in 2018, $500 million in 2020 and $150 million in 2021), GALIC has the option to prepay all or a portion of the advances. GALIC has invested the proceeds from the advances in fixed maturity securities with similar expected lives as the advances for the purpose of earning a spread over the interest payments due to the FHLB. At September 30, 2017, GALIC estimated that it had additional borrowing capacity of approximately $250 million from the FHLB.

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

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

In the annuity business, where profitability is largely dependent on earning a spread between invested assets and annuity liabilities, the duration of investments is generally maintained close to that of liabilities. In a rising interest rate environment, significant protection from withdrawals exists in the form of temporary and permanent surrender charges on AFG's annuity products. With declining rates, AFG receives some protection (from spread compression) due to the ability to lower crediting rates, subject to contractually guaranteed minimum interest rates ("GMIRs"). AFG began selling policies with GMIRs below 2% in 2003; almost all new business since late 2010 has been issued with a 1% GMIR. At September 30, 2017, AFG could reduce the average crediting rate on approximately $24 billion of traditional fixed and fixed-indexed annuities without guaranteed withdrawal benefits by approximately 88 basis points (on a weighted average basis). Annuity policies are subject to GMIRs at policy issuance. The table below shows the breakdown of annuity reserves by GMIR. The current interest crediting rates on substantially all of AFG's annuities with a GMIR of 3% or higher are at their minimum.

| | % of Reserves | | |
|---|---|---|---|
| | September 30, | December 31, | |
| GMIR | 2017 | 2016 | 2015 |
| 1 — 1.99% | 75% | 72% | 67% |
| 2 — 2.99% | 5% | 6% | 7% |
| 3 — 3.99% | 10% | 12% | 14% |
| 4.00% and above | 10% | 10% | 12% |
| | | | |
| Annuity benefits accumulated (in millions) | $32,671 | $29,907 | $26,622 |

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

Investments   AFG's investment portfolio at September 30, 2017, contained $37.82 billion in fixed maturity securities and $1.58 billion in equity securities classified as available for sale and carried at fair value with unrealized gains and losses included in a separate component of shareholders' equity on an after-tax basis. In addition, $350 million in fixed maturities and $60 million in equity securities were classified as trading with changes in unrealized holding gains or losses included in net investment income.

Fair values for AFG's portfolio are determined by AFG's internal investment professionals using data from nationally recognized pricing services as well as non-binding broker quotes. Fair values of equity securities are generally based on published closing prices. For mortgage-backed securities ("MBS"), which comprise approximately 12% of AFG's fixed maturities, prices for each security are generally obtained from both pricing services and broker quotes. For the remainder of AFG's fixed maturity portfolio, approximately 76% are priced using pricing services and the balance is priced primarily by using non-binding broker quotes. When prices obtained for the same security vary, AFG's internal investment professionals select the price they believe is most indicative of an exit price.

The pricing services use a variety of observable inputs to estimate fair value of fixed maturities that do not trade on a daily basis. Based upon information provided by the pricing services, these inputs include, but are not limited to, recent reported trades, benchmark yields, issuer spreads, bids or offers, reference data, and measures of volatility.

Included in the pricing of MBS are estimates of the rate of future prepayments and defaults of principal over the remaining life of the underlying collateral. Due to the lack of transparency in the process that brokers use to develop prices, valuations that are based on brokers' prices are classified as Level 3 in the GAAP hierarchy unless the price can be corroborated, for example, by comparison to similar securities priced using observable inputs.

Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by AFG's internal investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, these investment managers consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. In addition, AFG communicates directly with pricing services regarding the methods and assumptions used in pricing, including verifying, on a test basis, the inputs used by the services to value specific securities.

In general, the fair value of AFG's fixed maturity investments is inversely correlated to changes in interest rates. The following table demonstrates the sensitivity of such fair values to reasonably likely changes in interest rates by illustrating the estimated effect on AFG's fixed maturity portfolio and accumulated other comprehensive income that an immediate increase of 100 basis points in the interest rate yield curve would have at September 30, 2017 (dollars in millions). Effects of increases or decreases from the 100 basis points illustrated would be approximately proportional.

| | |
|---|---|
| Fair value of fixed maturity portfolio | $38,168 |
| Percentage impact on fair value of 100 bps increase in interest rates | (5.0 %) |
| Pretax impact on fair value of fixed maturity portfolio | $(1,908 ) |
| Offsetting adjustments to deferred policy acquisition costs and other balance sheet amounts | 750 |
| Estimated pretax impact on accumulated other comprehensive income | (1,158 ) |
| Deferred income tax | 405 |
| Estimated after-tax impact on accumulated other comprehensive income | $(753 ) |

Approximately 90% of the fixed maturities held by AFG at September 30, 2017, were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated and non-investment grade. Management believes that the high quality investment portfolio should generate a stable and predictable investment return.

MBS are subject to significant prepayment risk due to the fact that, in periods of declining interest rates, mortgages may be repaid more rapidly than scheduled as borrowers refinance higher rate mortgages to take advantage of lower rates. Although interest rates have been low in recent years, tighter lending standards have resulted in fewer buyers being able to refinance the mortgages underlying much of AFG's non-agency residential MBS portfolio.

Summarized information for AFG's MBS (including those classified as trading) at September 30, 2017, is shown in the table below (dollars in millions). Agency-backed securities are those issued by a U.S. government-backed agency; Alt-A mortgages are those with risk profiles between prime and subprime. The average life of the residential and commercial MBS is approximately 4-1/2 years and 5-1/2 years, respectively.

| | Amortized Cost | Fair Value | Fair Value as % of Cost | Unrealized Gain (Loss) | % Rated Investment Grade |
|---|---|---|---|---|---|
| Collateral type | | | | | |
| Residential: | | | | | |
| Agency-backed | $ 218 | $ 218 | 100 % | $ — | 100 % |
| Non-agency prime | 1,283 | 1,452 | 113 % | 169 | 28 % |
| Alt-A | 1,049 | 1,167 | 111 % | 118 | 15 % |
| Subprime | 515 | 562 | 109 % | 47 | 22 % |
| Commercial | 967 | 1,010 | 104 % | 43 | 95 % |
| | $ 4,032 | $ 4,409 | 109 % | $ 377 | 43 % |

The National Association of Insurance Commissioners ("NAIC") assigns creditworthiness designations on a scale of 1 to 6 with 1 being the highest quality and 6 being the lowest quality. The NAIC retains third-party investment management firms to assist in the determination of appropriate NAIC designations for MBS based not only on the probability of loss (which is the primary basis of ratings by the major ratings firms), but also on the severity of loss and statutory carrying value. At September 30, 2017, 96% (based on statutory carrying value of $3.97 billion) of AFG's MBS had an NAIC designation of 1.

Municipal bonds represented approximately 18% of AFG's fixed maturity portfolio at September 30, 2017. AFG's municipal bond portfolio is high quality, with 99% of the securities rated investment grade at that date. The portfolio is well diversified across the states of issuance and individual issuers. At September 30, 2017, approximately 76% of the municipal bond portfolio was held in revenue bonds, with the remaining 24% held in general obligation bonds. General obligation securities of California, Illinois and Michigan collectively represented approximately 1% of this portfolio. AFG does not own general obligation bonds issued by New Jersey, New York or Puerto Rico.

Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at September 30, 2017, is shown in the following table (dollars in millions). Approximately $674 million of available for sale fixed maturity securities and $84 million of available for sale equity securities had no unrealized gains or losses at September 30, 2017.

| | Securities With Unrealized Gains | Securities With Unrealized Losses |
|---|---|---|
| Available for Sale Fixed Maturities | | |
| Fair value of securities | $32,183 | $4,961 |
| Amortized cost of securities | $30,692 | $5,046 |
| Gross unrealized gain (loss) | $1,491 | $(85) |
| Fair value as % of amortized cost | 105% | 98% |
| Number of security positions | 4,487 | 735 |
| Number individually exceeding $2 million gain or loss | 80 | — |
| Concentration of gains (losses) by type or industry (exceeding 5% of unrealized): | | |
| Mortgage-backed securities | $385 | $(8) |
| States and municipalities | 259 | (23) |
| Banks, savings and credit institutions | 174 | (5) |
| Asset-backed securities | 143 | (15) |
| Manufacturing | 127 | (8) |
| Oil and gas extraction | 22 | (4) |
| Percentage rated investment grade | 91% | 88% |
| | | |
| Available for Sale Equity Securities | | |
| Fair value of securities | $1,318 | $177 |
| Cost of securities | $1,023 | $205 |
| Gross unrealized gain (loss) | $295 | $(28) |
| Fair value as % of cost | 129% | 86% |
| Number of security positions | 176 | 24 |
| Number individually exceeding $2 million gain or loss | 34 | 7 |

The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at September 30, 2017, based on their fair values. Securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

| | Securities With Unrealized Gains | Securities With Unrealized Losses |
|---|---|---|
| Maturity | | |
| One year or less | 2% | 2% |
| After one year through five years | 19% | 15% |
| After five years through ten years | 37% | 34% |
| After ten years | 12% | 18% |
| | 70% | 69% |
| Asset-backed securities (average life of approximately 5 years) | 18% | 22% |

| | | | | |
|---|---|---|---|---|
| Mortgage-backed securities (average life of approximately 4-1/2 years) | 12 | % | 9 | % |
| | 100 | % | 100 | % |

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

| | Aggregate Fair Value | Aggregate Unrealized Gain (Loss) | Fair Value as % of Cost |
|---|---|---|---|
| Fixed Maturities at September 30, 2017 | | | |
| Securities with unrealized gains: | | | |
| Exceeding $500,000 (887 securities) | $ 12,972 | $ 970 | 108 % |
| $500,000 or less (3,600 securities) | 19,211 | 521 | 103 % |
| | $ 32,183 | $ 1,491 | 105 % |
| Securities with unrealized losses: | | | |
| Exceeding $500,000 (39 securities) | $ 649 | $ (34 ) | 95 % |
| $500,000 or less (696 securities) | 4,312 | (51 ) | 99 % |
| | $ 4,961 | $ (85 ) | 98 % |

The following table (dollars in millions) summarizes the unrealized losses for all securities with unrealized losses by issuer quality and the length of time those securities have been in an unrealized loss position:

| | Aggregate Fair Value | Aggregate Unrealized Loss | Fair Value as % of Cost |
|---|---|---|---|
| Securities with Unrealized Losses at September 30, 2017 | | | |
| Investment grade fixed maturities with losses for: | | | |
| Less than one year (498 securities) | $ 3,682 | $ (45 ) | 99 % |
| One year or longer (116 securities) | 663 | (17 ) | 98 % |
| | $ 4,345 | $ (62 ) | 99 % |
| Non-investment grade fixed maturities with losses for: | | | |
| Less than one year (71 securities) | $ 318 | $ (7 ) | 98 % |
| One year or longer (50 securities) | 298 | (16 ) | 95 % |
| | $ 616 | $ (23 ) | 96 % |
| Common stocks with losses for: | | | |
| Less than one year (19 securities) | $ 141 | $ (27 ) | 84 % |
| One year or longer (none) | — | — | — % |
| | $ 141 | $ (27 ) | 84 % |
| Perpetual preferred stocks with losses for: | | | |
| Less than one year (2 securities) | $ 23 | $ — | 100 % |
| One year or longer (3 securities) | 13 | (1 ) | 93 % |
| | $ 36 | $ (1 ) | 97 % |

When a decline in the value of a specific investment is considered to be other-than-temporary, a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced by the amount of the charge. The determination of whether unrealized losses are other-than-temporary requires judgment based on subjective as well as objective factors as detailed in AFG's 2016 Form 10-K under Management's Discussion and Analysis — "Investments."

Based on its analysis, management believes AFG will recover its cost basis in the securities with unrealized losses and that AFG has the ability to hold the securities until they recover in value and had no intent to sell them at

September 30, 2017. Although AFG has the ability to continue holding its investments with unrealized losses, its intent to hold them may change due to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a particular issuer or industry, asset/liability management decisions, market movements, changes in views about appropriate asset allocation or the desire to offset taxable realized gains. Should AFG's ability or intent change with regard to a particular security, a charge for impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other-than-temporary impairment could be material to results of operations in future periods. Significant declines in the fair value of AFG's investment portfolio could have a significant adverse effect on AFG's liquidity. For information on AFG's realized gains

(losses) on securities, including charges for other-than-temporary impairment, see "Results of Operations — Consolidated Realized Gains (Losses) on Securities."

Uncertainties Management believes that the areas posing the greatest risk of material loss are the adequacy of its insurance reserves and contingencies arising out of its former railroad and manufacturing operations. See "Special asbestos and environmental reserve charges" under "Results of Operations — Property and Casualty Insurance Segment — Net prior year reserve development" for the quarters ended September 30, 2017 and 2016 and Management's Discussion and Analysis — "Uncertainties — Asbestos and Environmental-related ("A&E") Insurance Reserves" in AFG's 2016 Form 10-K.

MANAGED INVESTMENT ENTITIES

Accounting standards require AFG to consolidate its investments in collateralized loan obligation ("CLO") entities that it manages and owns an interest in (in the form of debt). See Note A — "Accounting Policies — Managed Investment Entities" and Note H — "Managed Investment Entities" to the financial statements. The effect of consolidating these entities is shown in the tables below (in millions). The "Before CLO Consolidation" columns include AFG's investment and earnings in the CLOs on an unconsolidated basis.

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AMERICAN FINANCIAL GROUP, INC. 10-Q
Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

CONDENSED CONSOLIDATING BALANCE SHEET

| | Before CLO Consolidation | Managed Investment Entities | Consol. Entries | | Consolidated As Reported |
|---|---|---|---|---|---|
| September 30, 2017 | | | | | |
| Assets: | | | | | |
| Cash and investments | $ 45,514 | $ — | $ (261 ) | (a) | $ 45,253 |
| Assets of managed investment entities | — | 4,767 | — | | 4,767 |
| Other assets | 10,143 | — | — | (a) | 10,143 |
| Total assets | $ 55,657 | $ 4,767 | $ (261 ) | | $ 60,163 |
| Liabilities: | | | | | |
| Unpaid losses and loss adjustment expenses and unearned premiums | $ 12,130 | $ — | $— | | $ 12,130 |
| Annuity, life, accident and health benefits and reserves | 33,338 | — | — | | 33,338 |
| Liabilities of managed investment entities | — | 4,700 | (194 ) | (a) | 4,506 |
| Long-term debt and other liabilities | 4,810 | — | — | | 4,810 |
| Total liabilities | 50,278 | 4,700 | (194 ) | | 54,784 |
| Shareholders' equity: | | | | | |
| Common Stock and Capital surplus | 1,255 | 67 | (67 ) | | 1,255 |
| Retained earnings | 3,435 | — | — | | 3,435 |
| Accumulated other comprehensive income, net of tax | 689 | — | — | | 689 |
| Total shareholders' equity | 5,379 | 67 | (67 ) | | 5,379 |
| Noncontrolling interests | — | — | — | | — |
| Total equity | 5,379 | 67 | (67 ) | | 5,379 |
| Total liabilities and equity | $ 55,657 | $ 4,767 | $ (261 ) | | $ 60,163 |
| December 31, 2016 | | | | | |
| Assets: | | | | | |
| Cash and investments | $ 41,649 | $ — | $ (216 ) | (a) | $ 41,433 |
| Assets of managed investment entities | — | 4,765 | — | | 4,765 |
| Other assets | 8,874 | — | — | (a) | 8,874 |
| Total assets | $ 50,523 | $ 4,765 | $ (216 ) | | $ 55,072 |
| Liabilities: | | | | | |
| Unpaid losses and loss adjustment expenses and unearned premiums | $ 10,734 | $ — | $— | | $ 10,734 |
| Annuity, life, accident and health benefits and reserves | 30,598 | — | — | | 30,598 |
| Liabilities of managed investment entities | — | 4,760 | (211 ) | (a) | 4,549 |
| Long-term debt and other liabilities | 4,272 | — | — | | 4,272 |
| Total liabilities | 45,604 | 4,760 | (211 ) | | 50,153 |
| Shareholders' equity: | | | | | |
| Common Stock and Capital surplus | 1,198 | 5 | (5 ) | | 1,198 |
| Retained earnings | 3,343 | — | — | | 3,343 |
| Accumulated other comprehensive income, net of tax | 375 | — | — | | 375 |
| Total shareholders' equity | 4,916 | 5 | (5 ) | | 4,916 |
| Noncontrolling interests | 3 | — | — | | 3 |
| Total equity | 4,919 | 5 | (5 ) | | 4,919 |

| | | | | |
|---|---|---|---|---|
| Total liabilities and equity | $ 50,523 | $ 4,765 | $ (216 ) | $ 55,072 |

(a) Elimination of the fair value of AFG’s investment in CLOs and related accrued interest.

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CONDENSED CONSOLIDATING STATEMENT OF EARNINGS

| | Before CLO Consolidation (a) | Managed Investment Entities | Consol. Entries | | Consolidated As Reported |
|---|---|---|---|---|---|
| Three months ended September 30, 2017 | | | | | |
| Revenues: | | | | | |
| Insurance net earned premiums | $ 1,273 | $ — | $ — | | $ 1,273 |
| Net investment income | 476 | — | (5 ) | (b) | 471 |
| Realized losses on securities | (12 ) | — | — | | (12 ) |
| Income of managed investment entities: | | | | | |
| Investment income | — | 54 | — | | 54 |
| Gain on change in fair value of assets/liabilities | — | 1 | — | (b) | 1 |
| Other income | 53 | — | (5 ) | (c) | 48 |
| Total revenues | 1,790 | 55 | (10 ) | | 1,835 |
| Costs and Expenses: | | | | | |
| Insurance benefits and expenses | 1,628 | — | — | | 1,628 |
| Expenses of managed investment entities | — | 55 | (10 ) | (b)(c) | 45 |
| Interest charges on borrowed money and other expenses | 133 | — | — | | 133 |
| Total costs and expenses | 1,761 | 55 | (10 ) | | 1,806 |
| Earnings before income taxes | 29 | — | — | | 29 |
| Provision for income taxes | 18 | — | — | | 18 |
| Net earnings, including noncontrolling interests | 11 | — | — | | 11 |
| Less: Net earnings attributable to noncontrolling interests | — | — | — | | — |
| Net earnings attributable to shareholders | $ 11 | $ — | $ — | | $ 11 |
| Three months ended September 30, 2016 | | | | | |
| Revenues: | | | | | |
| Insurance net earned premiums | $ 1,165 | $ — | $ — | | $ 1,165 |
| Net investment income | 450 | — | (17 ) | (b) | 433 |
| Realized gains on securities | 2 | — | — | | 2 |
| Income of managed investment entities: | | | | | |
| Investment income | — | 48 | — | | 48 |
| Gain on change in fair value of assets/liabilities | — | — | 11 | (b) | 11 |
| Other income | 50 | — | (4 ) | (c) | 46 |
| Total revenues | 1,667 | 48 | (10 ) | | 1,705 |
| Costs and Expenses: | | | | | |
| Insurance benefits and expenses | 1,372 | — | — | | 1,372 |
| Expenses of managed investment entities | — | 48 | (10 ) | (b)(c) | 38 |
| Interest charges on borrowed money and other expenses | 117 | — | — | | 117 |
| Total costs and expenses | 1,489 | 48 | (10 ) | | 1,527 |
| Earnings before income taxes | 178 | — | — | | 178 |
| Provision for income taxes | 65 | — | — | | 65 |
| Net earnings, including noncontrolling interests | 113 | — | — | | 113 |
| Less: Net earnings attributable to noncontrolling interests | 4 | — | — | | 4 |
| Net earnings attributable to shareholders | $ 109 | $ — | $ — | | $ 109 |

(a) Includes income of $5 million and $17 million in the third quarter of 2017 and 2016, respectively, representing the change in fair value of AFG’s CLO investments plus $5 million and $4 million in the third quarter of 2017 and 2016, respectively, in CLO management fees earned.

(b) Elimination of the change in fair value of AFG’s investments in the CLOs, including $5 million and $6 million in the third quarter of 2017 and 2016, respectively, in distributions recorded as interest expense by the CLOs.

(c) Elimination of management fees earned by AFG.

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CONDENSED CONSOLIDATING STATEMENT OF EARNINGS

| | Before CLO Consolidation (a) | Managed Investment Entities | Consol. Entries | | Consolidated As Reported |
|---|---|---|---|---|---|
| Nine months ended September 30, 2017 | | | | | |
| Revenues: | | | | | |
| Insurance net earned premiums | $ 3,371 | $ — | $ — | | $ 3,371 |
| Net investment income | 1,382 | — | (16 ) | (b) | 1,366 |
| Realized losses on securities | (1 ) | — | — | | (1 ) |
| Income of managed investment entities: | | | | | |
| Investment income | — | 155 | — | | 155 |
| Gain on change in fair value of assets/liabilities | — | 22 | (10 ) | (b) | 12 |
| Other income | 168 | — | (14 ) | (c) | 154 |
| Total revenues | 4,920 | 177 | (40 ) | | 5,057 |
| Costs and Expenses: | | | | | |
| Insurance benefits and expenses | 4,113 | — | — | | 4,113 |
| Expenses of managed investment entities | — | 177 | (40 ) | (b)(c) | 137 |
| Interest charges on borrowed money and other expenses | 350 | — | — | | 350 |
| Total costs and expenses | 4,463 | 177 | (40 ) | | 4,600 |
| Earnings before income taxes | 457 | — | — | | 457 |
| Provision for income taxes | 146 | — | — | | 146 |
| Net earnings, including noncontrolling interests | 311 | — | — | | 311 |
| Less: Net earnings attributable to noncontrolling interests | 2 | — | — | | 2 |
| Net earnings attributable to shareholders | $ 309 | $ — | $ — | | $ 309 |
| | | | | | |
| Nine months ended September 30, 2016 | | | | | |
| Revenues: | | | | | |
| Insurance net earned premiums | $ 3,202 | $ — | $ — | | $ 3,202 |
| Net investment income | 1,296 | — | (29 ) | (b) | 1,267 |
| Realized gains (losses) on: | | | | | |
| Securities | (32 ) | — | — | | (32 ) |
| Subsidiaries | 2 | — | — | | 2 |
| Income of managed investment entities: | | | | | |
| Investment income | — | 141 | — | | 141 |
| Gain on change in fair value of assets/liabilities | — | 2 | 7 | (b) | 9 |
| Other income | 184 | — | (12 ) | (c) | 172 |
| Total revenues | 4,652 | 143 | (34 ) | | 4,761 |
| Costs and Expenses: | | | | | |
| Insurance benefits and expenses | 3,868 | — | — | | 3,868 |
| Expenses of managed investment entities | — | 142 | (33 ) | (b)(c) | 109 |
| Interest charges on borrowed money and other expenses | 314 | — | — | | 314 |
| Total costs and expenses | 4,182 | 142 | (33 ) | | 4,291 |
| Earnings before income taxes | 470 | 1 | (1 ) | | 470 |
| Provision for income taxes | 190 | — | — | | 190 |
| Net earnings, including noncontrolling interests | 280 | 1 | (1 ) | | 280 |
| Less: Net earnings attributable to noncontrolling interests | 16 | — | — | | 16 |

| | | | | |
|---|---|---|---|---|
| Net earnings attributable to shareholders | $ 264 | $ 1 | $ (1 ) | $ 264 |

(a) Includes income of $16 million and $29 million in the first nine months of 2017 and 2016, respectively, representing the change in fair value of AFG's CLO investments plus $14 million and $12 million in the first nine months of 2017 and 2016, respectively, in CLO management fees earned.

(b) Elimination of the change in fair value of AFG's investments in the CLOs, including $26 million and $21 million in the first nine months of 2017 and 2016, respectively, in distributions recorded as interest expense by the CLOs.

(c) Elimination of management fees earned by AFG.

RESULTS OF OPERATIONS

General AFG's net earnings attributable to shareholders, determined in accordance with GAAP, include certain items that may not be indicative of its ongoing core operations. For example, core net operating earnings excludes realized gains (losses) on securities because such gains and losses are influenced significantly by financial markets, interest rates and the timing of sales. Similarly, significant gains and losses from the sale of real estate are excluded from core earnings as they are influenced by the timing of sales and realized gains (losses) on subsidiaries are excluded because such gains and losses are largely the result of the changing business strategy and market opportunities. In addition, special charges related to coverage that AFG no longer writes, such as the Neon exited lines charge in the second quarter of 2016 and for asbestos and environmental exposures are excluded from core earnings. The following table (in millions, except per share amounts) identifies non-core items and reconciles net earnings attributable to shareholders to core net operating earnings, a non-GAAP financial measure. AFG believes core net operating earnings is a useful tool for investors and analysts in analyzing ongoing operating trends and for management to evaluate financial performance against historical results because it believes this provides a more comparable measure of its continuing business.

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 |
| Components of net earnings attributable to shareholders: | | | | |
| Core operating earnings before income taxes | $158 | $217 | $582 | $574 |
| Pretax non-core items: | | | | |
| Realized gains (losses) on securities | (12) | 2 | (1) | (32) |
| Realized gain on subsidiaries | — | — | — | 2 |
| Gain on sale of apartment property | — | — | — | 32 |
| Special A&E charges | (113) | (41) | (113) | (41) |
| Neon exited lines charge | — | — | — | (65) |
| Loss on retirement of debt | (4) | — | (11) | — |
| Earnings before income taxes | 29 | 178 | 457 | 470 |
| Provision (credit) for income taxes: | | | | |
| Core operating earnings | 63 | 79 | 189 | 202 |
| Non-core items | (45) | (14) | (43) | (12) |
| Total provision for income taxes | 18 | 65 | 146 | 190 |
| Net earnings, including noncontrolling interests | 11 | 113 | 311 | 280 |
| Less net earnings attributable to noncontrolling interests: | | | | |
| Core operating earnings | — | 4 | 2 | 14 |
| Non-core items | — | — | — | 2 |
| Total net earnings attributable to noncontrolling interests | — | 4 | 2 | 16 |
| Net earnings attributable to shareholders | $11 | $109 | $309 | $264 |
| | | | | |
| Net earnings: | | | | |
| Core net operating earnings | $95 | $134 | $391 | $358 |
| Non-core items | (84) | (25) | (82) | (94) |
| Net earnings attributable to shareholders | $11 | $109 | $309 | $264 |
| | | | | |
| Diluted per share amounts: | | | | |

| | | | | |
|---|---|---|---|---|
| Core net operating earnings | $1.06 | $1.51 | $4.35 | $4.04 |
| Realized gains (losses) on securities | (0.08 ) | 0.02 | (0.01 ) | (0.21 ) |
| Realized gain on subsidiaries | — | — | — | 0.01 |
| Gain on sale of apartment property | — | — | — | 0.17 |
| Special A&E charges | (0.82 ) | (0.30 ) | (0.82 ) | (0.30 ) |
| Neon exited lines charge | — | — | — | (0.73 ) |
| Loss on retirement of debt | (0.03 ) | — | (0.08 ) | — |
| Net earnings attributable to shareholders | $0.13 | $1.23 | $3.44 | $2.98 |

Net earnings attributable to shareholders decreased $98 million in the third quarter of 2017 compared to the same period in 2016 due primarily to lower core net operating earnings, higher special A&E charges recorded in the third quarter of 2017 compared to the third quarter of 2016 and net realized losses on securities in the 2017 period compared to net realized gains in

the 2016 period. Core net operating earnings decreased $39 million in the third quarter of 2017 compared to the same period in 2016 reflecting lower underwriting profit in the property and casualty insurance segment due primarily to catastrophe losses from Hurricanes Harvey, Irma and Maria and two earthquakes in Mexico.

Net earnings attributable to shareholders increased $45 million in the first nine months of 2017 compared to the same period in 2016 due primarily to lower net realized losses on securities in the 2017 period compared to the 2016 period, a charge related to the exit of certain lines of business within Neon in the second quarter of 2016 and higher core net operating earnings. These results were partially offset by higher special A&E charges recorded in the 2017 period compared to the 2016 period, the impact of the gain on the sale of an apartment property in the second quarter of 2016 and losses on the retirement of debt in the 2017 period. Core net operating earnings increased $33 million in the first nine months of 2017 compared to the same period in 2016 reflecting higher earnings in the annuity segment and higher net investment income in the property and casualty insurance segment, partially offset by lower underwriting profit in the property and casualty insurance segment due primarily to catastrophe losses from Hurricanes Harvey, Irma and Maria and two earthquakes in Mexico.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

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

RESULTS OF OPERATIONS — QUARTERS ENDED SEPTEMBER 30, 2017 AND 2016

Segmented Statement of Earnings AFG reports its business as four segments: (i) Property and casualty insurance ("P&C"), (ii) Annuity, (iii) Run-off long-term care and life and (iv) Other, which includes holding company costs and income and expenses related to the managed investment entities ("MIEs").

AFG's net earnings attributable to shareholders, determined in accordance with GAAP, include certain items that may not be indicative of its ongoing core operations. The following tables for the three months ended September 30, 2017 and 2016 identify such items by segment and reconcile net earnings attributable to shareholders to core net operating earnings, a non-GAAP financial measure that AFG believes is a useful tool for investors and analysts in analyzing ongoing operating trends (in millions):

| | P&C | Annuity | Run-off long-term care and life | Other | | Total | Non-core reclass | GAAP Total |
|---|---|---|---|---|---|---|---|---|
| | | | | Consol' MIEs | Holding Co., other and unallocated | | | |
| Three months ended September 30, 2017 | | | | | | | | |
| Revenues: | | | | | | | | |
| Property and casualty insurance net earned premiums | $1,267 | $ — | $ — | $— | $ — | $1,267 | $ — | $1,267 |
| Life, accident and health net earned premiums | — | — | 6 | — | — | 6 | — | 6 |
| Net investment income | 94 | 375 | 6 | (5) | 1 | 471 | — | 471 |
| Realized losses on securities | — | — | — | — | — | — | (12) | (12) |
| Income of MIEs: | | | | | | | | |
| Investment income | — | — | — | 54 | — | 54 | — | 54 |
| Gain on change in fair value of assets/liabilities | — | — | — | 1 | — | 1 | — | 1 |
| Other income | 1 | 26 | — | (5) | 26 | 48 | — | 48 |
| Total revenues | 1,362 | 401 | 12 | 45 | 27 | 1,847 | (12) | 1,835 |
| | | | | | | | | |
| Costs and Expenses: | | | | | | | | |
| Property and casualty insurance: | | | | | | | | |
| Losses and loss adjustment expenses | 906 | — | — | — | — | 906 | 89 | 995 |
| Commissions and other underwriting expenses | 353 | — | — | — | 4 | 357 | — | 357 |
| Annuity benefits | — | 215 | — | — | — | 215 | — | 215 |
| Life, accident and health benefits | — | — | 6 | — | — | 6 | — | 6 |
| Annuity and supplemental insurance acquisition expenses | — | 54 | 1 | — | — | 55 | — | 55 |
| Interest charges on borrowed money | — | — | — | — | 21 | 21 | — | 21 |
| Expenses of MIEs | — | — | — | 45 | — | 45 | — | 45 |
| Other expenses | 8 | 30 | 3 | — | 43 | 84 | 28 | 112 |
| Total costs and expenses | 1,267 | 299 | 10 | 45 | 68 | 1,689 | 117 | 1,806 |
| Earnings before income taxes | 95 | 102 | 2 | — | (41) | 158 | (129) | 29 |
| Provision for income taxes | 43 | 34 | 1 | — | (15) | 63 | (45) | 18 |
| Net earnings, including noncontrolling interests | 52 | 68 | 1 | — | (26) | 95 | (84) | 11 |
| Less: Net earnings attributable to noncontrolling interests | — | — | — | — | — | — | — | — |
| Core Net Operating Earnings | 52 | 68 | 1 | — | (26) | 95 | | |
| Non-core earnings attributable to shareholders (a): | | | | | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Realized losses on securities, net of tax | — | — | — | — | (8) | (8) | 8 | — |
| Special A&E charges, net of tax | (58) | — | — | — | (16) | (74) | 74 | — |
| Loss on retirement of debt, net of tax | — | — | — | — | (2) | (2) | 2 | — |
| Net Earnings Attributable to Shareholders | $(6) | $ 68 | $ 1 | $— | $ (52) | $11 | $ — | $11 |

| | P&C | Annuity | Run-off long-term care and life | Consol. MIEs | Other Holding Co., other and unallocated | Total | Non-core reclass | GAAP Total |
|---|---|---|---|---|---|---|---|---|
| Three months ended September 30, 2016 | | | | | | | | |
| Revenues: | | | | | | | | |
| Property and casualty insurance net earned premiums | $1,159 | $ — | $ — | $— | $ — | $1,159 | $ — | $1,159 |
| Life, accident and health net earned premiums | — | — | 6 | — | — | 6 | — | 6 |
| Net investment income | 93 | 351 | 5 | (17) | 1 | 433 | — | 433 |
| Realized gains on securities | — | — | — | — | — | — | 2 | 2 |
| Income of MIEs: | | | | | | | | |
| Investment income | — | — | — | 48 | — | 48 | — | 48 |
| Gain on change in fair value of assets/liabilities | — | — | — | 11 | — | 11 | — | 11 |
| Other income | 3 | 26 | 2 | (4) | 19 | 46 | — | 46 |
| Total revenues | 1,255 | 377 | 13 | 38 | 20 | 1,703 | 2 | 1,705 |
| Costs and Expenses: | | | | | | | | |
| Property and casualty insurance: | | | | | | | | |
| Losses and loss adjustment expenses | 729 | — | — | — | — | 729 | 36 | 765 |
| Commissions and other underwriting expenses | 352 | — | — | — | 4 | 356 | — | 356 |
| Annuity benefits | — | 189 | — | — | — | 189 | — | 189 |
| Life, accident and health benefits | — | — | 8 | — | — | 8 | — | 8 |
| Annuity and supplemental insurance acquisition expenses | — | 53 | 1 | — | — | 54 | — | 54 |
| Interest charges on borrowed money | — | — | — | — | 19 | 19 | — | 19 |
| Expenses of MIEs | — | — | — | 38 | — | 38 | — | 38 |
| Other expenses | 17 | 28 | 3 | — | 45 | 93 | 5 | 98 |
| Total costs and expenses | 1,098 | 270 | 12 | 38 | 68 | 1,486 | 41 | 1,527 |
| Earnings before income taxes | 157 | 107 | 1 | — | (48) | 217 | (39) | 178 |
| Provision for income taxes | 59 | 38 | — | — | (18) | 79 | (14) | 65 |
| Net earnings, including noncontrolling interests | 98 | 69 | 1 | — | (30) | 138 | (25) | 113 |
| Less: Net earnings attributable to noncontrolling interests | 4 | — | — | — | — | 4 | — | 4 |
| Core Net Operating Earnings | 94 | 69 | 1 | — | (30) | 134 | | |
| Non-core earnings attributable to shareholders (a): | | | | | | | | |
| Realized gains on securities, net of tax and noncontrolling interests | — | — | — | — | 1 | 1 | (1) | — |
| Special A&E charges, net of tax | (23) | — | — | — | (3) | (26) | 26 | — |
| Net Earnings Attributable to Shareholders | $71 | $ 69 | $ 1 | $— | $ (32) | $109 | $ — | $109 |

(a) See the reconciliation of core earnings to GAAP net earnings under "Results of Operations — General" for details on the tax and noncontrolling interest impacts of these reconciling items.

Property and Casualty Insurance Segment — Results of Operations   Performance measures such as underwriting profit or loss and related combined ratios are often used by property and casualty insurers to help users of their financial statements better understand the company's performance. Underwriting profitability is measured by the combined

ratio, which is a sum of the ratios of losses and loss adjustment expenses, and commissions and other underwriting expenses to premiums. A combined ratio under 100% indicates an underwriting profit. The combined ratio does not reflect net investment income, other income, other expenses or federal income taxes.

AFG’s property and casualty insurance operations contributed $6 million in GAAP pretax earnings in the third quarter of 2017 compared to $121 million in the third quarter of 2016, a decrease of $115 million (95%). Property and casualty core pretax earnings were $95 million in the third quarter of 2017 compared to $157 million in the third quarter of 2016, a decrease of $62 million (39%). The decrease in GAAP and core pretax earnings reflects lower underwriting results due primarily to higher catastrophe losses from Hurricanes Harvey, Irma and Maria and two earthquakes in Mexico in the third quarter of 2017. The

decrease in GAAP pretax earnings also reflects higher special A&E charges in the third quarter of 2017 compared to the third quarter of 2016.

The following table details AFG's earnings before income taxes from its property and casualty insurance operations for the three months ended September 30, 2017 and 2016 (dollars in millions):

| | Three months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Gross written premiums | $2,104 | $1,899 | 11 % |
| Reinsurance premiums ceded | (671 ) | (631 ) | 6 % |
| Net written premiums | 1,433 | 1,268 | 13 % |
| Change in unearned premiums | (166 ) | (109 ) | 52 % |
| Net earned premiums | 1,267 | 1,159 | 9 % |
| Loss and loss adjustment expenses (*) | 906 | 729 | 24 % |
| Commissions and other underwriting expenses | 353 | 352 | — % |
| Core underwriting gain | 8 | 78 | (90 %) |
| | | | |
| Net investment income | 94 | 93 | 1 % |
| Other income and expenses, net | (7 ) | (14 ) | (50 %) |
| Core earnings before income taxes | 95 | 157 | (39 %) |
| Pretax non-core special A&E charges | (89 ) | (36 ) | 147 % |
| GAAP earnings before income taxes | $6 | $121 | (95 %) |

(*) Excludes pretax non-core special A&E charges of $89 million and $36 million in the third quarter of 2017 and 2016, respectively.

| Combined Ratios: | | | |
|---|---|---|---|
| Specialty lines | | | Change |
| Loss and LAE ratio | 71.4 % | 62.9 % | 8.5 % |
| Underwriting expense ratio | 27.9 % | 30.3 % | (2.4 %) |
| Combined ratio | 99.3 % | 93.2 % | 6.1 % |
| | | | |
| Aggregate — including exited lines | | | |
| Loss and LAE ratio | 78.5 % | 66.0 % | 12.5 % |
| Underwriting expense ratio | 27.9 % | 30.3 % | (2.4 %) |
| Combined ratio | 106.4 % | 96.3 % | 10.1 % |

AFG reports the underwriting performance of its Specialty property and casualty insurance business in the following sub-segments: (i) Property and transportation, (ii) Specialty casualty and (iii) Specialty financial.

To understand the overall profitability of particular lines, the timing of claims payments and the related impact of investment income must be considered. Certain "short-tail" lines of business (primarily property coverages) generally have quick loss payouts, which reduce the time funds are held, thereby limiting investment income earned thereon. In contrast, "long-tail" lines of business (primarily liability coverages and workers' compensation) generally have payouts

that are either structured over many years or take many years to settle, thereby significantly increasing investment income earned on related premiums received.

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Gross Written Premiums

Gross written premiums ("GWP") for AFG's property and casualty insurance segment were $2.10 billion for the third quarter of 2017 compared to $1.90 billion for the third quarter of 2016, an increase of $205 million (11%). Detail of AFG's property and casualty gross written premiums is shown below (dollars in millions):

| | Three months ended September 30, | | | | |
|---|---|---|---|---|---|
| | 2017 | | 2016 | | |
| | GWP | % | GWP | % | % Change |
| Property and transportation | $1,073 | 51 % | $991 | 52 % | 8 % |
| Specialty casualty | 850 | 40 % | 722 | 38 % | 18 % |
| Specialty financial | 181 | 9 % | 186 | 10 % | (3 %) |
| | $2,104 | 100% | $1,899 | 100% | 11 % |

Reinsurance Premiums Ceded

Reinsurance premiums ceded ("Ceded") for AFG's property and casualty insurance segment were 32% of gross written premiums for the third quarter of 2017 compared to 33% for the third quarter of 2016, a decrease of 1 percentage point. Detail of AFG's property and casualty reinsurance premiums ceded is shown below (dollars in millions):

| | Three months ended September 30, | | | | |
|---|---|---|---|---|---|
| | 2017 | | 2016 | | Change in |
| | Ceded | % of GWP | Ceded | % of GWP | % of GWP |
| Property and transportation | $(449) | 42 % | $(406) | 41 % | 1 % |
| Specialty casualty | (226) | 27 % | (218) | 30 % | (3 %) |
| Specialty financial | (31) | 17 % | (37) | 20 % | (3 %) |
| Other specialty | 35 | | 30 | | |
| | $(671) | 32 % | $(631) | 33 % | (1 %) |

Net Written Premiums

Net written premiums ("NWP") for AFG's property and casualty insurance segment were $1.43 billion for the third quarter of 2017 compared to $1.27 billion for the third quarter of 2016, an increase of $165 million (13%). Detail of AFG's property and casualty net written premiums is shown below (dollars in millions):

| | Three months ended September 30, | | | | |
|---|---|---|---|---|---|
| | 2017 | | 2016 | | |
| | NWP | % | NWP | % | % Change |
| Property and transportation | $624 | 44 % | $585 | 46 % | 7 % |
| Specialty casualty | 624 | 44 % | 504 | 40 % | 24 % |
| Specialty financial | 150 | 10 % | 149 | 12 % | 1 % |
| Other specialty | 35 | 2 % | 30 | 2 % | 17 % |
| | $1,433 | 100% | $1,268 | 100% | 13 % |

Net Earned Premiums

Net earned premiums ("NEP") for AFG's property and casualty insurance segment were $1.27 billion for the third quarter of 2017 compared to $1.16 billion for the third quarter of 2016, an increase of $108 million (9%). Detail of AFG's property and casualty net earned premiums is shown below (dollars in millions):

| | Three months ended September 30, | | | | |
|---|---|---|---|---|---|
| | 2017 | | 2016 | | |
| | NEP | % | NEP | % | % Change |
| Property and transportation | $527 | 42 % | $493 | 43 % | 7 % |
| Specialty casualty | 568 | 45 % | 497 | 43 % | 14 % |
| Specialty financial | 142 | 11 % | 145 | 12 % | (2 %) |
| Other specialty | 30 | 2 % | 24 | 2 % | 25 % |
| | $1,267 | 100% | $1,159 | 100% | 9 % |

The $205 million (11%) increase in gross written premiums for the third quarter of 2017 compared to the third quarter of 2016 reflects growth in the Property and transportation and Specialty casualty sub-segments. Overall average renewal rates increased approximately 1% in the third quarter of 2017.

Property and transportation Gross written premiums increased $82 million (8%) in the third quarter of 2017 compared to the third quarter of 2016. This increase was the result of higher gross written premiums in the agricultural and transportation businesses. This growth was partially offset by lower premiums resulting from an exit from the customs bond business, which was part of the ocean marine operations. Average renewal rates increased approximately 2% for this group in the third quarter of 2017. Reinsurance premiums ceded as a percentage of gross written premiums increased 1 percentage point, reflecting the impact of reinstatement premiums resulting from reinsured hurricane losses.

Specialty casualty Gross written premiums increased $128 million (18%) in the third quarter of 2017 compared to the third quarter of 2016. New accounts written in the targeted markets businesses were the primary driver of the increase. Additionally, higher gross written premiums in the workers' compensation businesses, primarily the result of rate increases in the state of Florida, and higher premiums in the executive liability and excess and surplus businesses and Neon, contributed to the year-over-year growth. Average renewal rates increased approximately 1% for this group in the third quarter of 2017. Reinsurance premiums ceded as a percentage of gross written premiums decreased 3 percentage points for the third quarter of 2017 compared to the third quarter of 2016, reflecting higher cessions in the prior year period as a result of the timing of reinsurance agreements at Neon.

Specialty financial Gross written premiums decreased $5 million (3%) in the third quarter of 2017 compared to the third quarter of 2016 due primarily to lower gross written premiums in the financial institutions business, partially offset by higher premiums in the surety business. Average renewal rates for this group decreased approximately 1% in the third quarter of 2017. Reinsurance premiums ceded as a percentage of gross written premiums decreased 3 percentage points for the third quarter of 2017 compared to the third quarter of 2016, reflecting lower premiums in the financial institutions business, which were largely ceded, partially offset by the impact of reinstatement premiums resulting from reinsured hurricane losses.

Other specialty The amounts shown as reinsurance premiums ceded represent business assumed by AFG's internal reinsurance program from the operations that make up AFG's other Specialty property and casualty insurance sub-segments.

Combined Ratio

The table below (dollars in millions) details the components of the combined ratio for AFG's property and casualty segment:

| | Three months ended September 30, | | | Three months ended September 30, | |
|---|---|---|---|---|---|
| | 2017 | 2016 | Change | 2017 | 2016 |
| Property and transportation | | | | | |
| Loss and LAE ratio | 77.3 % | 68.8 % | 8.5 % | | |
| Underwriting expense ratio | 21.6 % | 22.3 % | (0.7 %) | | |
| Combined ratio | 98.9 % | 91.1 % | 7.8 % | | |
| Underwriting profit | | | | $ 6 | $ 44 |
| | | | | | |
| Specialty casualty | | | | | |
| Loss and LAE ratio | 70.7 % | 66.5 % | 4.2 % | | |
| Underwriting expense ratio | 28.8 % | 30.9 % | (2.1 %) | | |
| Combined ratio | 99.5 % | 97.4 % | 2.1 % | | |
| Underwriting profit | | | | $ 2 | $ 13 |
| | | | | | |
| Specialty financial | | | | | |
| Loss and LAE ratio | 56.0 % | 31.6 % | 24.4 % | | |
| Underwriting expense ratio | 46.2 % | 54.8 % | (8.6 %) | | |
| Combined ratio | 102.2 % | 86.4 % | 15.8 % | | |
| Underwriting profit (loss) | | | | $ (3 ) | $ 19 |
| | | | | | |
| Total Specialty | | | | | |
| Loss and LAE ratio | 71.4 % | 62.9 % | 8.5 % | | |
| Underwriting expense ratio | 27.9 % | 30.3 % | (2.4 %) | | |
| Combined ratio | 99.3 % | 93.2 % | 6.1 % | | |
| Underwriting profit | | | | $ 9 | $ 78 |
| | | | | | |
| Aggregate — including exited lines | | | | | |
| Loss and LAE ratio | 78.5 % | 66.0 % | 12.5 % | | |
| Underwriting expense ratio | 27.9 % | 30.3 % | (2.4 %) | | |
| Combined ratio | 106.4 % | 96.3 % | 10.1 % | | |
| Underwriting profit (loss) | | | | $ (81 ) | $ 42 |

The Specialty property and casualty insurance operations generated an underwriting profit of $9 million in the third quarter of 2017 compared to $78 million in the third quarter of 2016, a decrease of $69 million (88%). The lower underwriting profit in the third quarter of 2017 reflects lower underwriting profit in each of the Specialty property and casualty insurance sub-segments due primarily to significantly higher catastrophe losses. Overall catastrophe losses were $107 million (8.4 points on the combined ratio) for the third quarter of 2017 compared to $14 million (1.2 points) for the third quarter of 2016. In connection with catastrophe losses incurred in the third quarter of 2017, AFG reduced profit-based commissions payable to agents by $8 million in the Specialty financial sub-segment and paid

$6 million in net reinstatement premiums, resulting in a total pretax loss from catastrophes of $105 million for the quarter.

Property and transportation Underwriting profit for this group was $6 million for the third quarter of 2017 compared to $44 million in the third quarter of 2016, a decrease of $38 million (86%). Lower underwriting profits in the crop, property and inland marine and ocean marine businesses were the primary drivers of these lower results. The comparable 2016 quarter included strong profitability in the crop business. Catastrophe losses were $23 million (4.4 points on the combined ratio) and related reinstatement premiums paid were $2 million for the third quarter of 2017 compared to catastrophe losses of $7 million (1.6 points) for the third quarter of 2016.

Specialty casualty Underwriting profit for this group was $2 million for the third quarter of 2017 compared to $13 million in the third quarter of 2016, a decrease of $11 million (85%). Improved underwriting results in the excess and surplus lines, targeted markets, workers' compensation and professional liability businesses were more than offset by lower underwriting profitability at Neon, due primarily to catastrophe losses. Catastrophe losses were $54 million (9.5 points on the combined

ratio) and related net reinstatement premiums paid were $2 million for the third quarter of 2017 compared to catastrophe losses of $2 million (0.3 points) for the third quarter of 2016.

Specialty financial   This group reported an underwriting loss of $3 million for the third quarter of 2017 compared to an underwriting profit of $19 million in the third quarter of 2016, a decrease of $22 million (116%) due primarily to catastrophe losses in the lender-placed mortgage property insurance business. Catastrophe losses were $29 million (20.4 points on the combined ratio) for the third quarter of 2017 compared to $5 million (3.3 points) for the third quarter of 2016. In connection with catastrophe losses incurred in the third quarter of 2017, the Specialty financial sub-segment reduced profit-based commissions payable to agents by $8 million (5.6 points favorable on the combined ratio) and paid $2 million in reinstatement premiums.

Other specialty   This group reported an underwriting profit of $4 million in the third quarter of 2017 compared to $2 million in the third quarter of 2016. This increase is due primarily to favorable prior year reserve development in the third quarter of 2017 in the business assumed by AFG's internal reinsurance program from the operations that make up AFG's other Specialty sub-segments.

Aggregate   As discussed below in more detail under "Net prior year reserve development," AFG recorded special charges to increase property and casualty A&E reserves by $89 million in the third quarter of 2017 and $36 million in the third quarter of 2016.

Losses and Loss Adjustment Expenses

AFG's overall loss and LAE ratio was 78.5% for the third quarter of 2017 compared to 66.0% for the third quarter of 2016, an increase of 12.5 percentage points. The components of AFG's property and casualty losses and LAE amounts and ratio are detailed below (dollars in millions):

| | Three months ended September 30, | | | | |
|---|---|---|---|---|---|
| | Amount | | Ratio | | Change in Ratio |
| | 2017 | 2016 | 2017 | 2016 | Ratio |
| Property and transportation | | | | | |
| Current year, excluding catastrophe losses | $392 | $337 | 74.4% | 68.4% | 6.0 % |
| Prior accident years development | (8 ) | (5 ) | (1.5 %) | (1.2 %) | (0.3 %) |
| Current year catastrophe losses | 23 | 7 | 4.4 % | 1.6 % | 2.8 % |
| Property and transportation losses and LAE and ratio | $407 | $339 | 77.3% | 68.8% | 8.5 % |
| Specialty casualty | | | | | |
| Current year, excluding catastrophe losses | $371 | $330 | 65.2% | 66.5% | (1.3 %) |
| Prior accident years development | (23 ) | (2 ) | (4.0 %) | (0.3 %) | (3.7 %) |
| Current year catastrophe losses | 54 | 2 | 9.5 % | 0.3 % | 9.2 % |
| Specialty casualty losses and LAE and ratio | $402 | $330 | 70.7% | 66.5% | 4.2 % |
| Specialty financial | | | | | |
| Current year, excluding catastrophe losses | $55 | $46 | 38.7% | 32.2% | 6.5 % |
| Prior accident years development | (5 ) | (6 ) | (3.1 %) | (3.9 %) | 0.8 % |
| Current year catastrophe losses | 29 | 5 | 20.4% | 3.3 % | 17.1% |
| Specialty financial losses and LAE and ratio | $79 | $45 | 56.0% | 31.6% | 24.4% |
| Total Specialty | | | | | |
| Current year, excluding catastrophe losses | $836 | $729 | 65.9% | 62.8% | 3.1 % |
| Prior accident years development | (38 ) | (14 ) | (2.9 %) | (1.1 %) | (1.8 %) |
| Current year catastrophe losses | 107 | 14 | 8.4 % | 1.2 % | 7.2 % |
| Total Specialty losses and LAE and ratio | $905 | $729 | 71.4% | 62.9% | 8.5 % |
| Aggregate — including exited lines | | | | | |
| Current year, excluding catastrophe losses | $836 | $729 | 65.9% | 62.8% | 3.1 % |
| Prior accident years development | 52 | 22 | 4.2 % | 2.0 % | 2.2 % |
| Current year catastrophe losses | 107 | 14 | 8.4 % | 1.2 % | 7.2 % |
| Aggregate losses and LAE and ratio | $995 | $765 | 78.5% | 66.0% | 12.5% |

Current accident year losses and LAE, excluding catastrophe losses

The current accident year loss and LAE ratio, excluding catastrophe losses for AFG's Specialty property and casualty insurance operations was 65.9% for the third quarter of 2017 compared to 62.8% for the third quarter of 2016, an increase of 3.1 percentage points.

Property and transportation The 6.0 percentage point increase in the loss and LAE ratio for the current year, excluding catastrophe losses reflects an increase in the loss and LAE ratio in the crop business for the third quarter of

2017 compared to the third quarter of 2016.

Specialty casualty   The 1.3 percentage point decrease in the loss and LAE ratio for the current year, excluding catastrophe losses reflects a decrease in the loss and LAE ratio at Neon, partially offset by an increase in the loss and LAE ratio in the public sector business.

Specialty financial The 6.5 percentage point increase in the loss and LAE ratio for the current year, excluding catastrophe losses reflects an increase in the loss and LAE ratio of the financial institutions business.

Net prior year reserve development
AFG's Specialty property and casualty insurance operations recorded net favorable reserve development related to prior accident years of $38 million in the third quarter of 2017 compared to $14 million in the third quarter of 2016, an increase of $24 million (171%).

Property and transportation Net favorable reserve development of $8 million in the third quarter of 2017 reflects lower than anticipated claim severity in the transportation businesses and lower than expected losses in the crop and equine businesses. Net favorable reserve development of $5 million in the third quarter of 2016 reflects lower than expected claim severity in the trucking business.

Specialty casualty Net favorable reserve development of $23 million in the third quarter of 2017 reflects lower than anticipated claim severity in the workers' compensation businesses and at Neon, partially offset by higher than anticipated claim severity in the general liability business. Net favorable reserve development of $2 million in the third quarter of 2016 reflects lower than anticipated claim severity and frequency in the workers' compensation businesses and lower than anticipated claim severity in directors and officers liability insurance, partially offset by higher than anticipated severity in New York contractor claims, adverse reserve development at Neon and higher than anticipated claim severity in general liability insurance.

Specialty financial Net favorable reserve development of $5 million in the third quarter of 2017 reflects lower than anticipated claim severity in the fidelity and trade credit businesses. Net favorable reserve development of $6 million in the third quarter of 2016 reflects lower than anticipated claim severity in the fidelity business and lower than expected claim frequency and severity in the surety business.

Other specialty In addition to the development discussed above, total Specialty prior year reserve development includes net favorable reserve development of $2 million in the third quarter of 2017 and $1 million in the third quarter of 2016, reflecting amortization of the deferred gain on the retroactive reinsurance transaction entered into in connection with the sale of businesses in 1998 and 2001 and reserve development associated with AFG's internal reinsurance program.

Special asbestos and environmental reserve charges During the third quarter of 2017, AFG completed a comprehensive external study of its asbestos and environmental exposures relating to the run-off operations of its property and casualty insurance segment and its exposures related to former railroad and manufacturing operations and sites. In addition to its ongoing internal monitoring of asbestos and environmental exposures, AFG has periodically conducted comprehensive external studies of its asbestos and environmental reserves with the aid of specialty actuarial, engineering and consulting firms and outside counsel, generally every two years, with an in-depth internal review during the intervening years.
As a result of the 2017 external study, AFG's property and casualty insurance segment recorded an $89 million pretax special charge to increase its asbestos reserves by $53 million (net of reinsurance) and its environmental reserves by $36 million (net of reinsurance). Over the past few years, the focus of AFG's asbestos claims litigation has shifted to smaller companies and companies with ancillary exposures. AFG's insureds with these exposures have been the driver of the property and casualty segment's asbestos reserve increases in recent years. AFG is seeing modestly increasing estimates for indemnity and defense compared to prior studies. Overall, the rate of new asbestos cases received is down modestly, however, increasing life expectancies in the U.S. have allowed more time for the impacts of asbestos

exposure to emerge. AFG's comprehensive external study incorporates, among other factors, the increase in projected industry ultimate losses attributable to asbestos exposures, as well as revised estimates for future claims emergence, which has resulted in an increase in AFG's provision for future asbestos claims.

The increase in property and casualty environmental reserves was primarily associated with updated estimates of site investigation costs with respect to existing sites and newly identified sites. AFG is seeing increased legal defense costs in environmental claims generally, as well as a number of claims and sites where the estimated investigation and remediation costs have increased. Certain individual claims are taking a longer time to settle than originally estimated, causing AFG to increase its reserves to reflect related increased costs. As in past years, there were no new or emerging broad industry trends that were identified in this study.

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At September 30, 2017, the property and casualty insurance segment's insurance reserves include A&E reserves of $408 million, net of reinsurance recoverables. At September 30, 2017, the property and casualty insurance segment's three-year survival ratios compare favorably with industry survival ratios published by S&P Global Market Intelligence (as of December 31, 2016) as detailed in the following table:

| | Property and Casualty Insurance Reserves Three-Year Survival Ratio (% Times Paid Losses) | | |
|---|---|---|---|
| | Asbestos | Environmental | Total A&E |
| AFG (9/30/2017) | 17.5 | 11.8 | 14.6 |
| Industry (12/31/2016) | 6.2 | 7.1 | 6.4 |

In addition, the 2017 external study encompassed reserves for asbestos and environmental exposures of AFG's former railroad and manufacturing operations. For a discussion of the $24 million pretax special charge recorded for those operations, see "Results of Operations — Holding Company, Other and Unallocated," for the quarters ended September 30, 2017 and 2016.

As a result of the 2016 internal review, AFG recorded a $41 million pretax special charge to increase its property and casualty segment's A&E reserves by $36 million and the reserves of its former railroad and manufacturing operations by $5 million. See Management's Discussion and Analysis — "Uncertainties — Asbestos and Environmental-related ("A&E") Insurance Reserves" and Management's Discussion and Analysis — "Results of Operations — Holding Company, Other and Unallocated" in AFG's 2016 Form 10-K.

Aggregate   Aggregate net prior accident years reserve development for AFG's property and casualty insurance segment includes the special A&E charges mentioned above and adverse reserve development of $1 million in the third quarter of 2017 related to business outside of the Specialty group that AFG no longer writes.

Catastrophe losses
AFG generally seeks to reduce its exposure to catastrophes through individual risk selection, including minimizing coastal and known fault-line exposures, and the purchase of reinsurance. Based on data available at December 31, 2016, AFG's exposure to a catastrophic earthquake or windstorm that industry models indicate should statistically occur once in every 100, 250 or 500 years as a percentage of AFG's Shareholders' Equity is shown below:

| Industry Model | Impact of modeled loss on AFG's Shareholders' Equity |
|---|---|
| 100-year event | Less than 1% |
| 250-year event | Less than 2% |
| 500-year event | Less than 4% |

Catastrophe losses of $107 million in the third quarter of 2017 resulted primarily from Hurricanes Harvey, Irma and Maria and two earthquakes in Mexico. AFG maintains comprehensive catastrophe reinsurance coverage, including a $15 million per occurrence net retention for its U.S.-based property and casualty insurance operations and a separate $15 million per occurrence retention for Neon. Subsequent to Hurricane Irma, AFG's operating units purchased replacement reinsurance coverage for those layers of the catastrophe reinsurance program affected by Hurricanes

Harvey and Irma. AFG’s property and casualty insurance operations further maintain supplemental fully collateralized reinsurance coverage up to 95% of $200 million for catastrophe losses in excess of $100 million of traditional catastrophe reinsurance through a catastrophe bond.

Catastrophe losses of $14 million in the third quarter of 2016 resulted primarily from flooding in Louisiana and multiple storms in the southern United States.

Commissions and Other Underwriting Expenses

AFG's property and casualty commissions and other underwriting expenses ("U/W Exp") were $353 million in the third quarter of 2017 compared to $352 million for the third quarter of 2016, an increase of $1 million. AFG's underwriting expense ratio, calculated as commissions and other underwriting expenses divided by net premiums earned, was 27.9% for the third quarter of 2017 compared to 30.3% for the third quarter of 2016, a decrease of 2.4 percentage points. Detail of AFG's property and casualty commissions and other underwriting expenses and underwriting expense ratios is shown below (dollars in millions):

| | Three months ended September 30, | | | | |
|---|---|---|---|---|---|
| | 2017 | | 2016 | | Change in |
| | U/W Exp | % of NEP | U/W Exp | % of NEP | % of NEP |
| Property and transportation | $114 | 21.6% | $110 | 22.3% | (0.7%) |
| Specialty casualty | 164 | 28.8% | 154 | 30.9% | (2.1%) |
| Specialty financial | 66 | 46.2% | 81 | 54.8% | (8.6%) |
| Other specialty | 9 | 32.5% | 7 | 36.3% | (3.8%) |
| | $353 | 27.9% | $352 | 30.3% | (2.4%) |

AFG's overall expense ratio decreased 2.4 percentage points in the third quarter of 2017 as compared to the third quarter of 2016.

Property and transportation Commissions and other underwriting expenses as a percentage of net earned premiums decreased 0.7 percentage points in the third quarter of 2017 compared to the third quarter of 2016 reflecting a change in the mix of business.

Specialty casualty Commissions and other underwriting expenses as a percentage of net earned premiums decreased 2.1 percentage points in the third quarter of 2017 compared to the third quarter of 2016 reflecting the impact of higher premiums on the ratio.

Specialty financial Commissions and other underwriting expenses as a percentage of net earned premiums decreased 8.6 percentage points in the third quarter of 2017 compared to the third quarter of 2016 reflecting lower profitability-based commissions paid to agents in the financial institutions business, including an $8 million commission expense reduction due to hurricane losses.

Property and Casualty Net Investment Income

Net investment income in AFG's property and casualty insurance operations was $94 million in the third quarter of 2017 compared to $93 million in the third quarter of 2016, an increase of $1 million (1%). In recent years, yields available in the financial markets on fixed maturity securities have generally declined, placing downward pressure on AFG's investment portfolio yield. The average invested assets and overall yield earned on investments held by AFG's property and casualty insurance operations are provided below (dollars in millions):

| | Three months ended September 30, | | | |
|---|---|---|---|---|
| | 2017 | 2016 | Change | % Change |

| | | | | |
|---|---|---|---|---|
| Net investment income | $94 | $93 | $1 | 1 % |
| Average invested assets (at amortized cost) | $9,851 | $9,647 | $204 | 2 % |
| Yield (net investment income as a % of average invested assets) | 3.82 % | 3.86 % | (0.04%) | |
| Tax equivalent yield (*) | 4.26 % | 4.34 % | (0.08%) | |

(*) Adjusts the yield on equity securities and tax-exempt bonds to the fully taxable equivalent yield.

The increase in average invested assets and net investment income in the property and casualty insurance segment for the third quarter of 2017 as compared to the third quarter of 2016 is due primarily to growth in the property and casualty insurance segment. The property and casualty insurance segment's overall yield on investments (net investment income as a percentage of average invested assets) was 3.82% for the third quarter of 2017 compared to 3.86% for the third quarter of 2016, a decrease of 0.04 percentage points, reflecting the impact of lower yields available in the financial markets and lower income from certain investments that are required to be carried at fair value through earnings, partially offset by the growth in average investments.

Property and Casualty Other Income and Expenses, Net

Other income and expenses, net for AFG's property and casualty insurance operations was a net expense of $7 million for the third quarter of 2017 compared to $14 million in the third quarter of 2016, a decrease of $7 million (50%). The table below details the items included in other income and expenses, net for AFG's property and casualty insurance operations (in millions):

| | Three months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Other income | $1 | $3 |
| Other expenses | | |
| Amortization of intangibles | 2 | 2 |
| NATL merger expenses | — | 2 |
| Other | 6 | 13 |
| Total other expenses | 8 | 17 |
| Other income and expenses, net | $(7) | $(14) |

Annuity Segment — Results of Operations

AFG's annuity operations contributed $102 million in pretax earnings in the third quarter of 2017 compared to $107 million in the third quarter of 2016, a decrease of $5 million (5%). AFG's annuity segment results for the third quarter of 2017 as compared to the third quarter of 2016 reflect an 11% increase in average annuity investments (at amortized cost), partially offset by lower investment yields due to the run-off of higher yielding investments. While both periods reflect the positive impact of a higher stock market and the negative impact of lower than anticipated interest rates on the fair value accounting for fixed-indexed annuities, the lower than anticipated interest rates in the 2017 quarter had a higher unfavorable impact compared to the 2016 quarter.

The following table details AFG's earnings before income taxes from its annuity operations for the three months ended September 30, 2017 and 2016 (dollars in millions):

| | Three months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Revenues: | | | |
| Net investment income | $375 | $351 | 7 % |
| Other income: | | | |
| Guaranteed withdrawal benefit fees | 15 | 14 | 7 % |
| Policy charges and other miscellaneous income | 11 | 12 | (8 %) |
| Total revenues | 401 | 377 | 6 % |
| | | | |
| Costs and Expenses: | | | |
| Annuity benefits (*) | 215 | 189 | 14 % |

| | | | |
|---|---|---|---|
| Acquisition expenses | 54 | 53 | 2 % |
| Other expenses | 30 | 28 | 7 % |
| Total costs and expenses | 299 | 270 | 11 % |
| Earnings before income taxes | $102 | $107 | (5 %) |

Detail of annuity earnings before income taxes (dollars in millions):

| | Three months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Earnings before income taxes — before the impact of derivatives related to FIAs | $106 | $106 | — % |
| Impact of derivatives related to FIAs | (4 ) | 1 | (500 %) |
| Earnings before income taxes | $102 | $107 | (5 %) |

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(*) Annuity benefits consisted of the following (dollars in millions):

| | Three months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Interest credited — fixed | $160 | $145 | 10 % |
| Interest credited — fixed component of variable annuities | 1 | 1 | — % |
| Other annuity benefits: | | | |
| Change in expected death and annuitization reserve | 5 | 5 | — % |
| Amortization of sales inducements | 4 | 6 | (33 %) |
| Change in guaranteed withdrawal benefit reserve | 18 | 18 | — % |
| Change in other benefit reserves | 16 | 10 | 60 % |
| Total other annuity benefits | 43 | 39 | 10 % |
| Total before impact of derivatives related to FIAs | 204 | 185 | 10 % |
| Derivatives related to fixed-indexed annuities: | | | |
| Embedded derivative mark-to-market | 127 | 109 | 17 % |
| Equity option mark-to-market | (116 ) | (105 ) | 10 % |
| Impact of derivatives related to FIAs | 11 | 4 | 175 % |
| Total annuity benefits | $215 | $189 | 14 % |

The profitability of a fixed annuity business is largely dependent on the ability of a company to earn income on the assets supporting the business in excess of the amounts credited to policyholder accounts plus expenses incurred (earning a "spread"). Performance measures such as net interest spread and net spread earned are often presented by annuity businesses to help users of their financial statements better understand the company's performance.

Net Spread on Fixed Annuities (excludes variable annuity earnings)

The table below (dollars in millions) details the components of these spreads for AFG's fixed annuity operations (including fixed-indexed annuities):

| | Three months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Average fixed annuity investments (at amortized cost) | $31,713 | $28,548 | 11 % |
| Average fixed annuity benefits accumulated | 32,029 | 28,538 | 12 % |
| | | | |
| As % of fixed annuity benefits accumulated (except as noted): | | | |
| Net investment income (as % of fixed annuity investments) | 4.70 % | 4.88 % | |
| Interest credited — fixed | (2.01 %) | (2.03 %) | |
| Net interest spread | 2.69 % | 2.85 % | |
| | | | |
| Policy charges and other miscellaneous income | 0.10 % | 0.14 % | |
| Other annuity benefit expenses, net of guaranteed withdrawal benefit fees | (0.33 %) | (0.36 %) | |
| Acquisition expenses | (0.65 %) | (0.72 %) | |
| Other expenses | (0.36 %) | (0.39 %) | |
| Change in fair value of derivatives related to fixed-indexed annuities | (0.14 %) | (0.05 %) | |
| Net spread earned on fixed annuities | 1.31 % | 1.47 % | |

The table below illustrates the impact of fair value accounting for derivatives related to fixed-indexed annuities on the annuity segment's net spread earned on fixed annuities:

| | Three months ended September 30, | | | |
|---|---|---|---|---|
| | 2017 | | 2016 | |
| Net spread earned on fixed annuities — before impact of derivatives related to FIAs | 1.36 | % | 1.46 | % |
| Impact of derivatives related to fixed-indexed annuities: | | | | |
| Change in fair value of derivatives | (0.14 | %) | (0.05 | %) |
| Related impact on amortization of deferred policy acquisition costs (*) | 0.09 | % | 0.06 | % |
| Related impact on amortization of deferred sales inducements (*) | — | % | — | % |
| Net spread earned on fixed annuities | 1.31 | % | 1.47 | % |

(*) An estimate of the related acceleration/deceleration of the amortization of deferred policy acquisition costs and deferred sales inducements.

Annuity Net Investment Income

Net investment income for the third quarter of 2017 was $375 million compared to $351 million for the third quarter of 2016, an increase of $24 million (7%). This increase reflects the growth in AFG's annuity business, partially offset by the impact of lower investment yields and lower investment income from certain investments that are required to be carried at fair value through earnings. The overall yield earned on investments in AFG's fixed annuity operations, calculated as net investment income divided by average investment balances (at amortized cost), decreased by 0.18 percentage points to 4.70% from 4.88% in the third quarter of 2017 compared to the third quarter of 2016. This decline in net investment yield reflects (i) the investment of new premium dollars at lower yields as compared to the existing investment portfolio and (ii) the impact of the reinvestment of proceeds from maturity and redemption of higher yielding investments at the lower yields available in the financial markets. During the first nine months of 2017, $3.6 billion in annuity segment investments with an average yield of 5.24% were redeemed or sold while the investments purchased during 2017 (with new premium dollars and the redemption/sale proceeds) had an average yield at purchase of 3.93%.

Annuity Interest Credited — Fixed

Interest credited — fixed for the third quarter of 2017 was $160 million compared to $145 million for the third quarter of 2016, an increase of $15 million (10%). The impact of growth in the annuity business was partially offset by lower interest crediting rates on new premiums as compared to the crediting rates on policyholder funds surrendered or withdrawn. The average interest rate credited to policyholders, calculated as interest credited divided by average fixed annuity benefits accumulated, decreased 0.02 percentage points to 2.01% in the third quarter of 2017 from 2.03% in the third quarter of 2016.

Annuity Net Interest Spread

AFG’s net interest spread decreased 0.16 percentage points to 2.69% from 2.85% in the third quarter of 2017 compared to the same period in 2016 due primarily to the impact of lower investment yields, partially offset by lower crediting rates. Features included in current annuity product offerings allow AFG to achieve its desired profitability at a lower net interest spread than historical product offerings. As a result, AFG expects its net interest spread to narrow in the future.

Annuity Policy Charges and Other Miscellaneous Income

Annuity policy charges and other miscellaneous income, which consist primarily of surrender charges, amortization of deferred upfront policy charges (unearned revenue) and income from sales of real estate were $11 million for the third quarter of 2017 compared to $12 million for the third quarter of 2016, a decrease of $1 million (8%). As a percentage of average fixed annuity benefits accumulated, annuity policy charges and other miscellaneous income decreased 0.04 percentage points to 0.10% from 0.14% in the third quarter of 2017 compared to the third quarter of 2016.

Other Annuity Benefits, Net of Guaranteed Withdrawal Benefit Fees

Other annuity benefits, net of guaranteed withdrawal benefit fees, for the third quarter of 2017 were $28 million compared to $25 million for the third quarter of 2016, an increase of $3 million (12%). As a percentage of average fixed annuity benefits accumulated, these net expenses decreased 0.03 percentage points to 0.33% from 0.36% in the third quarter of 2017 compared to third quarter of 2016. In addition to interest credited to policyholders' accounts and the change in fair value of derivatives related to fixed-indexed annuities, annuity benefits expense also includes the following expenses (in millions, net of guaranteed withdrawal benefit fees):

| | Three months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Change in expected death and annuitization reserve | $5 | $5 |
| Amortization of sales inducements | 4 | 6 |
| Change in guaranteed withdrawal benefit reserve | 18 | 18 |
| Change in other benefit reserves | 16 | 10 |
| Other annuity benefits | 43 | 39 |
| Offset guaranteed withdrawal benefit fees | (15 ) | (14 ) |
| Other annuity benefits, net | $28 | $25 |

As discussed under "Annuity Benefits Accumulated" in Note A — "Accounting Policies" to the financial statements, guaranteed withdrawal benefit reserves are accrued for and modified using assumptions similar to those used in establishing and amortizing deferred policy acquisition costs. The guaranteed withdrawal benefit reserve related to FIAs can be inversely impacted by the calculated FIA embedded derivative reserve as the value to policyholders of the guaranteed withdrawal benefits decreases when the benefit of stock market participation increases.

Annuity Acquisition Expenses

AFG's amortization of deferred policy acquisition costs ("DPAC") and commission expenses as a percentage of average fixed annuity benefits accumulated was 0.65% for the third quarter of 2017 compared to 0.72% for the third quarter of 2016 and has generally ranged between 0.75% and 0.85%. Variances from the general range relate primarily to the impact of (i) material changes in interest rates or the stock market on AFG's fixed-indexed annuity business, and (ii) differences in actual experience from actuarially projected estimates and assumptions. For example, the negative impact of lower than anticipated interest rates during the third quarter of 2017 on the fair value of derivatives related to fixed-indexed annuities (discussed below) resulted in a partially offsetting deceleration of the amortization of DPAC.

The table below illustrates the estimated impact of fair value accounting for derivatives related to fixed-indexed annuities on annuity acquisition expenses as a percentage of average fixed annuity benefits accumulated:

| | Three months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Before the impact of changes in the fair value of derivatives related to FIAs on the amortization of DPAC | 0.74 % | 0.78 % |
| Impact of changes in fair value of derivatives related to FIAs on amortization of DPAC (*) | (0.09%) | (0.06%) |

| | | |
|---|---|---|
| Annuity acquisition expenses as a % of fixed annuity benefits accumulated | 0.65 % | 0.72 % |

(*) An estimate of the acceleration/deceleration of the amortization of deferred policy acquisition costs resulting from fair value accounting for derivatives related to fixed-indexed annuities.

Annuity Other Expenses

Annuity other expenses were $30 million for the third quarter of 2017 compared to $28 million for the third quarter of 2016, an increase of $2 million (7%). Annuity other expenses represent primarily general and administrative expenses, as well as selling and issuance expenses that are not deferred. As a percentage of average fixed annuity benefits accumulated, these expenses were 0.36% for the third quarter of 2017 compared to 0.39% for the third quarter of 2016.

Change in Fair Value of Derivatives Related to Fixed-Indexed Annuities

AFG’s fixed-indexed annuities 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 the change in the fair value of the call option assets will

generally offset the economic change in the liabilities from the index participation. Both the index-based component of the annuities and the related call options are considered derivatives that must be adjusted for changes in fair value through earnings each period. The fair values of these derivatives are impacted by actual and expected stock market performance and interest rates as well as other factors. For a list of other factors impacting the fair value of the index-based component of AFG's annuity benefits accumulated, see Note D — "Fair Value Measurements" to the financial statements. The net change in fair value of derivatives related to fixed-indexed annuities increased annuity benefits by $11 million and $4 million in the third quarter of 2017 and 2016, respectively. During the third quarter of 2017, the negative impact of lower than anticipated interest rates on the fair value of these derivatives was partially offset by the positive impact of strong stock market performance. During the third quarter of 2016, slightly lower than anticipated interest rates had a negative impact on the fair value of these derivatives that was partially offset by a moderate increase in the stock market. As a percentage of average fixed annuity benefits accumulated, this net expense increased 0.09 percentage points to 0.14% in the third quarter of 2017 from 0.05% in the third quarter of 2016.

Fluctuations in interest rates and the stock market, among other factors, can cause volatility in the periodic measurement of fair value of the embedded derivative that management believes can be inconsistent with the long-term economics of these products. The table below illustrates the impact of fair value accounting for derivatives related to fixed-indexed annuities on the annuity segment's earnings before income taxes (dollars in millions):

| | Three months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Earnings before income taxes — before change in fair value of derivatives related to fixed-indexed annuities | $106 | $106 | — % |
| Change in fair value of derivatives related to fixed-indexed annuities | (11) | (4) | 175 % |
| Related impact on amortization of DPAC (*) | 7 | 5 | 40 % |
| Earnings before income taxes | $102 | $107 | (5 %) |

(*) An estimate of the related acceleration/deceleration of the amortization of deferred policy acquisition costs and deferred sales inducements.

As illustrated in the table above, the change in fair value of derivatives related to fixed-indexed annuities, including the related impact on amortization of DPAC, decreased the annuity segment's earnings before income taxes by $4 million in the third quarter of 2017 and increased the annuity segment's earnings before income taxes by $1 million in the third quarter of 2016.

Annuity Net Spread Earned on Fixed Annuities
AFG's net spread earned on fixed annuities decreased 0.16 percentage points to 1.31% from 1.47% in the third quarter of 2017 compared to the same period in 2016 due primarily to the net impact of changes in the fair value of derivatives and related DPAC amortization offset discussed above and by the 0.16 percentage points decrease in AFG's net interest spread.

Annuity Benefits Accumulated
Annuity premiums received 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 and other benefits are charged to expense and decreases for surrender and other policy charges are credited to other income.

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For certain products, annuity benefits accumulated also includes reserves for accrued persistency and premium bonuses, excess benefits expected to be paid on future deaths and annuitizations ("EDAR") and guaranteed withdrawal benefits. Annuity benefits accumulated also includes amounts advanced from the Federal Home Loan Bank of Cincinnati. The following table is a progression of AFG's annuity benefits accumulated liability for the three months ended September 30, 2017 and 2016 (in millions):

| | Three months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Beginning fixed annuity reserves | $31,704 | $28,222 |
| Fixed annuity premiums (receipts) | 869 | 932 |
| Surrenders, benefits and other withdrawals | (540) | (586) |
| Interest and other annuity benefit expenses: | | |
| Interest credited | 160 | 145 |
| Embedded derivative mark-to-market | 127 | 109 |
| Change in other benefit reserves | 34 | 31 |
| Ending fixed annuity reserves | $32,354 | $28,853 |
| | | |
| Reconciliation to annuity benefits accumulated per balance sheet: | | |
| Ending fixed annuity reserves (from above) | $32,354 | $28,853 |
| Impact of unrealized investment related gains | 138 | 180 |
| Fixed component of variable annuities | 179 | 189 |
| Annuity benefits accumulated per balance sheet | $32,671 | $29,222 |

Statutory Annuity Premiums

AFG's annuity operations generated statutory premiums of $876 million in the third quarter of 2017 compared to $941 million in the third quarter of 2016, a decrease of $65 million (7%). The following table summarizes AFG's annuity sales (dollars in millions):

| | Three months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Financial institutions single premium annuities — indexed | $360 | $435 | (17 %) |
| Financial institutions single premium annuities — fixed | 82 | 97 | (15 %) |
| Retail single premium annuities — indexed | 367 | 340 | 8 % |
| Retail single premium annuities — fixed | 19 | 18 | 6 % |
| Education market — fixed and indexed annuities | 41 | 42 | (2 %) |
| Total fixed annuity premiums | 869 | 932 | (7 %) |
| Variable annuities | 7 | 9 | (22 %) |
| Total annuity premiums | $876 | $941 | (7 %) |

Management attributes the 7% decrease to AFG's adherence to pricing discipline in a relatively low and decreasing interest rate environment during the year, as well as from aggressive pricing by certain of AFG's competitors.

AFG continues to implement product and process changes needed to comply with the Department of Labor ("DOL") Fiduciary Rule. Although the DOL Fiduciary Rule became effective on June 9, 2017, the DOL delayed certain requirements until January 1, 2018. As a result, insurance-only agents are able to continue selling fixed-indexed annuities through the end of 2017, provided the agent acts in the customer's best interest, makes no misleading statements and receives only reasonable compensation. The DOL recently released a proposal to delay full implementation until July 1, 2019. There is uncertainty as to whether the rule will take effect in its current form on that date.

AFG believes the biggest impact of the rule will be on insurance-only licensed agents whose qualified sales represented approximately 10% of its third quarter 2017 annuity premiums. AFG's management continues to believe that full implementation is likely to cause some short-term disruption in annuity premiums. Nonetheless, management does not believe the new rule will have a material impact on AFG's results of operations.

Annuity Earnings before Income Taxes Reconciliation

The following table reconciles the net spread earned on AFG's fixed annuities to overall annuity pretax earnings for the three months ended September 30, 2017 and 2016 (in millions):

| | Three months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Earnings on fixed annuity benefits accumulated | $105 | $105 |
| Earnings impact of investments in excess of fixed annuity benefits accumulated (*) | (4 ) | — |
| Variable annuity earnings | 1 | 2 |
| Earnings before income taxes | $102 | $107 |

(*) Net investment income (as a % of investments) of 4.70% and 4.88% for the three months ended September 30, 2017 and 2016, respectively, multiplied by the difference between average fixed annuity investments (at amortized cost) and average fixed annuity benefits accumulated in each period.

Run-off Long-Term Care and Life Segment — Results of Operations The following table details AFG's earnings before income taxes from its run-off long-term care and life operations for the three months ended September 30, 2017 and 2016 (dollars in millions):

| | Three months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Revenues: | | | |
| Net earned premiums: | | | |
| Long-term care | $ — | $ — | — % |
| Life operations | 6 | 6 | — % |
| Net investment income | 6 | 5 | 20 % |
| Other income | — | 2 | (100 %) |
| Total revenues | 12 | 13 | (8 %) |
| | | | |
| Costs and Expenses: | | | |
| Life, accident and health benefits: | | | |
| Long-term care | 1 | 2 | (50 %) |
| Life operations | 5 | 6 | (17 %) |
| Acquisition expenses | 1 | 1 | — % |
| Other expenses | 3 | 3 | — % |
| Total costs and expenses | 10 | 12 | (17 %) |
| Earnings before income taxes | $ 2 | $ 1 | 100 % |

The $1 million increase in earnings before income taxes reflects the impact of improved life claims experience in the third quarter of 2017 compared to the third quarter of 2016.

Holding Company, Other and Unallocated — Results of Operations AFG's net GAAP pretax loss outside of its insurance operations (excluding realized gains and losses) totaled $69 million in the third quarter of 2017 compared to $53 million in the third quarter of 2016, an increase of $16 million (30%). AFG's net core pretax loss outside of its insurance operations (excluding realized gains and losses) totaled $41 million in the third quarter of 2017 compared to $48 million in the third quarter of 2016, a decrease of $7 million (15%).

The following table details AFG's GAAP and core loss before income taxes from operations outside of its insurance operations for the three months ended September 30, 2017 and 2016 (dollars in millions):

| | Three months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Revenues: | | | |
| Net investment income | $1 | $1 | — % |
| Other income — P&C fees | 17 | 14 | 21 % |
| Other income | 9 | 5 | 80 % |
| Total revenues | 27 | 20 | 35 % |
| | | | |
| Costs and Expenses: | | | |
| Property and casualty insurance — commissions and other underwriting expenses | 4 | 4 | — % |
| Interest charges on borrowed money | 21 | 19 | 11 % |
| Other expense — expenses associated with P&C fees | 13 | 10 | 30 % |
| Other expenses (*) | 30 | 35 | (14 %) |
| Total costs and expenses | 68 | 68 | — % |
| Core loss before income taxes, excluding realized gains and losses | (41 ) | (48 ) | (15 %) |
| Pretax non-core special A&E charges | (24 ) | (5 ) | 380 % |
| Pretax non-core loss on retirement of debt | (4 ) | — | — % |
| GAAP loss before income taxes, excluding realized gains and losses | $(69) | $(53) | 30 % |

(*) Excludes pretax non-core special A&E charges of $24 million and $5 million in the third quarter of 2017 and 2016, respectively, and a pretax non-core loss on retirement of debt of $4 million in the third quarter of 2017.

Holding Company and Other — Net Investment Income
AFG recorded net investment income on investments held outside of its insurance operations of $1 million in both the third quarter of 2017 and the third quarter of 2016.

Holding Company and Other — P&C Fees and Related Expenses
Summit, a workers' compensation insurance business, collects fees from a small group of unaffiliated insurers for providing underwriting, policy administration and claims services. In addition, certain of AFG's property and casualty businesses collect fees from customers for ancillary services such as workplace safety programs and premium financing. In the third quarter of 2017, AFG collected $17 million in fees for these services compared to $14 million in the third quarter of 2016. Management views this fee income, net of the $13 million in the third quarter of 2017 and $10 million in the third quarter of 2016 in expenses incurred to generate such fees, as a reduction in the cost of underwriting its property and casualty insurance policies. Consistent with internal management reporting, these fees

and the related expenses are netted and recorded as a reduction of commissions and other underwriting expenses in AFG's segmented results.

Holding Company and Other — Other Income

Other income in the table above includes $5 million and $4 million in the third quarter of 2017 and 2016, respectively, in management fees paid to AFG by the AFG-managed CLOs (AFG's consolidated managed investment entities). The management fees are eliminated in consolidation — see the other income line in the Consolidate MIEs column under "Results of Operations — Segmented Statement of Earnings." Results for the third quarter of 2017 include $2 million in income related to the sale of real estate.

Holding Company and Other — Interest Charges on Borrowed Money

AFG's holding companies and other operations outside of its insurance operations recorded interest expense of $21 million in the third quarter of 2017 compared to $19 million in the third quarter of 2016, an increase of $2 million (11%). This increase reflects higher average indebtedness, partially offset by a lower weighted average interest rate on outstanding debt. The following table details the principal amount of AFG's long-term debt balances as of September 30, 2017 compared to July 1, 2016 (dollars in millions):

| | September 30, 2017 | July 1, 2016 |
|---|---|---|
| Direct obligations of AFG: | | |
| 9-7/8% Senior Notes due June 2019 | $ 350 | $ 350 |
| 3.50% Senior Notes due August 2026 | 300 | — |
| 6-3/8% Senior Notes due June 2042 | — | 230 |
| 5-3/4% Senior Notes due August 2042 | — | 125 |
| 4.50% Senior Notes due June 2047 | 350 | — |
| 6-1/4% Subordinated Debentures due September 2054 | 150 | 150 |
| 6% Subordinated Debentures due November 2055 | 150 | 150 |
| Other | 3 | 3 |
| Total principal amount of Holding Company Debt | $ 1,303 | $ 1,008 |
| | | |
| Weighted Average Interest Rate | 6.1 % | 7.4 % |

The increase in average indebtedness for the third quarter of 2017 as compared to the third quarter of 2016 reflects the following financing transactions completed by AFG between July 1, 2016 and September 30, 2017:

- Issued $300 million of 3.50% Senior Notes on August 22, 2016
- Issued $350 million of 4.50% Senior Notes on June 2, 2017
- Redeemed $230 million of 6-3/8% Senior Notes on June 26, 2017
- Redeemed $125 million of 5-3/4% Senior Notes on August 25, 2017

The redemption of the 6-3/8% and 5-3/4% Senior Notes and the issuance of the 4.50% Senior Notes in 2017 will result in annual pretax interest savings to AFG of $6 million.

Holding Company and Other — Special A&E Charges

As a result of the 2017 comprehensive external study and the 2016 internal review of A&E exposures discussed under "Special asbestos and environmental reserve charges" under "Results of Operations — Property and Casualty Insurance Segment — Net prior year reserve development," AFG's holding companies and other operations outside of its insurance operations recorded pretax special charges of $24 million in the third quarter of 2017 and $5 million in the third quarter of 2016 to increase liabilities related to the A&E exposures of AFG's former railroad and manufacturing operations. The $24 million charge in 2017 is due primarily to relatively small movements across several sites that primarily reflect changes in the scope and costs of investigation. In addition, AFG has seen a small increase in claims arising from exposure to deleterious substances other than asbestos, which has caused it to increase its estimated future liability. The $5 million charge in 2016 is due primarily to relatively small movements across several sites related to changes in the scope and costs of investigation.

Holding Company and Other — Loss on Retirement of Debt

AFG wrote off unamortized debt issuance costs of $4 million related to the redemption of its $125 million outstanding 5-3/4% Senior Notes due 2042 at par value on August 25, 2017.

Holding Company and Other — Other Expenses

Excluding the non-core special A&E charges and the non-core loss on retirement of debt discussed above, AFG's holding companies and other operations outside of its insurance operations recorded other expenses of $30 million in the third quarter of 2017 compared to $35 million in the third quarter of 2016, a decrease of $5 million (14%). This decrease reflects the impact of a $5 million donation to the University of Cincinnati College of Business in the third quarter of 2016.

Consolidated Realized Gains (Losses) on Securities AFG's consolidated realized gains (losses) on securities, which are not allocated to segments, were losses of $12 million in the third quarter of 2017 compared to gains of $2 million in the third quarter of 2016, a decrease of $14 million (700%). Realized gains (losses) on securities consisted of the following (in millions):

| | Three months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Realized gains (losses) before impairments: | | |
| Disposals | $29 | $22 |
| Change in the fair value of derivatives | (1) | (3) |
| Adjustments to annuity deferred policy acquisition costs and related items | (2) | (1) |
| | 26 | 18 |
| Impairment charges: | | |
| Securities | (44) | (18) |
| Adjustments to annuity deferred policy acquisition costs and related items | 6 | 2 |
| | (38) | (16) |
| Realized gains (losses) on securities | $(12) | $2 |

AFG's impairment charges on securities for the third quarter of 2017 consist of $29 million on equity securities and $15 million on fixed maturities compared to $16 million on equity securities and $2 million on fixed maturities in the third quarter of 2016. Approximately $14 million in impairment charges in the third quarter of 2017 relate to investments in pharmaceutical companies, $10 million relates to an investment in a media company and the remainder relates primarily to investments in various industrial entities. Approximately $11 million of the impairment charges recorded in the third quarter of 2016 are related to financial institutions and $6 million relates to a company in the forest products industry.

Consolidated Income Taxes AFG's consolidated provision for income taxes was $18 million for the third quarter of 2017 compared to $65 million for the third quarter of 2016, a decrease of $47 million (72%). See Note L — "Income Taxes" to the financial statements for an analysis of items affecting AFG's effective tax rate.

Consolidated Noncontrolling Interests AFG's consolidated net earnings attributable to noncontrolling interests was $4 million for the third quarter of 2016. The following table details net earnings in consolidated subsidiaries attributable to holders other than AFG (dollars in millions):

| | Three months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| National Interstate | $ — | $ 4 | (100 %) |
| Earnings attributable to noncontrolling interests | $ — | $ 4 | (100 %) |

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RESULTS OF OPERATIONS — NINE MONTHS ENDED SEPTEMBER 30, 2017 AND 2016

Segmented Statement of Earnings AFG reports its business as four segments: (i) Property and casualty insurance ("P&C"), (ii) Annuity, (iii) Run-off long-term care and life and (iv) Other, which includes holding company costs and income and expenses related to the managed investment entities ("MIEs").

AFG's net earnings attributable to shareholders, determined in accordance with GAAP, include certain items that may not be indicative of its ongoing core operations. The following tables for the nine months ended September 30, 2017 and 2016 identify such items by segment and reconcile net earnings attributable to shareholders to core net operating earnings, a non-GAAP financial measure that AFG believes is a useful tool for investors and analysts in analyzing ongoing operating trends (in millions):

| | P&C | Annuity | Run-off long-term care and life | Other Consol. MIEs | Other Holding Co., other and unallocated | Total | Non-core reclass | GAAP Total |
|---|---|---|---|---|---|---|---|---|
| Nine months ended September 30, 2017 | | | | | | | | |
| Revenues: | | | | | | | | |
| Property and casualty insurance net earned premiums | $3,354 | $— | $ — | $— | $ — | $3,354 | $ — | $3,354 |
| Life, accident and health net earned premiums | — | — | 17 | — | — | 17 | — | 17 |
| Net investment income | 276 | 1,082 | 16 | (16) | 8 | 1,366 | — | 1,366 |
| Realized losses on securities | — | — | — | — | — | — | (1 ) | (1 ) |
| Income of MIEs: | | | | | | | | |
| Investment income | — | — | — | 155 | — | 155 | — | 155 |
| Gain on change in fair value of assets/liabilities | — | — | — | 12 | — | 12 | — | 12 |
| Other income | 21 | 79 | 2 | (14) | 66 | 154 | — | 154 |
| Total revenues | 3,651 | 1,161 | 35 | 137 | 74 | 5,058 | (1 ) | 5,057 |
| Costs and Expenses: | | | | | | | | |
| Property and casualty insurance: | | | | | | | | |
| Losses and loss adjustment expenses | 2,150 | — | — | — | — | 2,150 | 89 | 2,239 |
| Commissions and other underwriting expenses | 1,046 | — | — | — | 16 | 1,062 | — | 1,062 |
| Annuity benefits | — | 635 | — | — | — | 635 | — | 635 |
| Life, accident and health benefits | — | — | 21 | — | — | 21 | — | 21 |
| Annuity and supplemental insurance acquisition expenses | — | 153 | 3 | — | — | 156 | — | 156 |
| Interest charges on borrowed money | — | — | — | — | 65 | 65 | — | 65 |
| Expenses of MIEs | — | — | — | 137 | — | 137 | — | 137 |
| Other expenses | 26 | 90 | 7 | — | 127 | 250 | 35 | 285 |
| Total costs and expenses | 3,222 | 878 | 31 | 137 | 208 | 4,476 | 124 | 4,600 |
| Earnings before income taxes | 429 | 283 | 4 | — | (134 ) | 582 | (125) | 457 |
| Provision for income taxes | 150 | 96 | 1 | — | (58 ) | 189 | (43) | 146 |
| Net earnings, including noncontrolling interests | 279 | 187 | 3 | — | (76 ) | 393 | (82) | 311 |
| Less: Net earnings attributable to noncontrolling interests | 2 | — | — | — | — | 2 | — | 2 |
| Core Net Operating Earnings | 277 | 187 | 3 | — | (76 ) | 391 | | |
| Non-core earnings attributable to shareholders (a): | | | | | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Realized losses on securities, net of tax | — | — | — | — | (1) | (1) | 1 | — |
| Special A&E charges, net of tax | (58) | — | — | — | (16) | (74) | 74 | — |
| Loss on retirement of debt, net of tax | — | — | — | — | (7) | (7) | 7 | — |
| Net Earnings Attributable to Shareholders | $219 | $187 | $3 | $— | $(100) | $309 | $— | $309 |

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| | P&C | Annuity | Run-off long-term care and life | Consol. MIEs | Other Holding Co., other and unallocated | Total | Non-core reclass | GAAP Total |
|---|---|---|---|---|---|---|---|---|
| Nine months ended September 30, 2016 | | | | | | | | |
| Revenues: | | | | | | | | |
| Property and casualty insurance net earned premiums | $3,184 | $— | $ — | $— | $— | $3,184 | $ — | $3,184 |
| Life, accident and health net earned premiums | — | — | 18 | — | — | 18 | — | 18 |
| Net investment income | 265 | 1,010 | 15 | (29) | 6 | 1,267 | — | 1,267 |
| Realized gains (losses) on: | | | | | | | | |
| Securities | — | — | — | — | — | — | (32) | (32) |
| Subsidiaries | — | — | — | — | — | — | 2 | 2 |
| Income of MIEs: | | | | | | | | |
| Investment income | — | — | — | 141 | — | 141 | — | 141 |
| Gain on change in fair value of assets/liabilities | — | — | — | 9 | — | 9 | — | 9 |
| Other income | 14 | 76 | 4 | (12) | 58 | 140 | 32 | 172 |
| Total revenues | 3,463 | 1,086 | 37 | 109 | 64 | 4,759 | 2 | 4,761 |
| Costs and Expenses: | | | | | | | | |
| Property and casualty insurance: | | | | | | | | |
| Losses and loss adjustment expenses | 1,940 | — | — | — | — | 1,940 | 93 | 2,033 |
| Commissions and other underwriting expenses | 1,017 | — | — | — | 13 | 1,030 | 8 | 1,038 |
| Annuity benefits | — | 640 | — | — | — | 640 | — | 640 |
| Life, accident and health benefits | — | — | 26 | — | — | 26 | — | 26 |
| Annuity and supplemental insurance acquisition expenses | — | 127 | 4 | — | — | 131 | — | 131 |
| Interest charges on borrowed money | — | — | — | — | 56 | 56 | — | 56 |
| Expenses of MIEs | — | — | — | 109 | — | 109 | — | 109 |
| Other expenses | 42 | 83 | 7 | — | 121 | 253 | 5 | 258 |
| Total costs and expenses | 2,999 | 850 | 37 | 109 | 190 | 4,185 | 106 | 4,291 |
| Earnings before income taxes | 464 | 236 | — | — | (126) | 574 | (104) | 470 |
| Provision for income taxes | 164 | 83 | — | — | (45) | 202 | (12) | 190 |
| Net earnings, including noncontrolling interests | 300 | 153 | — | — | (81) | 372 | (92) | 280 |
| Less: Net earnings attributable to noncontrolling interests | 14 | — | — | — | — | 14 | 2 | 16 |
| Core Net Operating Earnings | 286 | 153 | — | — | (81) | 358 | | |
| Non-core earnings attributable to shareholders (a): | | | | | | | | |
| Realized losses on securities, net of tax and noncontrolling interests | — | — | — | — | (19) | (19) | 19 | — |
| Realized gain on subsidiaries, net of tax | — | — | 1 | — | — | 1 | (1) | — |
| Gain on sale of apartment property, net of tax and noncontrolling interests | 15 | — | — | — | — | 15 | (15) | — |
| Special A&E charges, net of tax | (23) | — | — | — | (3) | (26) | 26 | — |
| Neon exited lines charge | (65) | — | — | — | — | (65) | 65 | — |
| Net Earnings Attributable to Shareholders | $213 | $153 | $ 1 | $— | $(103) | $264 | $ — | $264 |

(a) See the reconciliation of core earnings to GAAP net earnings under "Results of Operations — General" for details on the tax and noncontrolling interest impacts of these reconciling items.

Property and Casualty Insurance Segment — Results of Operations AFG's property and casualty insurance operations contributed $340 million in GAAP pretax earnings in the first nine months of 2017 compared to $395 million in the first nine months of 2016, a decrease of $55 million (14%). Property and casualty core pretax earnings were $429 million in the first nine months of 2017 compared to $464 million in the first nine months of 2016, a decrease of $35 million (8%). The decrease in GAAP pretax earnings reflects special A&E charges of $89 million in the first nine months of 2017 compared to $36 million in

the comparable 2016 period, lower core pretax earnings and a $32 million pretax non-core gain on the sale of an apartment property in the second quarter of 2016, partially offset by a pretax non-core charge of $65 million in the second quarter of 2016 related to the exit of certain lines of business within Neon. The decrease in GAAP and core pretax earnings reflects lower underwriting results due primarily to catastrophe losses from Hurricanes Harvey, Irma and Maria and two earthquakes in Mexico.

The following table details AFG's GAAP and core earnings before income taxes from its property and casualty insurance operations for the nine months ended September 30, 2017 and 2016 (dollars in millions):

| | Nine months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Gross written premiums | $4,931 | $4,540 | 9 % |
| Reinsurance premiums ceded | (1,341 ) | (1,237 ) | 8 % |
| Net written premiums | 3,590 | 3,303 | 9 % |
| Change in unearned premiums | (236 ) | (119 ) | 98 % |
| Net earned premiums | 3,354 | 3,184 | 5 % |
| Loss and loss adjustment expenses (a) | 2,150 | 1,940 | 11 % |
| Commissions and other underwriting expenses (b) | 1,046 | 1,017 | 3 % |
| Core underwriting gain | 158 | 227 | (30 %) |
| | | | |
| Net investment income | 276 | 265 | 4 % |
| Other income and expenses, net (c) | (5 ) | (28 ) | (82 %) |
| Core earnings before income taxes | 429 | 464 | (8 %) |
| Pretax non-core special A&E charges | (89 ) | (36 ) | 147 % |
| Pretax non-core Neon exited lines charge | — | (65 ) | (100 %) |
| Pretax non-core gain on sale of apartment property | — | 32 | (100 %) |
| GAAP earnings before income taxes | $340 | $395 | (14 %) |

(a) Excludes pretax non-core special A&E charges of $89 million and $36 million in the third quarter of 2017 and 2016, respectively, and a non-core charge of $57 million related to the exit of certain lines of business within Neon in the second quarter of 2016.
(b) Excludes a non-core charge of $8 million related to the exit of certain lines of business within Neon in the second quarter of 2016.
(c) Excludes a pretax non-core gain of $32 million on the sale of an apartment property in the second quarter of 2016.

| Combined Ratios: | | | |
|---|---|---|---|
| Specialty lines | | | Change |
| Loss and LAE ratio | 64.0 % | 61.0 % | 3.0 % |
| Underwriting expense ratio | 31.2 % | 31.9 % | (0.7 %) |
| Combined ratio | 95.2 % | 92.9 % | 2.3 % |

Aggregate — including exited lines

| | | | |
|---|---|---|---|
| Loss and LAE ratio | 66.7 % | 63.8 % | 2.9 % |
| Underwriting expense ratio | 31.2 % | 32.2 % | (1.0 %) |
| Combined ratio | 97.9 % | 96.0 % | 1.9 % |

AFG reports the underwriting performance of its Specialty property and casualty insurance business in the following sub-segments: (i) Property and transportation, (ii) Specialty casualty and (iii) Specialty financial.

Gross Written Premiums

Gross written premiums (“GWP”) for AFG’s property and casualty insurance segment were $4.93 billion for the first nine months of 2017 compared to $4.54 billion for the first nine months of 2016, an increase of $391 million (9%). Detail of AFG’s property and casualty gross written premiums is shown below (dollars in millions):

| | Nine months ended September 30, | | | | |
|---|---|---|---|---|---|
| | 2017 | | 2016 | | |
| | GWP | % | GWP | % | % Change |
| Property and transportation | $2,062 | 42 % | $1,927 | 43 % | 7 % |
| Specialty casualty | 2,350 | 48 % | 2,108 | 46 % | 11 % |
| Specialty financial | 519 | 10 % | 505 | 11 % | 3 % |
| | $4,931 | 100% | $4,540 | 100% | 9 % |

Reinsurance Premiums Ceded

Reinsurance premiums ceded (“Ceded”) for AFG’s property and casualty insurance segment were 27% of gross written premiums for both the first nine months of 2017 and the first nine months of 2016. Detail of AFG’s property and casualty reinsurance premiums ceded is shown below (dollars in millions):

| | Nine months ended September 30, | | | | |
|---|---|---|---|---|---|
| | 2017 | | 2016 | | Change in |
| | Ceded | % of GWP | Ceded | % of GWP | % of GWP |
| Property and transportation | $(721) | 35 % | $(649) | 34 % | 1 % |
| Specialty casualty | (625) | 27 % | (582) | 28 % | (1 %) |
| Specialty financial | (79) | 15 % | (87) | 17 % | (2 %) |
| Other specialty | 84 | | 81 | | |
| | $(1,341) | 27 % | $(1,237) | 27 % | — % |

Net Written Premiums

Net written premiums (“NWP”) for AFG’s property and casualty insurance segment were $3.59 billion for the first nine months of 2017 compared to $3.30 billion for the first nine months of 2016, an increase of $287 million (9%). Detail of AFG’s property and casualty net written premiums is shown below (dollars in millions):

| | Nine months ended September 30, | | | | |
|---|---|---|---|---|---|
| | 2017 | | 2016 | | |
| | NWP | % | NWP | % | % Change |
| Property and transportation | $1,341 | 37 % | $1,278 | 39 % | 5 % |
| Specialty casualty | 1,725 | 48 % | 1,526 | 46 % | 13 % |
| Specialty financial | 440 | 12 % | 418 | 13 % | 5 % |
| Other specialty | 84 | 3 % | 81 | 2 % | 4 % |
| | $3,590 | 100% | $3,303 | 100% | 9 % |

Net Earned Premiums

Net earned premiums ("NEP") for AFG's property and casualty insurance segment were $3.35 billion for the first nine months of 2017 compared to $3.18 billion for the first nine months of 2016, an increase of $170 million (5%). Detail of AFG's property and casualty net earned premiums is shown below (dollars in millions):

| | Nine months ended September 30, | | | | |
|---|---|---|---|---|---|
| | 2017 | | 2016 | | |
| | NEP | % | NEP | % | % Change |
| Property and transportation | $1,226 | 37 % | $1,197 | 38 % | 2 % |
| Specialty casualty | 1,613 | 48 % | 1,496 | 47 % | 8 % |
| Specialty financial | 435 | 13 % | 416 | 13 % | 5 % |
| Other specialty | 80 | 2 % | 75 | 2 % | 7 % |
| | $3,354 | 100 % | $3,184 | 100 % | 5 % |

The $391 million (9%) increase in gross written premiums for the first nine months of 2017 compared to the first nine months of 2016 reflects growth in each of the Specialty property and casualty insurance sub-segments. Overall average renewal rates increased 1% in the first nine months of 2017.

Property and transportation Gross written premiums increased $135 million (7%) in the first nine months of 2017 compared to the first nine months of 2016. This increase was the result of higher gross written premiums in the agricultural and transportation businesses, and the Singapore branch. This growth was partially offset by lower premiums resulting from an exit from the customs bond business, which was part of the ocean marine operations. Average renewal rates increased approximately 3% for this group in the first nine months of 2017. Reinsurance premiums ceded as a percentage of gross written premiums increased 1 percentage point for the first nine months of 2017 compared to the first nine months of 2016, reflecting a change in the mix of business and the impact of reinstatement premiums resulting from reinsured hurricane losses.

Specialty casualty Gross written premiums increased $242 million (11%) in the first nine months of 2017 compared to the first nine months of 2016. New accounts written in the targeted markets businesses were the primary driver of the increase. Additionally, higher gross written premiums in the workers' compensation businesses, primarily the result of rate increases in the state of Florida, coupled with growth in the executive liability businesses and Neon, contributed to the growth in gross written premiums in 2017. Average renewal rates increased approximately 1% for this group in the first nine months of 2017. Reinsurance premiums ceded as a percentage of gross written premiums decreased 1 percentage point for the first nine months of 2017 compared to the first nine months of 2016, reflecting a change in the mix of business.

Specialty financial Gross written premiums increased $14 million (3%) in the first nine months of 2017 compared to the first nine months of 2016 due primarily to growth in the fidelity and surety businesses, partially offset by lower premiums in the financial institutions business. Average renewal rates for this group decreased approximately 2% in the first nine months of 2017. Reinsurance premiums ceded as a percentage of gross written premiums decreased 2 percentage points for the first nine months of 2017 compared to the first nine months of 2016, reflecting lower premiums in the financial institutions business, which were largely ceded.

Other specialty The amounts shown as reinsurance premiums ceded represent business assumed by AFG's internal reinsurance program from the operations that make up AFG's other Specialty property and casualty insurance sub-segments.

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Combined Ratio

The table below (dollars in millions) details the components of the combined ratio for AFG's property and casualty segment:

| | Nine months ended September 30, | | | Nine months ended September 30, | |
|---|---|---|---|---|---|
| | 2017 | 2016 | Change | 2017 | 2016 |
| Property and transportation | | | | | |
| Loss and LAE ratio | 69.1% | 66.4% | 2.7 % | | |
| Underwriting expense ratio | 25.2% | 26.0% | (0.8 %) | | |
| Combined ratio | 94.3% | 92.4% | 1.9 % | | |
| Underwriting profit | | | | $70 | $91 |
| | | | | | |
| Specialty casualty | | | | | |
| Loss and LAE ratio | 66.4% | 65.0% | 1.4 % | | |
| Underwriting expense ratio | 30.7% | 30.7% | — % | | |
| Combined ratio | 97.1% | 95.7% | 1.4 % | | |
| Underwriting profit | | | | $46 | $65 |
| | | | | | |
| Specialty financial | | | | | |
| Loss and LAE ratio | 41.4% | 31.8% | 9.6 % | | |
| Underwriting expense ratio | 49.0% | 52.7% | (3.7 %) | | |
| Combined ratio | 90.4% | 84.5% | 5.9 % | | |
| Underwriting profit | | | | $42 | $64 |
| | | | | | |
| Total Specialty | | | | | |
| Loss and LAE ratio | 64.0% | 61.0% | 3.0 % | | |
| Underwriting expense ratio | 31.2% | 31.9% | (0.7 %) | | |
| Combined ratio | 95.2% | 92.9% | 2.3 % | | |
| Underwriting profit | | | | $161 | $227 |
| | | | | | |
| Aggregate — including exited lines | | | | | |
| Loss and LAE ratio | 66.7% | 63.8% | 2.9 % | | |
| Underwriting expense ratio | 31.2% | 32.2% | (1.0 %) | | |
| Combined ratio | 97.9% | 96.0% | 1.9 % | | |
| Underwriting profit | | | | $69 | $126 |

The Specialty property and casualty insurance operations generated an underwriting profit of $161 million for the first nine months of 2017 compared to $227 million for the first nine months of 2016, a decrease of $66 million (29%) with each of the Specialty property and casualty insurance sub-segments reporting lower year-over-year underwriting profit, due primarily to significantly higher catastrophe losses. Overall catastrophe losses were $132 million (3.9 points on the combined ratio) for the first nine months of 2017 compared to $43 million (1.3 points) for the first nine months of 2016. In connection with catastrophe losses incurred in the third quarter of 2017, AFG reduced profit-based commissions payable to agents by $8 million in the Specialty financial sub-segment and paid $6 million in net reinstatement premiums, resulting in a total pretax loss from catastrophes of $130 million for the nine months

ended September 30, 2017.

Property and transportation Underwriting profit for this group was $70 million for the first nine months of 2017 compared to $91 million for the first nine months of 2016, a decrease of $21 million (23%). Lower underwriting profits in the crop and ocean marine businesses were the primary drivers of these lower results. The comparable 2016 period included strong profitability in the crop business. Catastrophe losses were $39 million (3.2 points on the combined ratio) and related reinstatement premiums were $2 million for the first nine months of 2017 compared to catastrophe losses of $25 million (2.1 points) for the first nine months of 2016.

Specialty casualty Underwriting profit for this group was $46 million for the first nine months of 2017 compared to $65 million for the first nine months of 2016, a decrease of $19 million (29%). Higher underwriting profitability in the excess and surplus lines businesses was more than offset by lower underwriting profitability in the executive liability, workers' compensation and general liability businesses, due primarily to lower favorable prior year reserve development. Catastrophe losses were $57 million (3.5 points on the combined ratio) and related net reinstatement premiums were $2 million for the first nine months of 2017 compared to catastrophe losses of $6 million (0.4 points) for the first nine months of 2016.

Specialty financial Underwriting profit for this group was $42 million for the first nine months of 2017 compared to $64 million for the first nine months of 2016, a decrease of $22 million (34%). Higher underwriting profitability in the surety business was more than offset by lower underwriting profitability in the financial institutions business due primarily to higher catastrophe losses. Catastrophe losses were $35 million (8.0 points on the combined ratio) for the first nine months of 2017 compared to $9 million (2.2 points) for the first nine months of 2016. In connection with catastrophe losses incurred in the third quarter of 2017, the Specialty financial sub-segment reduced profit-based commissions payable to agents by $8 million (1.8 points on the combined ratio) and paid $2 million in reinstatement premiums.

Other specialty This group reported an underwriting profit of $3 million for the first nine months of 2017 compared to $7 million in the first nine months of 2016, a decrease of $4 million (57%). The decrease is due primarily to a $6 million charge to adjust the deferred gain on the retroactive reinsurance transaction entered into in connection with the sale of businesses in 1998.

Aggregate See "Special asbestos and environmental reserve charges" under "Results of Operations — Property and Casualty Insurance Segment — Net prior year reserve development" for the quarters ended September 30, 2017 and 2016 for a discussion of the $89 million and $36 million pretax non-core special A&E charges recorded in the third quarter of 2017 and 2016, respectively. As discussed below in more detail under "Net prior year reserve development," AFG recorded a $65 million non-core charge in the second quarter of 2016 related to the exit of certain lines of business within Neon, AFG's Lloyd's-based insurer.

Losses and Loss Adjustment Expenses
AFG's overall loss and LAE ratio was 66.7% for the first nine months of 2017 compared to 63.8% for the first nine months of 2016, an increase of 2.9 percentage points. The components of AFG's property and casualty losses and LAE amounts and ratio are detailed below (dollars in millions):

| | Nine months ended September 30, | | | | |
|---|---|---|---|---|---|
| | Amount | | Ratio | | Change in |
| | 2017 | 2016 | 2017 | 2016 | Ratio |
| Property and transportation | | | | | |
| Current year, excluding catastrophe losses | $844 | $804 | 68.9% | 67.1% | 1.8 % |
| Prior accident years development | (36) | (34) | (3.0 %) | (2.8 %) | (0.2 %) |
| Current year catastrophe losses | 39 | 25 | 3.2 % | 2.1 % | 1.1 % |
| Property and transportation losses and LAE and ratio | $847 | $795 | 69.1% | 66.4% | 2.7 % |
| Specialty casualty | | | | | |
| Current year, excluding catastrophe losses | $1,049 | $982 | 65.0% | 65.7% | (0.7 %) |
| Prior accident years development | (34) | (16) | (2.1 %) | (1.1 %) | (1.0 %) |
| Current year catastrophe losses | 57 | 6 | 3.5 % | 0.4 % | 3.1 % |
| Specialty casualty losses and LAE and ratio | $1,072 | $972 | 66.4% | 65.0% | 1.4 % |
| Specialty financial | | | | | |
| Current year, excluding catastrophe losses | $167 | $140 | 38.4% | 33.6% | 4.8 % |
| Prior accident years development | (22) | (17) | (5.0 %) | (4.0 %) | (1.0 %) |
| Current year catastrophe losses | 35 | 9 | 8.0 % | 2.2 % | 5.8 % |
| Specialty financial losses and LAE and ratio | $180 | $132 | 41.4% | 31.8% | 9.6 % |

| | | | | | |
|---|---|---|---|---|---|
| Total Specialty | | | | | |
| Current year, excluding catastrophe losses | $2,105 | $1,968 | 62.7% | 61.8% | 0.9 % |
| Prior accident years development | (90 ) | (71 ) | (2.6 %) | (2.1 %) | (0.5%) |
| Current year catastrophe losses | 132 | 43 | 3.9 % | 1.3 % | 2.6 % |
| Total Specialty losses and LAE and ratio | $2,147 | $1,940 | 64.0% | 61.0% | 3.0 % |
| | | | | | |
| Aggregate — including exited lines | | | | | |
| Current year, excluding catastrophe losses | $2,105 | $1,968 | 62.7% | 61.8% | 0.9 % |
| Prior accident years development | 2 | 22 | 0.1 % | 0.7 % | (0.6%) |
| Current year catastrophe losses | 132 | 43 | 3.9 % | 1.3 % | 2.6 % |
| Aggregate losses and LAE and ratio | $2,239 | $2,033 | 66.7% | 63.8% | 2.9 % |

Current accident year losses and LAE, excluding catastrophe losses
The current accident year loss and LAE ratio, excluding catastrophe losses for AFG's Specialty property and casualty insurance operations was 62.7% for the first nine months of 2017 compared to 61.8% for the first nine months of 2016, an increase of 0.9 percentage points.

Property and transportation   The 1.8 percentage point increase in the loss and LAE ratio for the current year, excluding catastrophe losses reflects an increase in the loss and LAE ratio of the crop business in the first nine months of 2017 compared to the first nine months of 2016.

Specialty casualty   The 0.7 percentage point decrease in the loss and LAE ratio for the current year, excluding catastrophe losses reflects a decrease in the loss and LAE ratio at Neon, partially offset by an increase in the loss and LAE ratio in the public sector business.

Specialty financial   The 4.8 percentage point increase in the loss and LAE ratio for the current year, excluding catastrophe losses reflects an increase in the loss and LAE ratio of the financial institutions business.

Net prior year reserve development
AFG's Specialty property and casualty insurance operations recorded net favorable reserve development related to prior accident years of $90 million in the first nine months of 2017 compared to $71 million in the first nine months of 2016, an increase of $19 million (27%).

Property and transportation   Net favorable reserve development of $36 million in the first nine months of 2017 reflects lower than expected losses in the crop and equine businesses and lower than expected claim severity in the property and inland marine and transportation businesses, partially offset by higher than expected claim severity in the ocean marine business. Net favorable reserve development of $34 million in the first nine months of 2016 reflects lower than expected losses in the crop operations and lower than expected claim severity in the property and inland marine and trucking businesses.

Specialty casualty   Net favorable reserve development of $34 million in the first nine months of 2017 reflects lower than anticipated claim severity in the workers' compensation businesses and at Neon, partially offset by higher than anticipated claim severity in the targeted markets and general liability businesses. Net favorable reserve development of $16 million in the first nine months of 2016 reflects lower than anticipated claim severity in workers' compensation business and directors and officers liability insurance and lower than expected claim frequency and severity in excess liability business, partially offset by adverse reserve development at Neon, higher than anticipated severity in New York contractor claims and higher than anticipated claim severity in general liability insurance.

Specialty financial Net favorable reserve development of $22 million in the first nine months of 2017 reflects lower than anticipated claim severity in the fidelity business and lower than expected claim frequency and severity in the surety business. Net favorable reserve development of $17 million in the first nine months of 2016 reflects lower than anticipated claim severity in the fidelity business and lower than expected claim frequency and severity in the surety business, partially offset by higher than anticipated claim frequency in the financial institutions business.

Other specialty   In addition to the development discussed above, total Specialty prior year reserve development includes net adverse reserve development of $2 million in the first nine months of 2017 and favorable reserve development of $4 million in the first nine months of 2016. The adverse reserve development in the first nine months of 2017 reflects a $6 million charge to adjust the deferred gain on the retroactive reinsurance transaction entered into

in connection with the sale of businesses in 1998, partially offset by the amortization of deferred gains on retroactive reinsurance and favorable reserve development associated with AFG's internal reinsurance program. Favorable reserve development in the first nine months of 2016 reflects amortization of deferred gains on retroactive reinsurance.

Special asbestos and environmental reserve charges See "Special asbestos and environmental reserve charges" under "Results of Operations — Property and Casualty Insurance Segment — Net prior year reserve development" for the quarters ended September 30, 2017 and 2016 for a discussion of the $89 million and $36 million special A&E charges recorded in the third quarter of 2017 and 2016, respectively.

Neon exited lines charge During the second quarter of 2016, AFG's specialist Lloyd's market insurer completed a strategic review of its business under a new leadership team and re-launched as Neon Underwriting Ltd. ("Neon"). As part of its strategic

review, Neon sold and/or exited certain historical lines of business including its UK and international medical malpractice and general liability classes. As a result of Neon's claims review of its exited lines of business, AFG recorded a charge of approximately $65 million including $57 million to increase loss reserves primarily related to its medical malpractice and general liability lines. Consistent with the treatment of other items that are not indicative of AFG's ongoing operations (both favorable and unfavorable), this charge was treated as non-core because it resulted from a special strategic review of lines of business that Neon no longer writes.

Aggregate Aggregate net prior accident years reserve development for AFG's property and casualty insurance segment includes the special A&E charges and Neon exited lines charge mentioned above and adverse reserve development of $3 million in the first nine months of 2017 related to business outside the Specialty group that AFG no longer writes.

Catastrophe losses
AFG generally seeks to reduce its exposure to catastrophes through individual risk selection, including minimizing coastal and known fault-line exposures, and the purchase of reinsurance. Catastrophe losses of $132 million in the first nine months of 2017 resulted primarily from Hurricanes Harvey, Irma and Maria, two earthquakes in Mexico and storms and tornadoes in several regions of the United States. Catastrophe losses of $43 million in the first nine months of 2016 resulted primarily from winter storms in the first quarter of 2016, April storms in Texas in the second quarter of 2016 and flooding in Louisiana and multiple storms in the southern United States in the third quarter of 2016.

Commissions and Other Underwriting Expenses
AFG's property and casualty commissions and other underwriting expenses ("U/W Exp") were $1.05 billion in the first nine months of 2017 compared to $1.03 billion for the first nine months of 2016, an increase of $21 million (2%). AFG's underwriting expense ratio was 31.2% for the first nine months of 2017 compared to 32.2% for the first nine months of 2016, a decrease of 1.0 percentage point. Detail of AFG's property and casualty commissions and other underwriting expenses and underwriting expense ratios is shown below (dollars in millions):

| | Nine months ended September 30, | | | | |
|---|---|---|---|---|---|
| | 2017 | | 2016 | | Change in |
| | U/W Exp | % of NEP | U/W Exp | % of NEP | % of NEP |
| Property and transportation | $309 | 25.2% | $311 | 26.0% | (0.8%) |
| Specialty casualty | 495 | 30.7% | 459 | 30.7% | — % |
| Specialty financial | 213 | 49.0% | 220 | 52.7% | (3.7%) |
| Other specialty | 29 | 35.4% | 27 | 36.9% | (1.5%) |
| Total Specialty | 1,046 | 31.2% | 1,017 | 31.9% | (0.7%) |
| Neon exited lines charge | — | | 8 | | |
| Total Aggregate | $1,046 | 31.2% | $1,025 | 32.2% | (1.0%) |

AFG's overall expense ratio decreased 1.0 percentage points in the first nine months of 2017 as compared to the first nine months of 2016.

Property and transportation Commissions and other underwriting expenses as a percentage of net earned premiums decreased 0.8 percentage points in the first nine months of 2017 compared to the first nine months of 2016 reflecting an increase in ceding commissions received from reinsurers in the crop business.

Specialty casualty   Commissions and other underwriting expenses as a percentage of net earned premiums were flat in the first nine months of 2017 compared to the first nine months of 2016.

Specialty financial   Commissions and other underwriting expenses as a percentage of net earned premiums decreased 3.7 percentage points in the first nine months of 2017 compared to the first nine months of 2016 reflecting lower profitability-based commissions paid to agents in the financial institutions business, including an $8 million commission expense reduction due to hurricane losses.

Aggregate   Aggregate commissions and other underwriting expenses for AFG's property and casualty insurance segment includes $8 million of restructuring charges recorded as part of the $65 million non-core charge related to the exit of certain lines of business within Neon, AFG's Lloyd's-based insurer, recorded in the second quarter of 2016. See "Neon exited lines

charge" under "Results of Operations — Property and Casualty Insurance Segment — Net prior year reserve development" for the nine months ended September 30, 2017 and 2016.

Property and Casualty Net Investment Income
Net investment income in AFG's property and casualty insurance operations was $276 million in the first nine months of 2017 compared to $265 million in the first nine months of 2016, an increase of $11 million (4%). In recent years, yields available in the financial markets on fixed maturity securities have generally declined, placing downward pressure on AFG's investment portfolio yield. The average invested assets and overall yield earned on investments held by AFG's property and casualty insurance operations are provided below (dollars in millions):

| | Nine months ended September 30, | | | |
|---|---|---|---|---|
| | 2017 | 2016 | Change | % Change |
| Net investment income | $276 | $265 | $11 | 4 % |
| Average invested assets (at amortized cost) | $9,853 | $9,507 | $346 | 4 % |
| Yield (net investment income as a % of average invested assets) | 3.73 % | 3.72 % | 0.01 % | |
| Tax equivalent yield (*) | 4.20 % | 4.22 % | (0.02%) | |

(*) Adjusts the yield on equity securities and tax-exempt bonds to the fully taxable equivalent yield.

The increase in average invested assets and net investment income in the property and casualty insurance segment for the first nine months of 2017 as compared to the first nine months of 2016 is due primarily to growth in the property and casualty insurance segment. The property and casualty insurance segment's overall yield on investments (net investment income as a percentage of average invested assets) was 3.73% for the first nine months of 2017 compared to 3.72% for the first nine months of 2016, an increase of 0.01 percentage points reflecting an increase in equity in the earnings of limited partnerships and similar investments, partially offset by the impact of lower yields available in the financial markets and lower income from certain investments that are required to be carried at fair value through earnings.

Property and Casualty Other Income and Expenses, Net
GAAP other income and expenses, net for AFG's property and casualty insurance operations was a net expense of $5 million for the first nine months of 2017 compared to net income of $4 million for the first nine months of 2016, a decrease of $9 million (225%). Core other income and expenses, net for AFG's property and casualty insurance operations was a net expense of $5 million for the first nine months of 2017 compared to $28 million for the first nine months of 2016, an improvement of $23 million (82%). The table below details the items included in GAAP and core other income and expenses, net for AFG's property and casualty insurance operations (in millions):

| | Nine months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Other income | | |

| | | |
|---|---|---|
| Income from the sale of real estate (*) | $ 16 | $ — |
| Other | 5 | 14 |
| Total other income | 21 | 14 |
| Other expenses | | |
| Amortization of intangibles | 6 | 6 |
| NATL merger expenses | — | 5 |
| Other | 20 | 31 |
| Total other expense | 26 | 42 |
| Core other income and expenses, net | (5 ) | (28 ) |
| Pretax non-core gain on sale of apartment property | — | 32 |
| GAAP other income and expenses, net | $ (5 ) | $ 4 |

(*) Excludes a pretax non-core gain of $32 million on the sale of an apartment property in the second quarter of 2016.

Other income for AFG’s property and casualty insurance operations includes a $4 million death benefit on a life insurance policy received in the second quarter of 2016.

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AMERICAN FINANCIAL GROUP, INC. 10-Q
Management's Discussion and Analysis of Financial Condition and Results of Operations — Continued

Annuity Segment — Results of Operations
AFG's annuity operations contributed $283 million in pretax earnings in the first nine months of 2017 compared to $236 million in the first nine months of 2016, an increase of $47 million (20%). AFG's annuity segment results for the first nine months of 2017 compared to the first nine months of 2016 reflect an 11% increase in average annuity investments (at amortized cost), higher equity in the earnings of limited partnerships and similar investments and the unfavorable impact of significantly lower than anticipated interest rates on the fair value accounting for fixed-indexed annuities in the 2016 period, partially offset by lower investment yields due to the run-off of higher yielding investments. While both periods reflect the positive impact of a higher stock market and the negative impact of lower than anticipated interest rates on the fair value accounting for fixed-indexed annuities, the decrease in interest rates in the first nine months of 2016 had a significantly higher unfavorable impact compared to the 2017 period.

The following table details AFG's earnings before income taxes from its annuity operations for the nine months ended September 30, 2017 and 2016 (dollars in millions).

| | Nine months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Revenues: | | | |
| Net investment income | $1,082 | $1,010 | 7 % |
| Other income: | | | |
| Guaranteed withdrawal benefit fees | 43 | 39 | 10 % |
| Policy charges and other miscellaneous income | 36 | 37 | (3 %) |
| Total revenues | 1,161 | 1,086 | 7 % |
| | | | |
| Costs and Expenses: | | | |
| Annuity benefits (*) | 635 | 640 | (1 %) |
| Acquisition expenses | 153 | 127 | 20 % |
| Other expenses | 90 | 83 | 8 % |
| Total costs and expenses | 878 | 850 | 3 % |
| Earnings before income taxes | $283 | $236 | 20 % |

Detail of annuity earnings before income taxes (dollars in millions):

| | Nine months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Earnings before income taxes — before the impact of derivatives related to FIAs | $305 | $292 | 4 % |
| Impact of derivatives related to FIAs | (22 ) | (56 ) | (61 %) |
| Earnings before income taxes | $283 | $236 | 20 % |

(*) Annuity benefits consisted of the following (dollars in millions):

| | Nine months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Interest credited — fixed | $469 | $426 | 10 % |

| | | | | |
|---|---|---|---|---|
| Interest credited — fixed component of variable annuities | 4 | 4 | — | % |
| Other annuity benefits: | | | | |
| Change in expected death and annuitization reserve | 13 | 14 | (7 | %) |
| Amortization of sales inducements | 14 | 17 | (18 | %) |
| Change in guaranteed withdrawal benefit reserve | 51 | 49 | 4 | % |
| Change in other benefit reserves | 36 | 23 | 57 | % |
| Total other annuity benefits | 114 | 103 | 11 | % |
| Total before impact of derivatives related to FIAs | 587 | 533 | 10 | % |
| Derivatives related to fixed-indexed annuities: | | | | |
| Embedded derivative mark-to-market | 386 | 188 | 105 | % |
| Equity option mark-to-market | (338 ) | (81 ) | 317 | % |
| Impact of derivatives related to FIAs | 48 | 107 | (55 | %) |
| Total annuity benefits | $635 | $640 | (1 | %) |

Net Spread on Fixed Annuities (excludes variable annuity earnings)

The table below (dollars in millions) details the components of the spreads for AFG's fixed annuity operations (including fixed-indexed annuities):

| | Nine months ended September 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2017 | | 2016 | | % Change | |
| Average fixed annuity investments (at amortized cost) | $30,919 | | $27,899 | | 11 | % |
| Average fixed annuity benefits accumulated | 31,141 | | 27,778 | | 12 | % |
| | | | | | | |
| As % of fixed annuity benefits accumulated (except as noted): | | | | | | |
| Net investment income (as % of fixed annuity investments) | 4.64 | % | 4.79 | % | | |
| Interest credited — fixed | (2.01 | %) | (2.04 | %) | | |
| Net interest spread | 2.63 | % | 2.75 | % | | |
| | | | | | | |
| Policy charges and other miscellaneous income | 0.12 | % | 0.14 | % | | |
| Other annuity benefit expenses, net of guaranteed withdrawal benefit fees | (0.31 | %) | (0.31 | %) | | |
| Acquisition expenses | (0.63 | %) | (0.58 | %) | | |
| Other expenses | (0.38 | %) | (0.39 | %) | | |
| Change in fair value of derivatives related to fixed-indexed annuities | (0.20 | %) | (0.51 | %) | | |
| Net spread earned on fixed annuities | 1.23 | % | 1.10 | % | | |

The table below illustrates the impact of fair value accounting for derivatives related to fixed-indexed annuities on the annuity segment's net spread earned on fixed annuities:

| | Nine months ended September 30, | | | |
|---|---|---|---|---|
| | 2017 | | 2016 | |
| Net spread earned on fixed annuities — before impact of derivatives related to FIAs | 1.32 | % | 1.37 | % |
| Impact of derivatives related to fixed-indexed annuities: | | | | |
| Change in fair value of derivatives | (0.20 | %) | (0.51 | %) |
| Related impact on amortization of deferred policy acquisition costs (*) | 0.11 | % | 0.23 | % |
| Related impact on amortization of deferred sales inducements (*) | — | % | 0.01 | % |
| Net spread earned on fixed annuities | 1.23 | % | 1.10 | % |

(*) An estimate of the related acceleration/deceleration of the amortization of deferred policy acquisition costs and deferred sales inducements.

Annuity Net Investment Income

Net investment income for the first nine months of 2017 was $1.08 billion compared to $1.01 billion for the first nine months of 2016, an increase of $72 million (7%). This increase reflects the growth in AFG's annuity business and higher equity in the earnings of limited partnerships and similar investments, partially offset by the impact of lower investment yields. The overall yield earned on investments in AFG's annuity operations, calculated as net investment income divided by average investment balances (at amortized cost), declined by 0.15 percentage points to 4.64% from 4.79% for the first nine months of 2017 compared to the first nine months of 2016. This decline in net investment yield reflects the investment of new premium dollars at lower yields as compared to the existing investment portfolio and the impact of the reinvestment of proceeds from maturity and redemption of higher yielding investments at the lower yields available in the financial markets, partially offset by higher equity in the earnings of limited partnerships and similar investments. During the first nine months of 2017, $3.6 billion in annuity segment investments with an average yield of 5.24% were redeemed or sold while the investments purchased during 2017 (with new premium dollars and the redemption/sale proceeds) had an average yield at purchase of 3.93%.

Annuity Interest Credited — Fixed

Interest credited — fixed for the first nine months of 2017 was $469 million compared to $426 million for the first nine months of 2016, an increase of $43 million (10%). The impact of growth in the annuity business was partially offset by lower interest crediting rates on new premiums as compared to the crediting rates on policyholder funds surrendered or withdrawn. The average interest rate credited to policyholders, calculated as interest credited divided by average fixed annuity benefits

accumulated, decreased 0.03 percentage points to 2.01% from 2.04% in the first nine months of 2017 compared to the first nine months of 2016.

Annuity Net Interest Spread
AFG's net interest spread decreased 0.12 percentage points to 2.63% from 2.75% in the first nine months of 2017 compared to the same period in 2016 due primarily to lower fixed maturity investment yields, partially offset by the impact of lower crediting rates and higher equity in the earnings of limited partnerships and similar investments. Features included in current annuity offerings allow AFG to achieve its desired profitability at a lower net interest spread than historical product offerings. As a result, AFG expects its net interest spread to narrow in the future.

Annuity Policy Charges and Other Miscellaneous Income
Annuity policy charges and other miscellaneous income, which consist primarily of surrender charges, amortization of deferred upfront policy charges (unearned revenue) and income from sales of real estate, were $36 million for the first nine months of 2017 compared to $37 million for the first nine months of 2016, a decrease of $1 million (3%). As a percentage of average fixed annuity benefits accumulated, annuity policy charges and other miscellaneous income decreased 0.02 percentage points to 0.12% from 0.14% in the first nine months of 2017 compared to the first nine months of 2016.

Other Annuity Benefits, Net of Guaranteed Withdrawal Benefit Fees
Other annuity benefits, net of guaranteed withdrawal benefit fees, for the first nine months of 2017 were $71 million compared to $64 million for the first nine months of 2016, an increase of $7 million (11%). As a percentage of average fixed annuity benefits accumulated, these net expenses were 0.31% in both the first nine months of 2017 and the first nine months of 2016. In addition to interest credited to policyholders' accounts and the change in fair value of derivatives related to fixed-indexed annuities, annuity benefits expense also includes the following expenses (in millions, net of guaranteed withdrawal benefit fees):

| | Nine months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Change in expected death and annuitization reserve | $13 | $14 |
| Amortization of sales inducements | 14 | 17 |
| Change in guaranteed withdrawal benefit reserve | 51 | 49 |
| Change in other benefit reserves | 36 | 23 |
| Other annuity benefits | 114 | 103 |
| Offset guaranteed withdrawal benefit fees | (43 ) | (39 ) |
| Other annuity benefits, net | $71 | $64 |

As discussed under "Annuity Benefits Accumulated" in Note A — "Accounting Policies" to the financial statements, guaranteed withdrawal benefit reserves are accrued for and modified using assumptions similar to those used in establishing and amortizing deferred policy acquisition costs. The guaranteed withdrawal benefit reserve related to FIAs can be inversely impacted by the calculated FIA embedded derivative reserve as the value to policyholders of the guaranteed withdrawal benefits decreases when the benefit of stock market participation increases.

Annuity Acquisition Expenses

AFG’s amortization of DPAC and commission expenses as a percentage of average fixed annuity benefits accumulated was 0.63% for the first nine months of 2017 compared to 0.58% for the first nine months of 2016 and has generally ranged between 0.75% and 0.85%. Variances from the general range relate primarily to the impact of (i) material changes in interest rates or the stock market on AFG’s fixed-indexed annuity business, and (ii) differences in actual experience from actuarially projected estimates and assumptions. For example, the negative impact of lower than anticipated interest rates during the first nine months of 2017 and the impact of significantly lower than anticipated interest rates during the first nine months of 2016 on the fair value of derivatives related to fixed-indexed annuities (discussed below) resulted in a partially offsetting deceleration of the amortization of DPAC.

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The table below illustrates the estimated impact of fair value accounting for derivatives related to fixed-indexed annuities on annuity acquisition expenses as a percentage of average fixed annuity benefits accumulated:

| | Nine months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Before the impact of changes in the fair value of derivatives related to FIAs on the amortization of DPAC | 0.74 % | 0.81 % |
| Impact of changes in fair value of derivatives related to FIAs on amortization of DPAC (*) | (0.11%) | (0.23%) |
| Annuity acquisition expenses as a % of fixed annuity benefits accumulated | 0.63 % | 0.58 % |

(*) An estimate of the acceleration/deceleration of the amortization of deferred policy acquisition costs resulting from fair value accounting for derivatives related to fixed-indexed annuities.

Annuity Other Expenses

Annuity other expenses were $90 million for the first nine months of 2017 compared to $83 million for the first nine months of 2016, an increase of $7 million (8%). Annuity other expenses represent primarily general and administrative expenses, as well as selling and issuance expenses that are not deferred. The increase in annuity other expenses reflects primarily growth in the business and an increase in the number of sales personnel focused on new initiatives and increased market share within existing financial institutions and retail marketing organizations in the first nine months of 2017 compared to the first nine months of 2016. As a percentage of average fixed annuity benefits accumulated, these expenses were 0.38% for the first nine months of 2017 and 0.39% for the first nine months of 2016.

Change in Fair Value of Derivatives Related to Fixed-Indexed Annuities

AFG's fixed-indexed annuities 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 the change in the fair value of the call option assets will generally offset the economic change in the liabilities from the index participation. Both the index-based component of the annuities and the related call options are considered derivatives that must be adjusted for changes in fair value through earnings each period. The fair values of these derivatives are impacted by actual and expected stock market performance and interest rates as well as other factors. For a list of other factors impacting the fair value of the index-based component of AFG's annuity benefits accumulated, see Note D — "Fair Value Measurements" to the financial statements. The net change in fair value of derivatives related to fixed-indexed annuities increased annuity benefits by $48 million in the first nine months of 2017 compared to $107 million in the first nine months of 2016. During the first nine months of 2017, the negative impact of lower than anticipated interest rates on the fair value of these derivatives was partially offset by the positive impact of strong stock market performance. During the first nine months of 2016, significantly lower than anticipated interest rates had an unfavorable impact on the fair value of these derivatives that was partially offset by the impact of an increase in the stock market. As a percentage of average fixed annuity benefits accumulated, this net expense decreased 0.31 percentage points to 0.20% from 0.51% for the first nine months of 2017 compared to the first nine months of 2016.

Fluctuations in interest rates and the stock market, among other factors, can cause volatility in the periodic measurement of fair value of the embedded derivative that management believes can be inconsistent with the long-term economics of these products. The table below illustrates the impact of fair value accounting for derivatives related to fixed-indexed annuities on the annuity segment's earnings before income taxes (dollars in millions):

| | Nine months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Earnings before income taxes — before change in fair value of derivatives related to fixed-indexed annuities | $305 | $292 | 4 % |
| Change in fair value of derivatives related to fixed-indexed annuities | (48 ) | (107 ) | (55 %) |
| Related impact on amortization of DPAC (*) | 26 | 51 | (49 %) |
| Earnings before income taxes | $283 | $236 | 20 % |

(*) An estimate of the related acceleration/deceleration of amortization of deferred sales inducements and deferred policy acquisition costs.

As illustrated in the table above, the change in fair value of derivatives related to fixed-indexed annuities, including the related impact on amortization of DPAC decreased the annuity segment's earnings before income taxes by $22 million in the first nine months of 2017 and $56 million in the first nine months of 2016.

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Annuity Net Spread Earned on Fixed Annuities
AFG's net spread earned on fixed annuities increased 0.13 percentage points to 1.23% from 1.10% in the first nine months of 2017 compared to the same period in 2016 due primarily to the net impact of changes in the fair value of derivatives and related DPAC amortization offset discussed above, partially offset by the 0.12 percentage decrease in AFG's net interest spread.

Annuity Benefits Accumulated
Annuity premiums received 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 and other benefits are charged to expense and decreases for surrender and other policy charges are credited to other income.

For certain products, annuity benefits accumulated also includes reserves for accrued persistency and premium bonuses, excess benefits expected to be paid on future deaths and annuitizations ("EDAR") and guaranteed withdrawal benefits. Annuity benefits accumulated also includes amounts advanced from the Federal Home Loan Bank of Cincinnati. The following table is a progression of AFG's annuity benefits accumulated liability for the nine months ended September 30, 2017 and 2016 (in millions):

| | Nine months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Beginning fixed annuity reserves | $29,647 | $26,371 |
| Fixed annuity premiums (receipts) | 3,410 | 3,295 |
| Federal Home Loan Bank advances | — | 150 |
| Surrenders, benefits and other withdrawals | (1,650) | (1,665) |
| Interest and other annuity benefit expenses: | | |
| Interest credited | 469 | 426 |
| Embedded derivative mark-to-market | 386 | 188 |
| Change in other benefit reserves | 92 | 88 |
| Ending fixed annuity reserves | $32,354 | $28,853 |
| | | |
| Reconciliation to annuity benefits accumulated per balance sheet: | | |
| Ending fixed annuity reserves (from above) | $32,354 | $28,853 |
| Impact of unrealized investment gains | 138 | 180 |
| Fixed component of variable annuities | 179 | 189 |
| Annuity benefits accumulated per balance sheet | $32,671 | $29,222 |

Statutory Annuity Premiums
AFG's annuity operations generated statutory premiums of $3.43 billion in the first nine months of 2017 compared to $3.32 billion in the first nine months of 2016, an increase of $108 million (3%). The following table summarizes AFG's annuity sales (dollars in millions):

| | Nine months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Financial institutions single premium annuities — indexed | $1,347 | $1,476 | (9 %) |
| Financial institutions single premium annuities — fixed | 559 | 316 | 77 % |

| | | | | |
|---|---|---|---|---|
| Retail single premium annuities — indexed | 1,310 | 1,299 | 1 | % |
| Retail single premium annuities — fixed | 61 | 60 | 2 | % |
| Education market — fixed and indexed annuities | 133 | 144 | (8 | %) |
| Total fixed annuity premiums | 3,410 | 3,295 | 3 | % |
| Variable annuities | 22 | 29 | (24 | %) |
| Total annuity premiums | $3,432 | $3,324 | 3 | % |

Management believes the 3% increase in annuity premiums in the first nine months of 2017 compared to the first nine months of 2016 is consistent with overall growth in the annuity industry, as sales of traditional fixed and fixed-indexed annuities have increased while sales of variable annuities have decreased. In addition, the increase reflects new products, additional staffing, and increased market share within existing financial institutions. Annuity sales slowed in the third quarter of 2017 as a result of

AFG's adherence to pricing discipline in a relatively low and decreasing interest rate environment during the year, as well as from aggressive pricing by certain of AFG's competitors.

Annuity Earnings before Income Taxes Reconciliation
The following table reconciles the net spread earned on AFG's fixed annuities to overall annuity pretax earnings for the nine months ended September 30, 2017 and 2016 (in millions):

| | Nine months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Earnings on fixed annuity benefits accumulated | $288 | $230 |
| Earnings impact of investments in excess of fixed annuity benefits accumulated (*) | (8 ) | 4 |
| Variable annuity earnings | 3 | 2 |
| Earnings before income taxes | $283 | $236 |

(*) Net investment income (as a % of investments) of 4.64% and 4.79% for the nine months ended September 30, 2017 and 2016, respectively, multiplied by the difference between average fixed annuity investments (at amortized cost) and average fixed annuity benefits accumulated in each period.

Run-off Long-Term Care and Life Segment — Results of Operations The following table details AFG's GAAP and core earnings before income taxes from its run-off long-term care and life operations for the nine months ended September 30, 2017 and 2016 (dollars in millions):

| | Nine months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Revenues: | | | |
| Net earned premiums: | | | |
| Long-term care | $ 2 | $ 2 | — % |
| Life operations | 15 | 16 | (6 %) |
| Net investment income | 16 | 15 | 7 % |
| Other income | 2 | 4 | (50 %) |
| Total revenues | 35 | 37 | (5 %) |
| Costs and Expenses: | | | |
| Life, accident and health benefits: | | | |
| Long-term care | 4 | 5 | (20 %) |
| Life operations | 17 | 21 | (19 %) |
| Acquisition expenses | 3 | 4 | (25 %) |
| Other expenses | 7 | 7 | — % |
| Total costs and expenses | 31 | 37 | (16 %) |
| Core earnings before income taxes | 4 | — | — % |

| | | | |
|---|---|---|---|
| Pretax non-core realized gain on subsidiaries | — | 2 | (100 %) |
| GAAP earnings before income taxes | $ 4 | $ 2 | 100 % |

The $4 million increase in core earnings before income taxes reflects the impact of improved life claims experience in the first nine months of 2017 compared to the first nine months of 2016.

Holding Company, Other and Unallocated — Results of Operations AFG's net GAAP pretax loss outside of its insurance operations (excluding realized gains and losses) totaled $169 million in the first nine months of 2017 compared to $131 million in the first nine months of 2016, an increase of $38 million (29%). AFG's net core pretax loss outside of its insurance operations (excluding realized gain and losses) totaled $134 million in the first nine months of 2017 compared to $126 million in the first nine months of 2016, an increase of $8 million (6%).

The following table details AFG's GAAP and core loss before income taxes from operations outside of its insurance operations for the nine months ended September 30, 2017 and 2016 (dollars in millions):

| | Nine months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| Revenues: | | | |
| Net investment income | $8 | $6 | 33 % |
| Other income — P&C fees | 46 | 43 | 7 % |
| Other income | 20 | 15 | 33 % |
| Total revenues | 74 | 64 | 16 % |
| Costs and Expenses: | | | |
| Property and casualty insurance — commissions and other underwriting expenses | 16 | 13 | 23 % |
| Interest charges on borrowed money | 65 | 56 | 16 % |
| Other expense — expenses associated with P&C fees | 30 | 30 | — % |
| Other expenses (*) | 97 | 91 | 7 % |
| Total costs and expenses | 208 | 190 | 9 % |
| Core loss before income taxes, excluding realized gains and losses | (134 ) | (126 ) | 6 % |
| Pretax non-core special A&E charges | (24 ) | (5 ) | 380 % |
| Pretax non-core loss on retirement of debt | (11 ) | — | — % |
| GAAP loss before income taxes, excluding realized gains and losses | $(169) | $(131) | 29 % |

(*) Excludes pretax non-core special A&E charges of $24 million and $5 million in the third quarter of 2017 and 2016, respectively, and a pretax non-core loss on retirement of debt of $11 million in the 2017 period.

Holding Company and Other — Net Investment Income
AFG recorded net investment income on investments held outside of its insurance operations of $8 million in the first nine months of 2017 compared to $6 million in the first nine months of 2016.

Holding Company and Other — P&C Fees and Related Expenses
Summit, a workers' compensation insurance business, collects fees from a small group of unaffiliated insurers for providing underwriting, policy administration and claims services. In addition, certain of AFG's property and casualty businesses collect fees from customers for ancillary services such as workplace safety programs and premium financing. In the first nine months of 2017, AFG collected $46 million in fees for these services, compared to $43 million in the first nine months of 2016. Management views this fee income, net of the $30 million in both the first nine months of 2017 and 2016, in expenses incurred to generate such fees, as a reduction in the cost of underwriting its property and casualty insurance policies. Consistent with internal management reporting, these fees and the related expenses are netted and recorded as a reduction of commissions and other underwriting expenses in AFG's segmented results.

Holding Company and Other — Other Income

Other income in the table above includes $14 million and $12 million in the first nine months of 2017 and 2016, respectively, in management fees paid to AFG by the AFG-managed CLOs (AFG's consolidated managed investment entities). The management fees are eliminated in consolidation — see the other income line in the Consolidate MIEs column under "Results of Operations — Segmented Statement of Earnings." Excluding amounts eliminated in consolidation, AFG recorded other income outside of its insurance operations of $6 million in the first nine months of 2017 and $3 million the first nine months of 2016. Results for the first nine months of 2017 include $2 million in income related to the sale of real estate.

Holding Company and Other — Interest Charges on Borrowed Money
AFG's holding companies and other operations outside of its insurance operations recorded interest expense of $65 million in the first nine months of 2017 compared to $56 million in the first nine months of 2016, an increase of $9 million (16%). This increase reflects higher average indebtedness, partially offset by a lower weighted average interest rate on outstanding debt.

The increase in average indebtedness for the first nine months of 2017 as compared to the first nine months of 2016 reflects the following financing transactions completed by AFG between January 1, 2016 and September 30, 2017:

- Issued $300 million of 3.50% Senior Notes on August 22, 2016
- Issued $350 million of 4.50% Senior Notes on June 2, 2017
- Redeemed $230 million of 6-3/8% Senior Notes on June 26, 2017
- Redeemed $125 million of 5-3/4% Senior Notes on August 25, 2017

The redemption of the 6-3/8% and 5-3/4% Senior Notes and the issuance of the 4.50% Senior Notes in 2017 will result in annual pretax interest savings to AFG of $6 million.

Holding Company and Other — Special A&E Charges
See "Holding Company and Other — Special A&E Charges" under "Results of Operations — Holding Company, Other and Unallocated" for the quarters ended September 30, 2017 and 2016 for a discussion of the $24 million and $5 million in non-core special A&E charges recorded in the third quarter of 2017 and 2016, respectively.

Holding Company and Other — Loss on Retirement of Debt
AFG wrote off unamortized debt issuance costs of $7 million related to the redemption of its $230 million outstanding 6-3/8% Senior Notes due 2042 at par value on June 26, 2017 and $4 million related to the redemption of its $125 million outstanding 5-3/4% Senior Notes due 2042 at par value on August 25, 2017.

Holding Company and Other — Other Expenses
Excluding the non-core special A&E charges and the non-core loss on retirement of debt discussed above, AFG's holding companies and other operations outside of its insurance operations recorded other expenses of $97 million in the first nine months of 2017 compared to $91 million in the first nine months of 2016, an increase of $6 million (7%). This increase reflects the impact of higher holding company expenses related to employee benefit plans that are tied to stock market performance for the first nine months of 2017 compared to the first nine months of 2016, partially offset by a $5 million donation to the University of Cincinnati College of Business in the third quarter of 2016.

Consolidated Realized Gains (Losses) on Securities AFG's consolidated realized gains (losses) on securities, which are not allocated to segments, were losses of $1 million in the first nine months of 2017 compared to $32 million in the first nine months of 2016, a decrease of $31 million (97%). Realized gains (losses) on securities consisted of the following (in millions):

| | Nine months ended September 30, | |
|---|---|---|
| | 2017 | 2016 |
| Realized gains (losses) before impairments: | | |
| Disposals | $61 | $82 |

| | | |
|---|---|---|
| Change in the fair value of derivatives | (4 ) | — |
| Adjustments to annuity deferred policy acquisition costs and related items | (5 ) | (7 ) |
| | 52 | 75 |
| Impairment charges: | | |
| Securities | (65 ) | (120 ) |
| Adjustments to annuity deferred policy acquisition costs and related items | 12 | 13 |
| | (53 ) | (107 ) |
| Realized gains (losses) on securities | $(1 ) | $(32 ) |

AFG's impairment charges on securities for the first nine months of 2017 consist of $49 million on equity securities and $16 million on fixed maturities compared to $83 million on equity securities and $37 million on fixed maturities in the first nine months of 2016. Approximately $24 million in impairment charges in the first nine months of 2017 relate to investments in pharmaceutical companies, $10 million relates to an investment in a media company and the remainder relates primarily to investments in various industrial entities. Approximately $68 million of the impairment charges recorded in the first nine months of 2016 are related to financial institutions and $19 million are on energy-related investments.

Consolidated Realized Gain on Subsidiaries The $2 million pretax realized gain on subsidiaries in the first nine months of 2016 represents an adjustment to the pretax realized loss on the sale of substantially all of AFG's run-off long-term care insurance business that was recorded in 2015.

Consolidated Income Taxes AFG's consolidated provision for income taxes was $146 million for the first nine months of 2017 compared to $190 million for the first nine months of 2016, a decrease of $44 million (23%). See Note L — "Income Taxes" to the financial statements for an analysis of items affecting AFG's effective tax rate.

Consolidated Noncontrolling Interests AFG's consolidated net earnings attributable to noncontrolling interests was $2 million for the first nine months of 2017 compared to $16 million for the first nine months of 2016. The following table details net earnings in consolidated subsidiaries attributable to holders other than AFG (dollars in millions):

| | Nine months ended September 30, | | |
|---|---|---|---|
| | 2017 | 2016 | % Change |
| National Interstate | $ — | $ 12 | (100 %) |
| Other | 2 | 4 | (50 %) |
| Earnings attributable to noncontrolling interests | $ 2 | $ 16 | (88 %) |

Other noncontrolling interests includes $2 million related to the gain on the sale of a hotel property in the first quarter of 2017 and $4 million related to the gain on the sale of an apartment property in the second quarter of 2016. Both properties were owned by an 80%-owned subsidiary of GAI.

RECENT ACCOUNTING STANDARDS

In January 2016, the FASB issued ASU 2016-01, Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities which, among other things, requires equity investments that are not accounted for under the equity method of accounting to be measured at fair value with changes in fair value recognized in net income, clarifies that the need for a valuation allowance on a deferred tax asset related to available for sale securities should be evaluated with other deferred tax assets and modifies disclosure requirements for financial instruments. AFG will be required to adopt the updated guidance effective January 1, 2018 (early adoption is not permitted). Although recording changes in the fair value of investments in equity securities in net income will result in more volatility in AFG's Statement of Earnings, it is not expected to have a material effect on the carrying value of AFG's investments or on overall shareholders' equity as AFG's investments in equity securities are currently carried at fair value through accumulated other comprehensive income. At the date of adoption, the net unrealized gain on equity securities included in AOCI will be reclassified to retained earnings in the Balance Sheet as the cumulative effect of an accounting change.

In February 2016, the FASB issued ASU 2016-02, Leases, which requires entities that lease assets for terms longer than one year to recognize the assets and liabilities for the rights and obligations created by those leases on the balance sheet based on the present value of cash flows. Qualitative and quantitative disclosures of the amount, timing and uncertainty of cash flows arising from leases will also be required. Although the guidance allows for early adoption, AFG expects to adopt the updated guidance effective January 1, 2019 (when it is required). The guidance will require the earliest comparative period presented to include the measurement and recognition of existing leases with an

adjustment to shareholders' equity as if the updated guidance had always been applied. Although the guidance will result in higher assets and higher liabilities from the recognition of assets and liabilities related to operating leases, it does not change the manner in which lease expense is recognized in the statement of earnings. Although management is currently evaluating the impact of this guidance, AFG does not expect it to have a material effect on its results of operations or financial position.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses: Measurement of Credit Losses on Financial Instruments, which provides a new credit loss model for determining credit-related impairments for financial instruments measured at amortized cost (e.g. mortgage loans or reinsurance recoverables) and requires an entity to estimate the credit losses expected over the life of an exposure or pool of exposures. The estimate of expected credit losses considers historical information, current information, as well as reasonable and supportable forecasts, including estimates of prepayments. The expected credit losses, and subsequent increases or decreases in such losses, will be recorded immediately through realized gains (losses) as an allowance that is deducted from the amortized cost basis of the financial asset, with the net carrying value of the financial asset presented on the balance sheet at the amount expected to be collected. The updated guidance also amends the current other-than-temporary impairment model for available for sale debt securities by requiring the recognition of impairments relating to credit losses through an allowance account and limits the amount of credit loss to the difference

between a security's amortized cost basis and its fair value. Subsequent increases or decreases in expected credit losses will be recorded immediately in the income statement through realized gains (losses). AFG will be required to adopt this guidance effective January 1, 2020. AFG cannot estimate the impact that the updated guidance will have on its results of operations, financial position or liquidity until the updated guidance is adopted.

ITEM 3
Quantitative and Qualitative Disclosure about Market Risk

As of September 30, 2017, there were no material changes to the information provided in Item 7A — Quantitative and Qualitative Disclosures about Market Risk of AFG's 2016 Form 10-K.

ITEM 4
Controls and Procedures

AFG's management, with participation of its Co-Chief Executive Officers and its Chief Financial Officer, has evaluated AFG's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15) as of the end of the period covered by this report. Based on that evaluation, AFG's Co-CEOs and CFO concluded that the controls and procedures are effective. There have been no changes in AFG's internal control over financial reporting during the third fiscal quarter of 2017 that materially affected, or are reasonably likely to materially affect, AFG's internal control over financial reporting.

In the ordinary course of business, AFG and its subsidiaries routinely enhance their information systems by either upgrading current systems or implementing new systems. There has been no change in AFG's business processes and procedures during the third fiscal quarter of 2017 that has materially affected, or is reasonably likely to materially affect, AFG's internal control over financial reporting.

PART II
OTHER INFORMATION
ITEM 2
Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities   AFG did not repurchase any shares of its Common Stock during the first nine months of 2017. There are 4,132,838 remaining shares that may be repurchased under the Plans authorized by AFG's Board of Directors in December 2014 and February 2016.

AFG acquired 32,509 shares of its Common Stock (at an average of $93.35 per share) in the first six months of 2017, 2,175 shares (at an average of $103.97 per share) in August 2017 and 238 shares (at $102.57 per share) in September 2017 in connection with its stock incentive plans.
ITEM 5
Other Information

Disclosure of Certain Activities Under Section 13(r) of the Securities Exchange Act of 1934   Section 13(r) of the Securities Exchange Act of 1934, as amended ("Section 13(r)"), requires a registrant to disclose in its annual or quarterly reports whether it or an affiliate knowingly engaged in certain activities, transactions or dealings related to Iran during the period covered by the report. Many of the activities, transactions and dealings that are required to be reported under Section 13(r) were previously subject to U.S. sanctions or prohibited by applicable local law. On January 16, 2016, the United States and the European Union eased sanctions against Iran pursuant to the Joint Comprehensive Plan of Action, and many of the reportable activities, transactions and dealings under Section 13(r) are no longer subject to U.S. sanctions and no longer prohibited by applicable local law.

Certain of the Company's subsidiaries located outside the United States subscribe to insurance policies that provide insurance coverage to vessels owned by international shipping and marine entities with vessels that travel worldwide. As a result, the insurance policies may be called upon to respond to claims involving or that have exposure to Iranian

petroleum resources, refined petroleum, and petrochemical industries. For example, certain of the Company's non-U.S. subsidiaries participate in global marine hull and war policies that provide coverage for damage to vessels navigating into and out of ports worldwide, which could include Iran.

For the nine months ended September 30, 2017, the Company is not aware of any additional premium with respect to underwriting insurance or reinsurance activities reportable under Section 13(r). Should any such risks have entered into the

stream of commerce covered by these insurance or reinsurance activities, the Company believes that the premiums associated with such business would be immaterial.

ITEM 6
Exhibits

| Number | Exhibit Description |
| --- | --- |
| 12 | Computation of ratios of earnings to fixed charges. |
| 31(a) | Certification of Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002. |
| 31(b) | Certification of Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002. |
| 31(c) | Certification of Chief Financial Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002. |
| 32 | Certification of Co-Chief Executive Officers and Chief Financial Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002. |
| 101 | The following financial information from American Financial Group's Form 10-Q for the quarter ended September 30, 2017, formatted in XBRL (Extensible Business Reporting Language):<br>(i) Consolidated Balance Sheet<br>(ii) Consolidated Statement of Earnings<br>(iii) Consolidated Statement of Comprehensive Income<br>(iv) Consolidated Statement of Changes in Equity<br>(v) Consolidated Statement of Cash Flows<br>(vi) Notes to Consolidated Financial Statements |

Signature
Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

American Financial Group, Inc.

November 3, 2017 By: /s/ Joseph E. (Jeff) Consolino
Joseph E. (Jeff) Consolino
Executive Vice President and Chief Financial Officer